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Linking Pay to Performance – Critical Issues to Consider

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The purpose of this study was to understand the underlying theories behind performance-based compensation, its possible motivational effects and the critical issues to consider when designing and implementing pay-for-performance compensation. This study also aimed to understand the critique around pay-for-performance systems and the possible challenges of using performance-based pay.

The theoretical framework of the study consists of motivational and economic theories on employee motivation and pay-for-performance. The theoretical part of the study is a literature review of existing studies and articles on the aforementioned theories, employee motivation, pay-for-performance systems and different compensation elements. The empirical part of the study is a qualitative research and semi-structured interviews were used for data collection. Six highly experienced professionals working with HR and/or compensation & benefits related tasks were interviewed during March-April 2017. The interview data was analyzed by building a matrix of key issues identified in the interviews and word cloud approach was used in addition to the matrix to further illustrate the interview results. The results of the empirical study were then compared to the findings of the literature review which revealed multiple consistencies.

The results of this study show that a well-functioning pay-for-performance system can influence the efforts and choices of employees who already have basic level of motivation, by steering their focus and attention on activities that create value to the company. If used properly, performance-based pay can even increase collaboration among employees. However, based on the research results, financial rewards could undermine a company's ability to build trust and commitment in case management and employees lack in communication, honesty and understanding of the overall purpose of the pay-for-performance system. Thus, organizations should consider the key psychological and emotional realities to ensure successful implementation and execution of performance-based pay.

Keywords

Pay-for-performance, compensation, performance, performance-based pay, performance ratings, motivation

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1 Introduction

The objective of this study is to understand the underlying theories behind performance-based compensation, its possible motivational effects and the critical issues to consider when designing and implementing pay-for-performance compensation (PFP, performance-based pay). This study also aims to understand the critique around pay-for-performance systems and the possible challenges of using performance-based pay.

In recent decades, growing proportion of firms have included performance-based pay schemes in their compensation packages, linking pay to employee or company performance. According to Bryson al. (2011, 6) such growth in incentive pay schemes has been fueled by the concern over inefficiencies in the workplace and the belief that incentive pay can raise productivity. Traditional pay systems for non-executive staff have generally been characterized by standardization across and within sectors (e.g., government, particular industries) and within organizations. With economies gradually opening up to world trade and foreign investment, local employers were forced to compete with companies with sophisticated technology, more productive ways of providing goods and services, and the advantage of being global players. In many instances these foreign companies are also able to attract the best local talent. (de Silva 2012, 3-4.)

Governments and private companies have had to compete in the global market by developing competitive advantages, which are affected by costs and quality. Economies which are seeking to progress from low wage cost manufacturing to highly skilled and technology-based production need pay systems which not merely recognize skill differentials (as standard pay systems do), but also provide an incentive to acquire skills and multi skills facilitated by years of careful and correct investment in education and training. In the area of industrial relations, the outcomes of collective bargaining often leave employers with little or no capacity to make further payments on account of performance under a scheme. According to de Silva (2012) the movement towards decentralization of collective bargaining has been the result of the need to address efficiency and performance issues at the company level and the desire to seek ways to introduce performance criteria into wage increases. (de Silva 2012, 3-4.)

In their research in 2011, Bryson & al. (2011, 3) found that the diffusion of incentive pay schemes ranges from around 10-15 percent in some European countries to over 40 percent in Scandinavian countries and the US. They also found that individual pay and profit/gain sharing schemes are widely diffused while share ownership schemes are much less common (particularly in Europe). Higher product and labor market regulation seems

to be associated to a lower diffusion of incentive pay while capital market development is a necessary requirement for a wider diffusion of incentive pay (i.e. in particular sharing and ownership schemes). According to their research a worker is more likely to be covered by an incentive scheme in a large size firm and in a high-skilled occupation but participation is less likely for females and in the public sector overall.

The definition of compensation can include all forms of financial return and tangible benefits employees receive as part of the employment relationship. There are multiple dimensions of compensation and reward management (e.g. benefits, pay level, pay structure) of which this study focuses on pay-for-performance (PFP). PFP is an interesting phenomenon, especially due to its potential as a basis for organization differentiation from competitors as well as a potentially powerful driver of performance (Gerhart & al. 2009, 4). However, as performance-based pay is only one dimension of employee compensation, the effects of merit or variable pay plans will most likely depend greatly on the larger compensation context. (Milkovich & Wigdor 1991, 152.)

Pay-for-performance plans are designed to deliver pay increases to employees based on some measure of performance. In theory, such plans offer several potential benefits:

- They can support the organization's personnel philosophy by helping to communicate the organization's goals to its employees.
- Goal theory suggests that performance-based pay plans can support a certain level of performance that is consistent with the organization's mission.
- They can help ensure consistency in the distribution of pay increases. For example, under a plan that ties pay increases to a specific financial goal, payouts are distributed only when that goal is met.
- Motivation theory suggests that pay-for-performance can positively influence individual’s performance and effort to achieve goals that are rewarded.

(Milkovich & Wigdor 1991, 152.)

Despite the appeal of PFP systems, challenges exist. According to Glassman, Glassman, Champagne & Zugelder one of the problems is that management practices, including the use of a PFP system, are rarely based on good academic evidence about what really works and what does not work (Glassman & al. 2010, 232). So the popularity of PFP systems does not suggest that either scholars or managers are in agreement as to if and how PFP compensation is an efficient tool to enhance employee performance (Beer & Cannon 2004, 3-4). PFP and variable pay in general has raised much debate recently and especially the popular press emphasizes the detrimental effects of performance-related pay

(EY 2016a, Nalbantian & al. 2014, 33). At the same time the need to cut back on compensation expenses puts greater emphasis on differentiation of performance ratings and pay and even more emphasis on variable compensation.

Pay-for-performance systems have been criticized for the possible destructive effects that PFP can cause on creativity, intrinsic motivation, teamwork, and self-esteem (Kohn 1993; Amabile 1996, 119; Meyer 1975, 55-62.) Some scholars also argue that incentives may work too well, motivating employees to focus excessively on rewards instead of working comprehensively for the benefit of the organization. (Beer & Cannon 2004, 3-4.) Research findings on PFP systems and their effects on employee motivation and performance have been somewhat conflicting but some scholars feel that PFP research findings have sometimes been ignored, causing a “knowing/doing” gap between what science knows and what business does. (Glassman & al. 2010, 232; Pink 2009.) The difference in research results can be at least partly explained by the differences between economic and psychological theories. Psychological theory places much more importance on individual differences to explain differences in performance. Economist do recognize the role of ability in performance but psychologists have found many more variables to consider, such as personality, the need for achievement and self-esteem. (Perkins & White 2011, 169.) Such complexity may be rather inconvenient for example from the management point of view but it should be clear from the range of approaches that there is no generally accepted “one size fits all” answer. As employment and compensation systems continue to evolve, the basic assumptions regarding the functional consequences of mainstream thinking may be open to further challenge. (Perkins & White 2011, 49.)

In order to truly diminish the knowing/doing gap, I believe it is crucial to understand the underlying theories on motivation as well as the prevailing economic models. As stated in the EY report “Executive Remuneration in Finland - Empirical data analysis, legislation, taxation and vision”, an optimal pay mix can be determined best by having a clear understanding of how performance is defined and how it can be measured. (EY 2016a, 15). And therefore this study aims to gather a wide range of data to draw conclusions that could shed light on what is working and what is not in terms of pay-for-performance.

This study comprises of two main parts; the literature review (chapter 3) and the empirical study (chapter 4). The empirical study includes interviews of HR professionals from Finnish companies. The purpose of the empirical study is to gain insights on the personal views of the interviewees on performance management and performance-related pay. In chapter 2 I clarify the research question and discuss the research scope as well as the conceptual and theoretical backgrounds in more detail.

2 Research scope and objectives

The goal of this research is to understand how pay-for-performance compensation can affect employee motivation and performance and have a wide overview of the underlying theories behind pay-for-performance compensation and also to understand the possible challenges in applying performance-related pay and.

Variable pay is widely used for both, non-executive employees and executives. This study includes references to executive remuneration as well, but the main focus is on PFP on a general level and therefore certain special characteristic related only to executive compensation is excluded. The issues in executive PFP are somewhat similar to the general issues in broader discussion of employee PFP. At the same time, however, executive compensation is unique in important ways (its magnitude, the key role of stock plans, the amount of public interest and regulatory scrutiny). (Gerhart & al. 2009, 5.)

2.1 Research question

1. What are the critical issues in designing and implementing pay-for-performance systems?

    1.1 What are the underlying theories of pay-for-performance systems?

    1.2 How can performance-based pay increase employee performance and productivity?

2.2 Conceptual and theoretical framework

The role of theory in performance and reward management is important especially when trying to adopt a systematic approach while still being mindful of the complexity involved. Although theory in general involves simplifications compared to the complexities of the empirical world, it does offer a way to systematically evaluate how to engage with specific contexts in all their diversity. (Perkins & White 2011, 31.) The field of compensation is not only complex but also ever-changing which is why new research findings and viewpoints are expected to rise in the future as well.

Pay-for-performance is a relatively young research field but a substantial amount of literature both on performance related pay and the assessment of work performance exists (Milkovich & Wigdor 1991, 35-36; White 2016, 326). There have been many suggestive theories on pay-for-performance and pay-for-performance strategies have begun to draw the attention of students of economics, finance, accounting, sociology, psychology, management, and organizational science, as well as compensation consultants. The topic is

interdisciplinary which creates variety of viewpoints but can also cause complications. (Milkovich & Wigdor 1991, 35-36.)

As pay-for-performance stretches out to multiple fields of science, researchers have also noted the limitations of having one narrow view. For example, many common features of compensation systems are not easily explained by traditional economic theory alone. Baker, Jensen and Murphy (1988, 33-35) also agree in their paper “Compensation and incentives: practice vs. theory” that the economic understanding of internal incentive structures is far from complete and the first step in building a successful theory of organizational incentives is recognizing the variety of phenomena that economists have ignored, either because they do not fit the prevailing theory or because they do not fit into the familiar forms or standards of evidence.

The psychological literature places much more emphasis upon individual differences in performance compared to the economic theory. Psychologists have also found more variables to consider, such as personality, the need for personal achievement and self-esteem. While the content theories of motivation (e.g., Maslow, Herzberg) indicate that pay is not a motivator, the concept of linking pay to performance is strongly embedded in management culture and appears to be supported by several process theories of motivation (e.g. goal theory, expectancy theory, equity theory). (White 2016, 326.) The use and effectiveness of PFP for both, non-executives and executives, has been often viewed with skepticism by management literature but as suggested by Gerhart, Rynes and Smithey Fulmer (2009, 76-77), differentiation between different research fields should not require showing that the other discipline is all wrong.

It is also interesting how few studies have viewed PFP as a precursor to performance but instead most PFP studies examine performance rather as a precursor to pay. This can reveal the relationship between performance and pay, but not necessarily PFP’s motivational effect. (Nyberg & al. 2013, 2.) Both views are taken into account in the literature review of this research.

2.3 EY People Advisory Services / About the sponsoring agency

EY is one of the world’s leading providers of professional services in assurance, tax, transactions and advisory. EY employs over 230.000 people in 150 countries. While much of EY’s business can be run on a global level, services are provided locally when we talk through 28 Regions. (EY 2017.) The researcher has been working at EY in Helsinki since 2010.

EY People Advisory Services (PAS) believes a better working world can be achieved through helping companies harness the power of their workforce – the right people, with the right capabilities, in the right place, for the right cost, doing the right things to drive business performance in a sustainable manner.

EY PAS works globally to address complex issues relating to organization transformation, end-to-end workforce lifecycles, effective talent deployment and mobility (figure 1) in order to maximize value from evolving and virtual workforces, and the changing role of HR in support of the execution of business strategy. PAS is currently a business of some 10,500 people with expert teams operating in 76 countries. (EY 2017.)

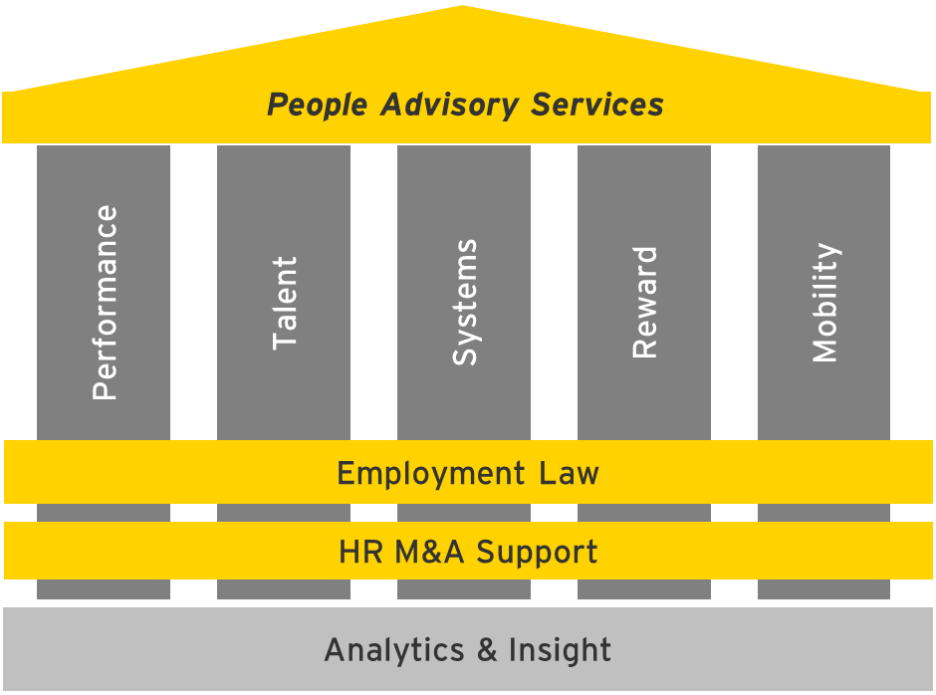

Figure 1. EY People Advisory Services, EY 2017

EY Reward practice provides services within the area of compensation and benefits to a wide range of clients. The services provided by EY PAS cover a wide range of services, including but not limited to reward strategy, executive remuneration, incentive plan design and implementation, performance metric review and re-design, retention and transaction incentive design, reward strategy and pay structure design as well as performance management process design and review. (EY 2017.)

3 Literature review

The literature review focuses on the psychological, economical and sociological theories behind pay-for-performance, employee motivation and performance measurement. In addition, the literature review aims to identify critical issues in designing and implementing pay-for-performance system by reviewing research results, white papers and articles from the field of psychology, management and economics.

3.1 Defining pay-for-performance

Wages and pay have traditionally been determined through government regulation, minimum wage determination, negotiation with unions, decisions of arbitration or labor courts and the individual contract of employment. The factors or criteria influencing pay and pay increases traditionally included profit (but generally unrelated to individual or group performance), job evaluation, seniority, cost of living, need for manpower, negotiating strength of the parties and skills. Performance measures have been of less importance in determining pay increases. Though skills might have been reflected in pay differentials, pay systems did not really encourage skill acquisition and application. (de Silva 2012, 3.) But incentive pay does have a long tradition in economic analysis and policymaking. Compensation systems based on employee performance are seen as a way to correct some of the imperfections in labor, product and capital markets that affect the employment relationship. By motivating individual workers, incentive schemes are expected to raise job satisfaction, improve interpersonal relationships, lower absenteeism and waste of material or capital, and lower turnover rates. This should produce long-lasting effect on company performance. (Bryson & al. 2011, 6.)

There is no single approved definition of pay-for-performance. It is described as both, a form of pay progression within a grade or scale based on individual performance appraisal or review, or as any form of system that relates pay to work performance in some way. The broader definition would cover most forms of variable pay. (White 2016, 326.) Merit pay (chapter 3.2.2) is sometimes even excluded from the pay-for-performance definition, but in this study I also consider merit pay being part of pay-for-performance compensation, provided that it is connected to either employee or even company performance. Unlike other forms of variable pay, merit pay rewards performance by increasing the employee's base salary on a long-term basis. Milkovich and Wigdor (1991, 151) include merit in pay-for-performance, dividing PFP into two general categories; merit pay plans and variable pay plans. They further divide the latter category namely in two; individual incentive plans and group incentive plans.

Another example of defining PFP is to divide them into four categories as follows:

- Individual-based or based on individual performance
- Profit-sharing, typically applies organization-wide
- Gain-sharing, typically applies to a single facility, site or business
- Employee share ownership schemes (long-term incentives)

(de Silva 2012, 5; Masternak & Associates 2016.)

Furthermore, performance-based pay can be divided into “if/then” and “now/that” rewards, depending on how the incentive is communicated and paid. According to Irvine (2016), if/then rewards refers to incentives programs in which participants are pre-defined, a goal is established, and a deadline to achieve that goal is set. “If” a participant achieves that goal, “then” he or she will receive the incentive reward. Now/that rewards are associated with spontaneous recognition of employee behaviors and actions and are only given as a surprise reinforcement after an employee has demonstrated a desired behavior or achieved a goal. (Irvine 2016.)

Pay-for-performance systems are frequently used by companies in an effort to improve employee performance by linking compensation (Bevilacqua & Singh 2009, 20.). According to Rynes & al (2005, 573) “PFP’s presumed link to both past and future performance (as well as to employee attraction and retention) explains its popularity in practice and its centrality in theoretical approaches to reward systems.” As a result of the belief that PFP plans offer significant opportunities for improved employee performance, incentives have become a larger portion of total executive pay and have become part of the compensation design for a wider range of employee levels and categories. (Bevilacqua & Singh 2009, 21.)

In order for PFP to work efficiently two processes, compensation management and performance management should function well separately but also operate together as an integrated system. Compensation management requires accurate assessments from the performance management system in order to realize its full potential. And in order to reach the full benefits of performance management it needs a well-administered compensation system. (Summers 2005, 18-19.) Furthermore, performance is believed to be a joint function of both motivation and ability (Vroom 1964) and it is believed that it can be improved with the help of performance evaluation in two ways: through developmental feedback, and through administrative decisions that link evaluated performance to organizational rewards and punishments such as pay, promotion, or discharge. (Rynes & al. 2005, 573.)

3.2 Types of performance pay

PFP is only one dimension of employee compensation. Other dimensions of reward management include competitiveness of salaries with the marketplace, benefit packages and cost-of-living considerations, among others. According to Milkovich and Wigdor (1991, 152) the effects of merit or variable pay plans will depend in good measure on this larger compensation context.

This chapter presents the most common PFP plans; individual performance-based bonus, merit plan, group incentive plans (profit sharing, gainsharing), long-term incentives (overview of executive compensation) and promotion-based incentives. These plans are primarily implemented to motivate employees to strive for superior productivity (incentive effects) and to attract adequately skilled employees (sorting effects) (Fehrenbacher & Pedell 2012, 2).

3.2.1 Individual performance-based bonus

Individual performance-based bonus is typically a cash lump sum payment paid in addition to the employees' base salary. Unlike merit increase, bonus pay is not added to the base salary. Bonus pay has been widely used in organizations to motivate employees' performance (Sturman & Short 2000, 2-4) and although the payouts can be large, they also carry the risk to the individual of receiving no payout if performance thresholds are not met. (Milkovich & Wigdor 1991, 151.) Usually the formula and the relationship between performance and the payment of the lump sum are known beforehand (de Silva 2012, 8) and the bonus is paid out upon achievement of these pre-determined goals. Bonus is paid at various intervals, for example monthly, quarterly or annually (Irvine, 2016).

There is surprisingly little relevant empirical research on bonus pay despite the potential cost savings of bonuses to companies (relative to merit pay) and the motivational and performance benefits suggested by theory. The few existing employee bonus pay studies are generally supportive of the idea that bonus pay is positively related to performance. (Nyberg & al. 2013, 6-7.) Bonus pay is attractive from the company's point of view because the one-time cash reward links pay to performance but does not increase fixed labor costs. (Park & Sturman 2012, 7-8.)

Although bonus pay is flexible, it has also potential problems: Discretionary payment sometimes fails to provide a strong link between pay and employees' true performance and it is also possible that the difference in rewards between high and low performers may not be very significant. It has also been suggested that because bonuses are one-time

payments, they can have less economic value than permanent merit increases (Park & Sturman 2012, 7-8.). The economic value of bonus compared to merit increase is further discussed in chapter 3.5.5.

Sales commissions are common examples of bonus pay plans but they may in fact have less to do with performance because factors such as product quality, brand name and price may contribute more to sales than the ability of the seller to convince the buyers. Feedback (appraisals) may also be less significant in this category since the criteria is often statistical and no further measurement is needed. (de Silva 2012, 8.)

3.2.2 Merit increase

Merit pay is a form of reward in which individuals receive permanent pay increases as a function of their individual performance ratings (Heneman & Werner 2005, 17). The merit pay plan is often based on an individual's performance and is assessed by a performance appraisal, usually by the employee's supervisor. A key characteristic of merit pay, compared to other forms of pay-for-performance, is that merit pay permanently increases employees' base pay. (Park & Sturman 2012, 6-7; Gerhart & al. 2009, 16.) The term "merit pay" should not be confused with the term "merit system" which is a term used in the public sector to describe hiring and promotion decisions rather than compensation decision (Heneman & Werner 2005, 6).

Merit pay plans do not conform as closely as individual incentive plans to the theoretical conditions thought to be conducive to improved performance. Although merit plans often focus on individual performance, pay increase guidelines typically consider also position and time in grade in addition to the performance rating while company performance often determine the overall increase budgets. In order for the merit increase to positively affect employee's motivation, increases should be meaningful and clearly differentiate outstanding from average or even poor performance. (Milkovich & Wigdor 1991, 153-158.)

The theory-based arguments for merit and bonus pay representations of PFP are, in general, similar. PFPs' influence can also be evaluated by the way employees trust and believe that their increased efforts will result in an outcome that generates the merit reward from the organization. (Nyberg & al. 2013, 6.) Merit ratings are also associated with probabilities of promotion, which in turn are associated with considerably higher rewards than "regular" merit increases and result in significant accumulations over time. According to Gerhart & al. (2009, 21), a review of existing research suggests that merit pay both exists in most organizations, and positively influences performance.

Despite the ways that merit pay may seem to incentivize employee performance, the effectiveness of merit pay has been questioned. Some researchers have been concerned that organizations often fail to link merit pay to employees' actual performance because of measurement error associated with their performance appraisal system. (Park & Sturman 2012, 6-7.) Furthermore, due to merit pay being integrated into the base salary, the merit pay is not lost due to poor performance later, and therefore may even cease to be an incentive. (de Silva 2012, 7.)

It is also suggested that employees may become more accustomed to salary increases spread across pay periods and therefore employees may view merit pay as a common obligation that should be, whereas bonus pay may be seen as a reward that needs to be earned every year. In addition, one-time bonus may work as a more vivid goal for the employees to strive toward. As suggested above, equivalent dollar value delivered by merit pay should be valued higher by the employees, due to the potential for compounding the increase in future periods. However, a research by Nyberg & al. (2013, 25-26) suggest that employees may not respond as expected and instead they might value a one-time bonus payment higher.

3.2.3 Group incentive plans

Compensation in small group or team-based systems can be conflicting in terms of reward objectives. While one of the objectives if to foster member cooperation and cohesiveness, recognizing individual differences in the team members' contributions toward team accomplishments can be a conflicting objective. Although there have been a large number of studies on group rewards in laboratory settings, findings are very scarce and therefore do not provide much advice to managers on how to deal with this conflict. (Gerhart & al. 2009, 32-33.) Group incentive plans differ from the two preceding types (individual bonus and merit pay) in basing compensation decisions on unit or system performance rather than individual performance. Although payouts can sometimes be large, depending on the company's financial or market situation, they are not usually added to base pay. (Milkovich & Wigdor 1991, 152.)

Some group incentive plans retain many of the motivational features of individual incentive plans (quantitative performance goals, relatively large and frequent payouts), but it can be difficult for the individuals to see how their performance contributes to group- or organizational-level measures and therefore the motivational link may weakened. Furthermore, payouts may occur only in good times and depend on larger environmental and economic forces beyond the control of the individual employee. (Milkovich & Wigdor 1991, 154.)

Profit sharing and gain sharing are two very typical group incentive plans which seem very similar on the surface but unlike gain sharing, profit sharing is not linked to the performance of an individual or a department, but rather is related to the profits of the whole company. As with gain sharing, increases in the company's profits are distributed among employees according to a pre-negotiated formula, but unlike gain sharing, the focus is not on the performance of one single employee or department. Instead, profit sharing emphasizes the importance of teamwork within a business by dividing financial rewards among all employees, not just those in the group responsible for the profit increases. (SozoFirm 2017.)

No neat definition of profit sharing covers the variety of plans that can legitimately claim to share profits with employees (Kruse 1993, 1).Profit sharing pay outs are based on meeting a profitability target (e.g., return on assets or net income). Profit sharing can be either deferred or paid in cash, while payouts may be either formula-based (e.g., a fixed percentage of net income) or discretionary. (Gerhart & al. 2009, 26.) Although most profit-sharing schemes link bonuses to company or establishment-level profit, many combine this with other indicators of collective performance such as sales, absenteeism or quality. Individual employees' payouts may all be equal in a given organizations or may depend on wages, lengths of service with the company and/or on individual records such as absenteeism. Regulated schemes, such as in France may specify that all or most employees must be eligible on the same terms. (Bryson & al. 2011, 11.)

According to Kruse (1993) much of the early support for profit sharing can be described as ideological. Many proponents viewed profit sharing as a way to integrate workers into the capitalist system by sharing the benefits of capitalism in a more direct and tangible way than allowed by fixed wages. However, much of the support for profit sharing during the twentieth century has shifted from a broad ideological approach to support based on more narrowly construed economic reasons. The dominant argument for profit sharing in the twentieth century has been the idea that it can motivate employees to work harder for increased profits, primarily through increased productivity. It is argued that by tying employee pay to profits, the incentives of employees and owners can become aligned so that productivity-reducing conflict is minimized and productivity-enhancing cooperation and innovation are encouraged. A second argument for profit sharing is that it can aid economic stability and decrease unemployment by making wages more responsive to economic conditions. Profit sharing is therefore seen as one potential solution to economic instability. However, as stated by Kruse, simply making employee pay more flexible, however, may not contribute toward macroeconomic stability as flexible wages can also affect the purchasing power. (Kruse 1993, 1-3.)

Although the incentive effects of profit sharing are hypothesized to be positive, they may nevertheless be limited by the large number of employees involved and the riskiness of returns (Rynes & al. 2005, 588). An important issue for the potential economic effects of profit sharing is whether the formula for determining bonuses is known beforehand to employees (as in most regulated European schemes) or whether the level of bonuses is left to the discretion of management in any given year, as with many US profit-sharing schemes (Bryson & al. 2011, 11).

Baker, Jensen and Murphy (1988) claim that the productive effects and popularity of profit sharing plans are poorly understood by economists. A common economic argument for team-based incentives is that these policies encourage mutual monitoring: Worker A has incentives to monitor co-workers if the co-workers' performance affects worker A's compensation and vice versa. Such mutual-monitoring system can however suffer from the free-rider problem and over-monitoring problem can arise if workers prefer monitoring others to working themselves. (Baker & al. 1988, 21-22.)

The typical measure of productivity in profit sharing research is value added (the extent to which the price of a product exceeds the cost of the factor inputs such as labor and capital), rather than a measure of physical productivity (e.g., units produced). As the price of a product can be influenced by many factors other than productivity, such as industry trends and marketing and therefore finding a relation between profits distributed per worker and value added does not necessarily mean that profit sharing causes higher productivity. (Gerhart & al. 2009, 28.)

Gainsharing links pay to results-based performance at a collective (usually facility) level. There are a number of expected advantages in gainsharing, for example, gainsharing systems can be customized to target multiple objectives in addition to productivity, such as meetings deadlines, safety, or customer satisfaction. (Rynes & al. 2005, 589.) Theoretically, gain sharing programs are expected to be less motivational than individual incentive programs, considering that outcomes are dependent on other workers as well as broader environmental factors (e.g., economic downturns or entry of new competitors). Gainsharing is however expected to be more motivational than corporate-level programs such as stock- and profit-based plans. (Rynes & al. 2005, 589.) And despite the low expectations on the motivational effects of gainsharing, the empirical evidence on gain sharing appears to be quite favorable (Schuster 1996, 18).

Milkovich and Wigdor (1991, 86) suggest that group incentive plans in general might "provide a way to accommodate the complexity and interdependence of jobs, the need for

work group cooperation, and the existence of work group performance norms and still offer the motivational potential of clear goals, clear pay-to-performance links, and relatively large pay increases." But gain sharing programs do have potential challenges as well. Distributing the gain sharing amount among employees can cause resistance, dissatisfaction can arise in years when there is no bonus payouts and high performers seem to favor individual PFP which can increase the negative sorting effect in the organization. (Gerhart & al. 2009, 24-26.)

3.2.4 Long-term incentives

Long term incentive (LTI) plans are operated especially for executives as an incentive to improve performance and they can also provide an opportunity to reduce fixed costs. Examples of such schemes are:

- share option plans to promote convergence of stockholder/executive interests
- bonus linked to long-term performance (3-5 years) to encourage focus on long term goals
  (de Silva 2012, 10.)

Compared to nonexecutive employees, executives usually have a much larger percentage of their compensation in the form of PFP. Executives are also unique in a way they are generally required to maintain a significant personal equity stake in the corporation on an ongoing basis. This increases their own personal investment risk through a lack of portfolio diversification, making the fundamental agency theory challenge (the trade-off between incentives and risk) particularly important. These equity stakes usually come from stock and option holdings that have accumulated over the years. (Gerhart & al. 2009, 47.)

Long-term incentives are offered to executives to increase their focus on the longer term and thus align the interests of executives and companies' (long-term) shareholders. Plan length usually varies from 1 to 6 years, for example majority of plans in Finnish companies have a total length of 3 years. According to EY 's 2016 report "Executive Remuneration in Finland - Empirical data analysis, legislation, taxation and vision offer", most of the surveyed Finnish companies offer LTI grants every year in order to continuously provide long-term incentives. According to report, this "prevents longer-term focus from faltering, should performance targets of previous grants become or seem unattainable". (EY 2016a, 21.)

One of the challenges with long-term incentives is the extent to which employees feel their performance is connected to the level of reward. And even though LTI is generally limited

to higher level employees, who arguable have a more direct effect on firm performance, the link between individual performance and long-term incentives may potentially be weaker than for other forms of compensation. Long-term incentives also generally have restrictions on their liquidity, meaning that employees who are given long-term incentives generally cannot get immediate value from them because there are vesting requirements and/or restrictions on when the awards can be converted into cash. As a result, gaining a long-term incentive award often does not translate into a form of pay with immediate spendable value. Therefore, on a dollar-per-dollar basis, long-term incentives may have less immediate value than immediately tangible rewards. (Park & Sturman 2012, 7-8)

3.2.5 Piece-rate schemes

Another traditional method of rewarding performance is piece rates. The piece rate pay method compensates employees a set amount for each unit of work completed. For example, in a manufacturing setting, an employee receives a set amount for each item he produces, regardless of how fast or slow he works. (Frost 2016.) It is however suggested that piece rates should also have additional criteria such as a reasonable time frame within which the production should be completed, in order for the rates to be related to performance. (de Silva 2012, 8.)

The primary motivation behind instituting a piece-rate scheme is to increase worker effort. While it may seem obvious that moving from hourly wages to piece rates would increase effort, according to Lazear (2000), it is not. When a firm institutes an hourly wage schedule, it usually couples the payment with some minimum level of output that is acceptable. It is possible, therefore, that the minimum acceptable output chosen for hourly wage workers exceeds the level of output that workers voluntarily choose under a piece rate. Further, it may be that the minimum level chosen under hourly wages is so high that only the most able workers can make the cut. Hourly wages that are coupled with some minimum standard could in principle be called performance pay because an output-based performance standard must be met to retain employment. (Lazear 2000, 1347.)

3.2.6 Promotion-based incentives

Wage levels are often tied to job levels instead of individuals, especially in hierarchical organizations. Promotions are used as an incentive for higher employee performance especially in large and hierarchical organizations. Promotion-based reward systems seem to have some advantages compared to bonus-based incentive schemes but also challenges and restrictions. The incentives generated by promotion opportunities depend greatly on

the probability of promotion and this leads to the first challenge with promotion-based reward systems. Such systems require organizational growth to feed the reward system and therefore they can work well in rapidly growing firms, but are likely to generate challenges in slowly growing or shrinking firms. (Baker & al. 1988, 11-12.)

The probability of future promotion is often lower the higher employees move in the organization's hierarchy and therefore bonus-based incentives will be more common in the higher levels. For employees whose promotion potential is doubtful (either due to previous promotion or falling short of the promotion standard) the incentive effect will be reduced or absent. (Baker & al. 1988, 13.)

In tournament promotion systems the best performer at each level is promoted to the next higher level (Baker & al. 1988, 15). In this model pay varies significantly from one career level to the next, with less emphasis on individual differentiation based on performance among employees in the same level. The motivation to perform well is based on the competition for advancement, rather than the size of the base pay increase or annual incentive. Best performers are still likely to see increase in their salaries via promotions based on relative performance evaluation. (Nalbantian & al. 2014, 34.)

In many cases, however, the best performer at one level in the hierarchy may not be the best candidate for the next level job. Especially the change from a specialist to a manager can be challenging if the employee would rather find promotion possibilities in his/her area of expertise. Specific talent needs can be a challenge especially when talents for the next level in the hierarchy are not perfectly correlated with talents required to be the best performer in the current job. Tournament promotion systems cannot simultaneously provide optimal incentives and matching; employee differentiation is needed for matching to matter but for tournaments to provide optimal incentives, employees must be alike, since differences in ability may lead to reduced incentive if participants know that those with high ability will win. (Baker & al. 1988, 15-16.)

According to a survey conducted by Nalbantian, Adkins and Levine in 2014, companies using the tournament promotion model judged their plans as more effective than companies relying on more traditional incentive compensation models. The tournament model is associated with build-from-within talent cultures. However, given the model's reliance on relative ranking (and thus, competition), for employers requiring high level of collaboration the tournament model is less likely to be appropriate. (Nalbantian & al. 2014, 35.)

3.2.7 Other models

There is more than one way to design and execute pay-for-performance. The following alternative pay-for-performance models could be considered as alternatives or in combinations with traditional variable pay models.

- In the efficiency wage model, overall pay (and benefit) levels are targeted above the market median and employees must perform to high standards to stay in the organization. The desire to keep a high-value position is expected to deliver incentives to perform well.
- Service or bonding model is based on the development of planned increases shifting pay from early to later in the career once performance is credibly demonstrated. This model also ties in employees, helping to preserve firm-specific knowledge key to productivity while enforcing performance minimums to stay with the organization.

(Nalbantian & al. 2014 34-35.)

3.3 Theories underlying motivation and performance

The underlying rationale for pay-for-performance is based on theories of motivation and the ability of financial rewards to adequately motivate an employee and thus affect the individual's performance. (Suff & al. 2007, 4; Bevilacqua & Singh 2009, 22). Behaviourists like Skinner (1974) consider learning to take place only through external positive and negative reinforcements. Taylorism applied this thinking to financial rewards, arguing that money was the sole motivator for workers to perform. Such employer-centric view of reward was based on the premise that behaviour can be controlled and moulded to suit employer needs. (Suff & al. 2007, 4.)

There are a number of economic and psychological theories that attempt to address employee responses to performance related pay. Theories from these two disciplines often predict similar outcomes, even though their causal explanations differ. (Nyberg & al. 2013, 3-4.) While economists focus on formal models linking performance and pay, organizational behavior scholars consistently emphasize that the process of managing a pay system is equally as important as the formal design of the system. The latter place equal, or even greater, importance on the psychological interactions between a manager and an employee, individual perceptions, social comparisons, equity, trust, and self-esteem. (Gibbs 1991, 1.)

Although the preceding theories propose a variety of ideas about pay and motivation, essentially PFP operates on motivation and performance through two general processes - “incentive effect” and “sorting effect”. The incentive effect is the potential impact of PFP on current employees’ performance and it has been the primary focus of most PFP theory and research. The sorting effect is the potential impact of PFP on the attributes of an organization’s workforce through differential attraction and retention processes (different types of PFP systems may cause different types of people to apply to and stay with an organization, and these people may have different levels of ability. (Rynes & al. 2005, 581.)

In this chapter I will provide an overview of the most prominent theories underlying motivation and employee performance. Such review is crucial to have a deeper understanding on the possible effects, benefits and challenges as well as the complexities of performance-related compensation.

3.3.1 The economic model on motivation

A central task of economic theory is to break down a problem to its essentials in order to thoroughly understand and carefully analyze the matter. In principle, after the core of the problem is understood, economists turn their attention to the nuances that separate their models from reality. In the area of employee motivation, labor economists have focused largely on three core problems: sorting potential employees, achieving optimal performance on the job, and regulating turnover. (Ritter & Taylor 1997, 4.)

Economic models of compensation generally assume that higher performance requires greater effort. In order to provide incentives, these models predict the existence of reward systems that structure compensation so that the expected utility of an employee’s increases with observed productivity (Baker & al. 1988, 3). While economists recognize that nonmonetary rewards for performance can be important they tend to focus on monetary rewards because money is a general unit of exchange, it allows the employee to choose his or her own rewards (at least those which can be purchased with money) and because money represents a generalized claim on resources. (Baker & al. 1988, 3; Gibbs 1991, 3-4.)

Economic theory has historically assumed that employees are economically rational and self-interested (Milgrom & Roberts 1992; Pfeffer 1998). Although this assumption does not explain the several employee behaviors that are not economically rational (Ariely et al. 2009), the idea of employees weighing options and always acting in a manner that maximizes incentive payouts provides an explanation for many behaviors as well as a solid foun-

dation for certain predictions. (Nyberg & al. 2013, 4-5.) Gibbs (1991, 1) lists common features of organizational incentive systems are not easily explained by traditional economic theory. These include equal pay, the overwhelming use of promotion-based incentive systems, the absence of up-front fees for jobs and effective bonding contracts, and the general reluctance of employers to fire, penalize, or give poor performance evaluations to employees. According to Gibbs, typical explanations for these practices offered by behaviorists and practitioners are distinctly uneconomic. (Gibbs 1991, 1.)

Milgrom and Roberts (1992) have introduced five economic principles that influence incentive contracts: informativeness, incentive intensity, monitoring intensity, equal compensation, and ratchet effect. They use incentive intensity as a mechanism for determining when employers should use incentive contracts. According to Milgrom & Roberts there are four key elements that should be considered to reach this decision:

- The amount of additional money that can be achieved through increased employee effort
- The ability to measure the rewarded activities (i.e., job performance)
- The employee's risk tolerance, and
- The employee's responsiveness to PFP

The economic model as an explanation for PFP and employee motivation has faced criticism, most importantly about the way it assumes employees to act rationally when evaluating rewards and effort required. According to Pfeffer (1998) economic models portray work as hard and aversive as they imply that the only way people can be induced to work is through combination of rewards and sanctions. Believing that people only work hard if rewarded for doing so or if assuming that people are untrustworthy and require constant monitoring may cause these assumptions to become self-fulfilling.

3.3.1.1 Agency Theory

The principal–agent problem, known as the agency theory (or agency dilemma) in political science and economics is a central theory in the economic model. It occurs when one person or entity (the "agent") is able to make decisions on behalf of, or that impact, another person or entity: the "principal" (Eisenhardt 1989, 57-74.). The principal uses rewards and commands in order to raise the performance of the agent. The agent could be an employee, but more general everyone who is given a task to perform. An agent performs by considering the benefits as well as the cost of his action, which both increase in performance. (Frey & Jergen 2000, 4.)

An incentive dilemma exists in circumstances where the agent is motivated to act in his own best interests, which are contrary to those of the principal. The goal of agency theory is to find a solution to this problem by aligning the interests of a company and an employee. (Eisenhardt 1989, 57-74.) Agency theory is the primary economic theory used to explain when different types of monetary incentives should be used and how they should be structured. It also supports the argument that incentive and sorting effects are caused by monetary incentive systems. (Fehrenbacher & Pedell 2012, 2.) Regardless of what form the rewards take (e.g. pay, status or recognition) agency theory implies that the motivation problem is addressed by measuring performance and tying rewards to the measures. In theory, a reward system thus uses available information to most accurately (and cost-effectively) measure performance and tie pay and other rewards to the outcome of the measurement process. As a result, different employees with the same tasks would earn different rewards, depending on their documented performance. (Gibbs 1991, 3-4.)

Agency theory highlights potential losses in productivity that can occur when the interests of owners and employees are imperfectly aligned. Pay-for-performance (PFP) has been proposed as a potential solution to this problem. (Frey & Jegen 2000, 1.) A fundamental assumption of the agency theory is that individuals are fully rational and they are presumed to be motivated solely by self-interest. Individuals are further presumed to have preferences to increase wealth and leisure. Agency theory (similar to most models of economic behavior) therefore posits that individuals will not exert effort on a task unless it contributes to their own economic well-being in some way. Incentives that are not contingent on performance generally do not satisfy this criterion. Agency theory thus suggests, similarly to the expectancy theory) that incentives play a fundamental role in motivation and the control of performance because individuals have utility for increases in wealth. (Bonner & Sprinkle 2002, 308.)

Additionally, agency models typically assume that individuals (employees) are strictly risk-averse (Bonner & Sprinkle 2002, 308), therefore agency theory emphasizes that results-based plans increase risk-bearing among employees (at least if some part of fixed salary would be replaced with an incentive component). Therefore one of the main challenges is to design plans that maximize incentives for employees while keeping the negative effects of risk (in the form of negative employee reactions) under control. (Gerhart & al. 2009, 11.)

3.3.1.2 Sorting effect

Most of the theories of compensation and motivation concentrate on the effect that PFP has, holding the employee population constant. Sole focus on the incentive effect may result in overlooking an important mechanism by which PFP can have an impact. Scholars

have increasingly recognized that PFP may change the employee population and its attributes via sorting effect. In some circumstances this effect can be as (or more) important than the incentive effect. (Gerhart & al. 2009, 74.)

Sorting effect's assumed impact on better job–employee fit is based on people who are motivated by money applying for and staying in a position where PFP is used. Similarly, those not motivated by money are likely to quit and look for a job where pay is less dependent on performance. Although the reason for increased productivity may not matter in the end, it is important to distinguish between the incentive effect and the sorting effect. When productivity improvement involves the same employees (little turnover), the productivity increase is most likely due to the incentive effect. However, if personnel change, then the improvement in performance is likely because of the sorting effect. (Glassman & al. 2010, 232.) Organizations may as well select and retain employees differently depending on the nature of the organization's culture or PFP strategies. (Rynes & al. 2005, 581.)

3.3.2 Motivational theories

The effects of pay on individual's actions have been explained in behavioral literature through different motivational theories. The most cited theories that aim to explain the actions of individuals as a reward target are for example the expectancy theory, goal theory, and the theory on intrinsic and extrinsic motivation. (Hakonen 2006, 18.) In key psychological perspectives, scholars posit that PFP will affect performance via such mechanisms as instrumentality, which is the perceived link between performance and pay (Nyberg & al. 2013, 2.)

A large amount of studies in psychology has focused on testing hypotheses that negative evaluative feedback and extrinsic rewards (including money) are largely detrimental to motivation and performance. However, on the contrary, some psychologists have taken strong positions supporting the importance of pay as a motivator. For example, Lawler (1971) reviewed empirical evidence on pay, finding that it was rated more highly than Herzberg et al. (1957) had reported years earlier. Lawler also developed a process model of motivation suggesting that pay should in fact be a significant motivator because of its instrumentality for obtaining many other outcomes. (Rynes & al. 2005, 580-581.)

3.3.2.1 Intrinsic and extrinsic motivation

When evaluating the effectiveness of money for rewarding and motivating employee behaviour, opinions have historically been divided. Needs theory and process theory are two approaches that help explain the relationship between pay and motivation. These ap-

proaches may not be direct opposites, but they do argue for different pay–motivation relationships. According to needs theory, motivation is an internal drive to satisfy various levels of needs. As the drive is assumed internal, it generally cannot be manipulated by extrinsic rewards. Needs theorists from Maslow (hierarchy theory, 1943) to Herzberg (motivation-hygiene theory, 1959) argue that since money does not satisfy higher order needs, it has a limited ability to motivate. (Glassman & al. 2010, 231.) Frey (1997, 1) for example, has stated that "intrinsic motivation is of great importance for all economic activities and that it is inconceivable that people are motivated solely or even mainly by external incentives".

Process theory, on the other hand, is primarily concerned with the process by which behaviour is initiated and sustained. Motivation is seen largely as a function of external forces and the appropriate use of incentives. Process theory is based on the potential for a relatively strong relationship between motivation and pay. But in order for such strong relationship, employees must believe the reward allocation is fair (equity theory). Rewards must also be valued, performance expectations must be perceived as reasonable, and the reward must be given when the performance goal is reached (expectancy theory). Process theory does not rule out internal need-satisfaction but it emphasizes the external incentives that come from working and considers money as a primary motivator. (Glassman & al. 2010, 231.)

In addition to Maslow's hierarchy of needs theory and Herzberg's motivator-hygiene theory, Deci & Ryan's (1985) cognitive evaluation theory has a similar implication that monetary rewards are not a major determinant of work motivation, except perhaps for employees at low income levels. According to Maslow's need hierarchy theory (1943) a human need that is deprived acts as a primary motivator while a need that is satisfied has less motivational impact. At the bottom of Maslow's hierarchy are physiological (food, sleep) and safety (e.g. accommodation) needs. These needs are likely to be most effectively satisfied by money. But once these basic needs are satisfied, individuals are assumed to focus on "higher" needs, such as love, esteem (including achievement, independence, confidence), and self-actualization ("to become everything that one is capable of becoming") (Maslow 1943, 382). Maslow's theory hypothesized that these higher-order needs are more likely to be met through engagement in meaningful work than through monetary rewards and that as people move up the hierarchy, pay becomes less important. (Rynes & al. 2005, 574-575.)

Herzberg's motivation-hygiene theory focuses on identifying factors that contribute to either satisfaction, or dissatisfaction, at work. Like Maslow, Herzberg (1959) saw hygienic

needs as being driven by people's "animal nature". Most importantly for present purposes, Herzberg posited that money was more likely to be a "hygienic" factor, meaning that money is capable of causing or reducing dissatisfaction than satisfying or motivating. Thus, Herzberg believed that money played a role in creating or reducing dissatisfaction, but not in contributing to satisfaction or motivation. (Rynes & al. 2005, 574-575.)

Deci & Ryan's (1985) cognitive evaluation theory (CET) also challenges the role of money in motivation. Simplified, CET argues that placing strong emphasis on monetary rewards is likely to decrease people's intrinsic interest, thus dampening a potentially powerful alternative source of motivation. Deci & Ryan describe intrinsic motivation as "based in the innate, organismic needs for competence and self-determination", and argue that it occurs in its purest form when "a person does an activity in the absence of a reward contingency or control". They also argue that when effort is exerted in exchange for pay, pay takes on a controlling aspect that threatens the individual's need for self-determination. (Deci & Ryan 1985, 33-35.)

Another scholar criticizing external rewards is Alfie Kohn who claims that no artificial incentive can ever match the power of intrinsic motivation. According to him, people who do exceptional work may be glad to be paid and even more satisfied to be well paid, but they do not work to collect a paycheck. He further states that extrinsic motivators are a poor substitute for genuine interest in one's job and that rewards, like punishment, may actually undermine the intrinsic motivation that results in optimal performance. (Kohn 1993.)

3.3.2.2 Goal-setting theory

Goal-setting theory proposes that personal goals are the primary determinant of, and immediate precursor to, effort. This implies that personal goals are the stimulant of the incentive-induced effort increases. In particular, earlier research indicates that specific and challenging personal goals lead to greater effort than goals that are vague or easy, or no goals at all. Challenging goals lead to greater effort than easy goals simply because people must exert more effort to attain the goal. (Locke & Latham, 1990, 72).

The manner in which monetary incentives affect effort in a goal-setting conceptualization is not completely clear, but several processes have been proposed (Bonner & Sprinkle 2002, 309). In particular, Locke, Shaw, Saari, and Latham (1981) proposed three possible ways in which incentives can affect effort via goal setting. First, monetary incentives may cause people to set goals when they otherwise would not. Such an effect of monetary incentives is not captured by expectancy theory or most economic models of behavior since

individuals' ''goals'' are presumed to be well-specified in advance. Second, monetary incentives might cause people to set more challenging goals than they otherwise would and these goals in turn lead to higher effort. Finally, monetary incentives may result in higher goal commitment (and thus greater effort) than noncontingent incentives or no incentives. This proposed effect of incentives on effort typically would not appear in expectancy theory or expected utility theory conceptualizations because commitment is presumed to be invariant. (Locke & al., 1981.)

3.3.2.3 Expectancy theory

Expectancy theory (e.g. Vroom, 1964) proposes that people act to maximize expected satisfaction with outcomes. From a psychological perspective, expectancy theory is the most common framework used to address PFP efficacy and employee reactions to PFP (Gerhart & Rynes, 2003). This approach dictates that motivation to perform is a multiplicative function of valence (the perceived value of the reward), instrumentality (the perceived likelihood that the desired performance will be rewarded), and expectancy (the perceived likelihood that effort will result in the desired performance). Hence, increasing any of the three components should result in greater motivation to perform. (Nyberg & al. 2013, 4.)

Figure 2 illustrates the three key elements in expectancy theory: expectancy, instrumentality and valence. A person is motivated to the degree that he or she believes that (a) effort will lead to acceptable performance (expectancy), (b) performance will be rewarded (instrumentality), and (c) the value of the rewards is highly positive (valence).

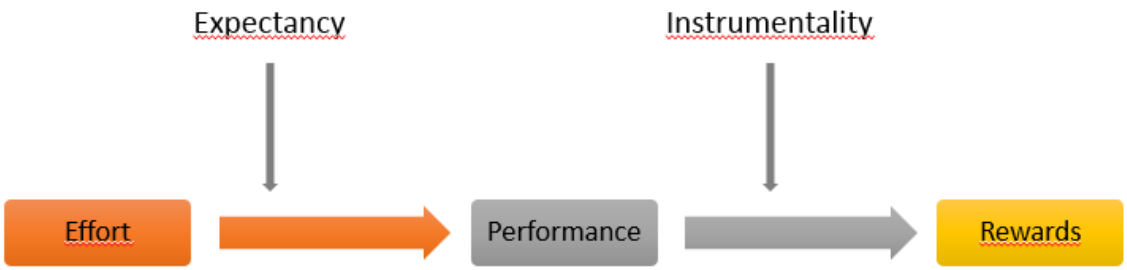

Figure 2. Basic expectancy model. Modified from Lunenburg, 2011.

3.3.2.4 Motivation crowding theory

The motivation crowding effect suggests that an external intervention through monetary incentives or punishments may undermine (and under different identifiable conditions strengthen) intrinsic motivation. The theoretical possibility of crowding effects has been widely accepted among economists although many of them have been critical about its empirical relevance. Motivation crowding theory it is one of the most important anomalies in economics as it may reverse the most fundamental economic "law", namely that raising

monetary incentives increases supply. The crowding-out effect suggests that there are relevant circumstances in which it is advisable not to use the price mechanism to elicit a higher supply but to rely on a quite different type of incentive, intrinsic motivation. (Frey & Jegen 2000, 1-3.)

3.4 Critical issues in linking pay to performance

Attracting and retaining the right talent is on the top the list of priority outcomes expected of pay-for-performance programs, followed closely by motivating employees to focus on the right things and perform at higher levels. To do so, organizations must optimize their rewards programs and seriously consider whether the prevalent variable pay model is the right one. (Nalbantian & al. 2014, 34.) In the next sub-chapter I aim to summarize the most critical aspects of linking pay to performance. I find it important and interesting to understand both the critique and challenges as well as the possible benefits of implementing and managing PFP systems.

3.4.1 Linking reward management and performance management

Effective pay-for-performance requires that two processes, compensation management and performance management, not only function well separately but also operate together in an integrated way. Compensation management cannot fully realize its potential without accurate assessments of individual employees' performance, assessments that properly come from a performance management system. And performance management cannot fully realize its potential without a well-administered compensation system. Although it would seem that these two processes can and should go hand in hand, they don't always in practice. Too often, they lose touch in the execution. (Summers 2005, 18-19.) One of the key barriers in achieving a true pay-for-performance model has been the lack of automation tools which makes it challenging to have a single view of performance and compensation data linked together, provide performance calibration, and ensure the right people are aligned with the right compensation and incentive options (Oracle 2012, 3).

Figure 3 illustrates the components of an integrated pay-for-performance solution. It shows how performance management can help align individual efforts with corporate strategy and facilitates the ongoing management of these efforts throughout the year. It shows how performance evaluation plays a pivotal role, providing an assessment of individuals' performance that then is used as the principal driver of compensation decisions. Because it is a fully integrated process, pay decisions are expected to be based on well-documented evaluations and the performance on which employees are evaluated should contribute to the execution of corporate strategy. (Summers 2005, 18-19.)

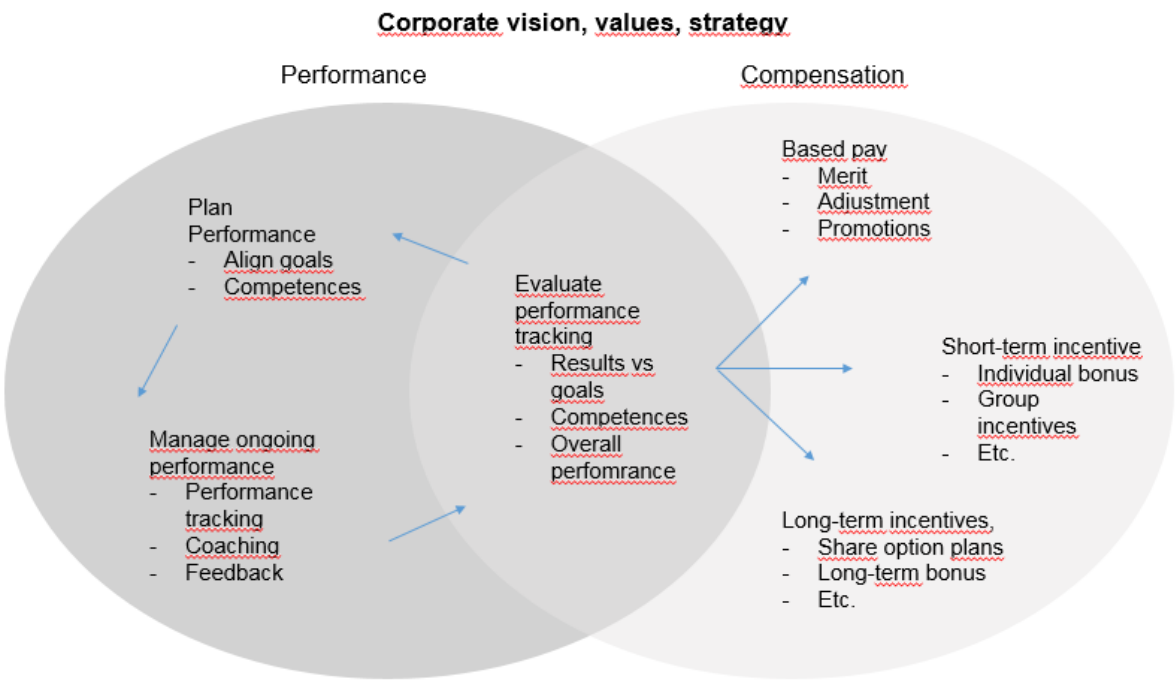

Figure 3. Integrated Pay-for-Performance Solution. Modified from Summers 2005, 19.

Performance evaluation has two distinct functions: to develop employees through such mechanisms as feedback and goal setting, and to evaluate employees for purposes of making administrative decisions (e.g., pay increases or promotions). Meyer and colleagues (1965) argued that these two performance appraisal functions should be kept completely separate from one another, meaning that evaluations of performance and discussions of pay should be separated from discussions of how to improve (or "develop") performance. This recommendation was based on the supposedly distracting and demoralizing aspects of criticism, as well as the authoritarian nature of evaluation. (Meyer et al. 1989, 26.) However, studies attempting to test this assertion did not obtain supportive results. Dorfman et al. (1986) found that discussion of pay and advancement during the performance evaluation session led to higher employee satisfaction with the PE process. Prince & Lawler (1986) found that discussion of salary during evaluation had either no impact or a slightly positive impact on performance evaluation processes (e.g., employee participation) and outcomes (e.g., satisfaction with the overall performance evaluation). Boswell & Boudreau (2002) found no difference in employee satisfaction with performance evaluation, satisfaction with supervisor, or awareness of developmental opportunities between developmental evaluations and those where development was combined with evaluation for administrative and reward purposes. Moreover, they found that employees reported higher intentions to use developmental feedback when developmental feedback was combined with evaluation. (Rynes & al. 2005, 577-578.)

3.4.2 Designing and structuring performance-based pay plan

Corporate belt tightening and global economic volatility and tightened corporate economy continue to put pressure on HR budgets and as a response, companies are scrutinizing salary increase budgets, staffing levels and the pace of benefit cost increases. Total rewards represent a significant expense in companies' operating budgets. While it is natural that companies focus their attention on the costs of salary and benefits, it's also important for companies to ensure they are making the best use of their performance-based rewards, including incentive programs. (Towers Watson 2013, 2.)

Many organizations provide a significant amount of compensation through incentive programs such as bonuses, profit sharing or stock-based incentives (Towers Watson 2013, 2). Incentive compensation should be considered as an important tool for a company trying to improve employee performance. If designed and executed well, an incentive plan can motivate the employee to work harder, smarter, and in better alignment with the company's objectives. Successful incentive plan can also improve recruitment and retention but if designed poorly, it can undermine these objectives. (Gibbs 2012, 1.)

But companies have struggled to show a link between incentive programs and employee engagement as well as struggled to gain positive return on incentive program investments. According to a study by Towers Watson in 2013, companies may need to rethink the concept of engagement considering the changing nature of the global work environment and gain a better understanding of how incentives drive motivation and engagement among different employee groups. (Towers Watson 2013, 2) The design and implementation of pay-for-performance indeed involves complex tradeoffs and has several interacting components (Gibbs 2012, 1) and companies should be critical in analyzing the applicability of the pay system for that company. According to OECD's report from 2015, performance-based pay should be primarily used to support wider leadership and organizational change instead of just a tool to motivate employees (OECD 2005, 7).

According to Kiisa Hulkko-Nyman, performance-based pay in general is managed fairly well but there is room for improvement as companies may sometimes settle for a system that works well but is not optimal. Communication and linking the system to the company strategy are key issues in ensuring that a PFP system works as intended. Employees need to understand the system in order for it to work and company needs take the time to evaluate what is the most suitable system for them and what are suitable metrics. (Hulkko-Nyman 2016a.)

In order to motivate employees and provide them incentives to perform, any pay-for-performance plan must theoretically (a) define and communicate performance goals that employees understand and view as doable; (b) consistently link pay and performance; and (c) provide payouts that employees see as meaningful. These conditions may seem straightforward due to which there is a risk that designing and implementing pay-for-performance can seem deceptively simple. According to Milkovich and Vigdor, selecting the best pay-for-performance plan and implementing it in an organizational context so that these conditions are met is as much an art as a science. Furthermore, it is impossible to generalize about which pay-for-performance plans work best. (Milkovich & Wigdor 1991, 165.)

Just as companies cannot assume some other company's approach will fit in their organization, companies should not forget their internal differences in employee segments, business units or for example multinational locations. For example, managerial and professional jobs may not be well suited to piecework (Lazear 2000, 1358). Also assuming pay design will work globally can be risky as attitudes to incentive pay are very different for example in develop and emerging markets – different demographic groups have a different attitude to risk, and cultural factors also have their part to play in different geographies (PwC 2012, 7). Task-level differences can be even greater than the cultural differences between countries thus modification according to task groups should also be considered (Jokiranta 2002).

All in all, incentive plans are a combination of numerous factors and one must take into consideration the needs of the company and personnel as well as the specific job requirements. (Jokiranta 2002.) According to Hulkko-Nymans dissertation, it seems that "it is not a question of how much is paid but how incentives are paid that best explains incentive systems outcomes. The psychological mechanisms, the context, and the type of ROP system together contribute to the ROP outcomes." (Hulkko-Nyman 2016b, 163.)

Every pay program has its advantages and disadvantages. Programs differ in their sorting and incentive effects, their incentive intensity and risk, their use of behaviors versus results, and their emphasis on individual versus group measures of performance. For example, individual based plans are likely to fit better where work is independent and competition between individuals is encouraged, but less well where there is interdependence and a greater need for cooperation in which case group and organization-based plans would seem to provide the solution. However, group-based plans may have weaker incentive effects and may also have adverse sorting effects, particularly as the number of employees

covered increases. Because of the limitations of any single pay program, organizations often decide to use a portfolio of programs (e.g., merit pay combined with profit sharing) that focus on different objectives. Hybrid plans are not always superior, especially if there are mixed or conflicting messages and the relative size of incentives tied to different performance objectives is not consistent with the stated priorities. (Gerhart & al. 2009, 39-40.)

Both individual- and group-based pay plans have potential limitations. Individual-based plans may generate too little cooperation when work is highly interdependent and may be seen as unfair when individual effort and ability play smaller part in determining performance. On the other hand, group-based plans can weaken incentive effects via free-rider problems, which generally increase with group size. Group-based plans can also result in detrimental sorting effects if high performers go elsewhere to have their individual contributions recognized and rewarded. According to Rynes & al (2005), plans that use aggregate performance measures (gain sharing, profit sharing, stock plans) would seem most likely to suffer from weakened incentive effects and unfavorable sorting with respect to individual performance. On the other hand, group plans may have positive incentive effects if they promote cooperation, attract people with cooperative values, and avoid overly narrow individual goals. (Rynes & al. 2005, 586.)

Combining different plan types may also mean mixing short-term and long-term incentives, especially for executives. For executives, short-term performance is typically measured by the level of profit that a company generates in a year. However, focusing on maximizing annual profit can be very harmful for sustainable profitability. For instance, executives who are solely incentivized to maximize annual profit might reject sound investments or cut R&D costs and thus potentially harming long-term business performance. Most companies have tried to mitigate this risk by providing executives with long-term incentives as well. In addition, in the absence of one perfect short-term performance measure, companies have chosen to combine different short-term performance measures to mitigate this risk. (EY 2016a, 19.)

A PFP system works best when there is a narrow range of job tasks and people across departments or within a department who perform different jobs are not part of the same evaluation standards. This way the identification and weighting of the PFP requirements are more straightforward. However, if the job is multifaceted or if people from different departments are compared, it becomes difficult to identify relevant components and determine their relative value and importance. (Glassman & al. 2010, 233.)

Table 1 demonstrates some of the questions that an organization should ask when designing and implementing pay-for-performance plans. Performance evaluation, employee motivation and the possible unintended consequences are discussed in more detail later in this study.

Table 1. Pay-for-Performance Issues Checklist. Modified from Glassman & al. 2010, 236.

Funding	
Is the merit pay adequate to motivate given the effort needed to excel	Yes
Will the reward be noticeable in the paycheck?	Yes
Is there enough money to reward all high performers?	Yes
Is the program ongoing?	Yes
Are there funds to train evaluators?	Yes
Are there funds to help employees improve?	Yes
Are there funds to provide necessary resources to perform?	Yes
Is there enough money to mitigate unintended consequences related to money	Yes
Job characteristics	
Are tasks to be rewarded within a narrow range?	Yes
Is performance capped or limited?	No
Are the goals stable?	Yes
Does employee have adequate resources to succeed?	Yes
Does the employee have control over outcomes?	Yes
Does the job attract extrinsically motivated people?	Yes
Is teamwork required to achieve merit?	No
Performance feedback	
Are desired outcomes clearly identified?	Yes
Are measured criteria relevant, agreed on, and understood?	Yes
Are performance goals appropriate in number and weight?	Yes
Does the system clearly identify superior performers?	Yes
Will the evaluators be candid?	Yes
Are the evaluator and employee dependent on each other?	No
Is assessment conducted by trained and independent evaluators?	Yes
Will the evaluators take the task seriously?	Yes
Unintended consequences	
Will intrinsic motivation disappear?	No
Will teams become dysfunctional?	No
Will goals or weights cause certain things to not be done?	No
Will goals result in "gaming," unethical or illegal behavior?	No
Will the system exacerbate "politics" in the organization?	No
Will the system result in illegal discrimination?	No
The reward is too small and demotivates workers	No

Items in italics should be answered "NO" to indicate that the pay-for-performance system is appropriate

To further challenge the design of a pay-for-performance plan, Nyberg & al (2013) argue that employees' effort is not simply a function of organizational pay policy or the employees' pay, as is often assumed in PFP research. Rather, effort and performance are also dependent on employee characteristics such as employee tenure, employee experience within the system, PFP system characteristics, and job characteristics. (Nyberg & al. 2013, 5.) Furthermore, as important as it is to focus on the design and implementation of a PFP plan, similarly important is to remember continuous assessment of the plan. Measures and targets degrade, errors in design need correcting, strategy and structure change, requiring focus on different activities. Therefor every incentive plan needs to be changed from time to time.

3.4.3 Measuring and rating performance

A major decision in the design and success of PFP programs is to choose how to define and measure performance (Gerhart & al. 2009, 9). In deciding on performance measures that will be used to determine pay, there are at least three key choices:

- How much emphasis can or should be placed on results-oriented performance measures (e.g., number of units produced) relative to behaviour-based ones (effort or quality)?
- How strong should incentives be and how will risk aversion influence their effectiveness?
- How much emphasis should be placed on individual contributions relative to collective contributions?

In practice, many organizations use multiple performance measures to balance multiple (and sometimes conflicting) objectives. (Rynes & al. 2005, 582-583.)

The evaluation of employee's performance is directed towards two fundamental goals. The first is to create a measure that accurately assesses the level of an individual's performance on something called the job. The second is to create a performance measurement system that will advance one or more operational functions in an organization: personnel decisions, compensation policy, communication of organizational objectives, and facilitation of employee performance. (Milkovich & Wigdor 1991, 137.)

Pay-for-performance systems can be based on objective measures (such as sales, divisional profits, or the number of items produced) or subjective measures (such as the estimated "value" of the employee to the organization). While some jobs, such as sales, may be suitable for certain level of objective measurement, performance in most jobs cannot be measured objectively due to e.g. joint effort and challenges in observability mean that individual output is not readily quantifiable. Consequently, subjective performance measures, particularly supervisory ratings, are more often used. Organizations are also increasingly supplementing individual-level measures with group, unit, or organization-level performance measures; especially to the degree that work is interdependent. Furthermore, organizations are increasingly building risk into both individual (e.g., bonuses) and group-based pay programs (e.g., gain sharing). (Rynes & al. 2005, 582-583.)

In addition to the classification of measures into objective and subjective, empirical research looking at the impact of using performance measures for determining pay can also

be classified according to single or multiple performance criteria. Single performance criteria refers to situations where performance is assessed taking into consideration only for example financial information while the multiple performance criteria refers to those situations where performance is evaluated according to both, financial as well as non-financial information. (Franco-Santos 2000, 48.)

Challenges associated with performance measurement often include misspecifying the performance measure which in the worst case results in employees “gaming the system”. Piece-rate workers, for example, may sacrifice quality for quantity, while managers paid on the basis of annual accounting profits may sacrifice long-run profitability for short-run earnings. (Rynes & al. 2005, 582-583.) Objective measures in a way are easy for managers to justify and evaluate as they do not have to justify their personal assessment of performance in an objective performance-measurement system. Lawler (1971, 171) concluded that “pay plans based on subjective criteria have little chance of success” because employees don’t trust managers to accurately evaluate their performance. Similarly, Hamner (1975, 19) argues that performance-based pay “should, whenever possible, be based on objective . . . rather than subjective measures.” However, since determining solely objective measures is at the same time one of the biggest challenges in performance measurement, it is understandable that companies try to balance the issue by creating multiple performance measures and combining both objective and subjective measures.

But although accuracy and adequate resources in measurement are required, many applied psychologists and management experts feel that the search for a very high degree of precision in measurement is not economically viable in most applied settings. Therefore, according to Milkovich & Wigdor (1991, 150-151), for most personnel management decisions, including pay decisions, the goal of a performance evaluation system should be to support and encourage informed managerial judgment and not to aspire to a degree of standardization, precision, and empirical support that would be required of, for example, selection tests. In this context, informed judgment means that there are demonstrable and credible links between the performance of the individuals being rated and the manager’s evaluation of that performance. (Gibbs 2012, 7.)
In theory, a standardized, objectives-based pay-for-performance system should be a straightforward exercise. It seems logical to set goals, provide feedback about progress during a six- or 12-month cycle, look back at the end of the cycle and agree on whether these goals were achieved, and link an individual’s compensation to the results. By the 1970s, most large organizations adopted a rating system to define employee perfor-

mance, typically ranking people on a 1–3 or 1–5 scale. (Rock & al 2014). Ratings are often are part of a forced-curve review system meaning that certain percentage of employees needs to be delegated to the middle group of performers and a considerably smaller percentage can be placed in the group (best performers) and so on (Sahadi 2015).

In the 1980s, former General Electric CEO Jack Welch popularized the “rank-and-yank” practice of rating employees and weeding out the bottom 10 percent. While that may have worked for a while, critics say it eventually forced managers to get rid of talented people. GE phased out the practice in the mid-2000s, but many companies still use some form of forced ranking in their performance appraisals. (Meinert 2015.)

Although most traditional performance-rating systems involve some kind of scale, whether it’s numerical (the manager ranks an employee on a scale of one to four), or qualitative, such as ‘meets expectations’ or ‘exceeds expectations, asking managers to rank employees based on generic competencies and skills doesn’t tend to give an accurate portrayal of the employee’s value. As a result, some companies are revamping old ratings and aiming at developing ratings that are tied to what you’re doing right and how to get stronger, rather than what you’re doing wrong. (Christensen 2015.)

The decision to eliminate performance ratings has been praised by many, but it does not mean it will be easy. One thing that often remains unclear when company informs they ditch performance ratings is how they will evaluate employee performance going forward us most of these companies do not actually remove performance-based pay or performance reviews altogether. And even if companies claim they’ve done away with annual reviews and rankings, there are often “shadow rankings,” where companies still do effectively the same thing, but more informally, in the background. And if no formal reviews are produced, linking pay to performance in a way that is can even become more challenging than before (Nisen 2015.)

The supporters of removing ratings consider the results of no-rating systems to be better than their rating and ranking counterparts in terms of satisfaction, retention, and engagement scores (Rock & al 2014). The variety of company structures and cultures is enormous and both approaches (ratings or no ratings) may have they place among the variety of organizations. However, no system excels if it is not supported by the company culture that creates trust, management’s ability to lead the system and open communication.

When considering the alternatives to using formal performance ratings as the basis for pay decisions, one option is to give everyone the same pay increment. After all if you are

not appraising performance how can you based pay on performance? This alternative is probably not a valid solution for many in which case organizations need to face the realization that if they're going to base pay on performance then they have to appraise performance one way or another.

There are a few key questions that every company should raise when evaluating and perhaps reinventing their approach to performance evaluations, ratings and performance-based pay:

- **Management must decide what to reward**
  As with any other decision within the company, performance-based pay should support the company strategy and the desired culture. If there are too many goals, the relative value of the various job components can be difficult to establish and having too many goals also violates the basic requirement of a functional PFP system – simplicity. (Glassman & al. 2010, 234.)
- **What to do about pay for truly low and high performers and everyone else?**
  For low performers, the issue isn't really about pay but more about how to improve their performance or help them find more suitable path somewhere else. Even if the pay decision (at best a small pay increment and probably none at all) is clear, there should be a process in place to identify poor performers and to decide what action to take. For high-performers, most likely many agree that high performers should be paid more than low or average performers. But true high performers need to be identified appropriately in order to reward the right people. Finally, companies need to decide how formal they want their performance evaluation to be. In case the main reason for eliminating ratings was to simplify the process to reduce administrational burden, the end result may be not having anything elaborate or formal in terms of how pay decisions are made for this middle group. (Creelman 2015.)
- **The goal of performance conversations**
  Considering the investment in terms of time and resources used, performance conversations should have a clear target and purpose. Lately, conversations aim to evolve from assessing past performance to setting goals, planning growth, and taking action. Conversations about goals have taken on new importance, since they are an important cornerstone of setting clear expectations, especially in a process without ratings. There’s an implicit recognition that performance and engagement are strongest when employees feel supported by a manager’s guidance and coaching and when they have more ownership of the process. (Rock & Jones 2015.)

- **Performance review cycle**
  Timing of performance evaluation has been a major topic within the overall debate on performance evaluations and especially the traditional annual reviews have faced a significant amount of criticism. Irvine (2016) for example suggests using recognition and rewards to far more effectively remunerate employees throughout the year. Setting goals once a year is often out-of-sync with many business cycles and therefore it has been suggested that goals revisited and revised at least quarterly (Sahadi 2015). Managers are also are being urged to use their judgment about a conversation frequency that best sup-ports employee performance. Some companies are also asking direct reports to play a more proactive role in owning the responsibility for scheduling and preparing for performance conversations. (Rock & Jones 2015.)

It might be easy to assume that companies are moving away from ratings in order to eliminate pay-for-performance altogether. According to by David Rock and Beth Jones at the NeuroLeadership Institute, it turns out that in a no-ratings world, pay-for-performance is alive and well. Despite having no simple rating for employee performance, companies are working out how to identify low performers, often using specific language to describe someone who isn't up to standards. High performers are benefiting via the same or even more differentiated pay as a result of compensation going back towards "manager discretion". In short, companies are encouraging managers to get to know their people better through having better-quality conversations about performance, then to differentiate compensation based on their own judgment. (Rock & Jones 2015)

In summary, the existing evidence shows that when there are good performance measures that are fair and transparent, performance-pay can enhance employee productivity and improve match quality. However, the use of performance-pay is constrained by the quality of available performance measures. (Lemieux & et al. 2007, 7; Bevilacqua & Singh 2009, 22). A good evaluation motivates the employee to use his information, expertise, and experience of events as they unfold at work, and so forth to allocate effort and make decisions in ways that promote the company's objective (Gibbs 2012, 9.)

3.4.4 Motivation

As compensation packages become more complex, and with individuals often being incentivized by multiple PFP systems, research needs to examine the real impact of various types of pay plans (Park & Sturman 2012, 83). In their research, Nyberg & al (2013) point out that combining psychological- and economic-based tools presents a novel mechanism for understanding how, when, and why PFP works. The conclusions of their research are

consistent with the idea that instrumentality, valence, and incentive intensity are all factors in directing employees' effort and thus affecting their future performance. Their findings support PFP efficacy, as they show that performance-base pay (both merit and bonus pay) are positively associated with future performance. (Nyberg & al 2013, 23-24.) Similarly Milkovich and Wigdor (1991) found empirical research to indicate that individual incentive plans can motivate employees and improve individual performance. (Milkovich & Wigdor 1991, 153.)

Multiple theories support one or more aspects of the positive effects of pay on future performance. Reinforcement theory posits that employees will continue to exhibit certain positive behaviours when they are rewarded for doing so. Incentive plans that continue to reward certain behaviours consistently over time eventually hard wire certain activities or performance levels into the day-to-day actions of employees. (Bevilacqua & Singh 2009, 22.) Monetary incentives may also motivate people to invest effort to acquire the skills needed to perform a task so that future performance and rewards will be higher than they otherwise would be. This notion of increased effort is referred to as strategy development and consists of conscious problem solving, planning, or innovation on the part of the person performing the task. (Bonner & Sprinkle 2002, 307.)

From an expectancy theory perspective, experience within the PFP system will affect an employee´s perception and expectation of instrumentality, as employees will likely believe that prior experience will be representative of future experience. Similarly, an underlying assumption in the incentive intensity principle is that the strength of the relationship between prior incentives and prior performance will affect the employee's expectations of receiving future rewards. Thus, it is reasonable to conclude that the longer an employee's tenure, the better well-formed her or his attitudes and beliefs about pay practices. Research suggests that even short-term disappointment would ultimately have relatively little influence, as employees with more tenure and subsequent understanding of the pay system will be more likely to see the disappointing outcome as an anomaly. (Nyberg & al. 2013, 9)

Throughout this study, prior literature has proven that performance-based pay is more complex than what might be expected. Research and practice in the area of PFP requires one to deal with a number of trade-offs and conundrums. Strengthening PFP links can generate powerful motivation effects, but sometimes towards unanticipated and undesirable directions. Similarly, the relative emphasis given to results-based and behavior-based measures of performance may contribute to too much or too little focus on certain perfor-

mance objectives. The relative emphasis given to individual and group/organization performance in PFP plans may be beneficial for some objectives, but detrimental to others. Therefore, as in other areas of management, one best way advice (e.g., do or do not use individual PFP plans) or simplified conclusions (e.g., pay does or does not motivate) are rarely valid, but rather depend on the circumstances. (Gerhart & al. 2009, 5.)

According to Alfie Kohn (1993) argues that even if people were principally concerned with their salaries, this does not prove that money is motivating. According to him there is no firm basis for the assumption that paying people more will encourage them to do better work or even, in the long run, more work. Although it is reasonable to assume that if someone's take-home pay was cut in half, his or her morale would suffer enough to undermine performance. But it doesn't necessarily follow that doubling that person's pay would result in better work. (Kohn 1993.) In his article "Incentives can be bad for business" (1998), Kohn offers three reasons why incentive systems are counterproductive; First, rewards encourage people to focus narrowly on a task, to do it as quickly as possible, and to take few risks. Second, extrinsic rewards can wear down intrinsic interest and third, people come to see themselves as being controlled by a reward. (Kohn 1998.)

A second group of performance-based pay critics argue that, while financial incentive schemes improve productivity in principle, in practice they induce significant adverse side effects that are costly to employee morale and productivity. The costs of dealing with many of the problems induced by merit systems simply outweigh the limited organizational benefits they offer. Among the side effects often mentioned are horizontal equity concerns, and problems associated with imperfect performance measurement. In his article "How to ruin motivation with pay" Hamner (1975) argues that merit systems decrease motivation because managers systematically mismanage pay-for-performance programs. Aggressive pay-for-performance systems ultimately involve distinguishing workers on the basis of their performance, and critics often refer to behavioral literature arguing that treating employees differently from each other is detrimental to employee morale (Baker & al. 1988, 5-6.)

Kohn (1993) also points out that not receiving a reward one had expected to receive is also indistinguishable from being punished. Whether the incentive is withheld or withdrawn deliberately, or simply not received by someone who had hoped to get it, the effect is identical. And the more desirable the reward, the more demoralizing it is to miss out. According to Kohn, rewarding people for doing something right is not very different from identifying people doing something wrong and threaten to punish them if they do it again.

Ultimately, Kohn argues, managers are creating a workplace in which people feel controlled, not an environment conducive to exploration, learning, and progress. (Kohn 1993)

As incentive plans are often tied to the overall performance of the company, there is a risk that especially in difficult economic times, compensation budgets may be decreased or even cut midperiod, resulting in unanticipated changes or eliminations of plans and an overall distrust by all of those involved in participation or administration of the systems (Bevilacqua & Singh 2009, 22). In this sense Kohn's arguments on the demoralizing effects of incentives is justified but a pay system that is well understood, clearly communicated and considered to be fair by all stakeholders should hopefully manage expectations in a way that short-term disappointment would not undermine future performance.

While much of the research on pay-for-performance focuses on whether or not such pay method can or cannot affect positively on employee performance, some studies have also focused on the possible differences between different pay plans (for example between merit pay and bonus).

Expectancy theory suggests that a compensation plan with a greater link between employee performance and rewards should motivate employees to perform better. This supports conventional wisdom that, in general, how you pay matters. But managers should not blindly think that employees don't really care about how much they get and instead simply only want a fair pay system. Different types of pay plans provide different types of rewards, and according to Park & Sturman (2012) as well as Nyberg & al (2013), employees appear to respond differently to these awards based on their value.

However, interestingly there are differences in the conclusions made in earlier research on the perceived value of different compensation elements, especially merit pay and bonus (or other one-time pay). Typically, bonuses are fully allocated to the employee shortly after the year in which the bonus-earning performance was assessed. While the employee possesses the entire bonus early in the following year, an employee earning a merit increase receives relatively small increments over the course of the following year, fully acquiring the merit increase only at the end of the second year. (Kahneman et al., 1990.)

Traditional economic rationale (e.g., the incentive intensity principle) suggests that employees should be more motivated by merit increases than by bonus pay. The expectation is that people rationally understand and act upon what is in their long-term best interests. However, according to Nyberg & al (2013) substantial research now indicates that actors often do not act as economically rational regarding their long-term economic outcomes, as had long been assumed in traditional economics models. (Nyberg & al. 2013, 8.) Because

the perceived value of a good instantly increases when the good is obtained the endowment effect suggests that employees may value bonuses more than an equivalently sized merit increase because unlike merit pay, bonus is fully obtained in the year in which it is designed to motivate performance. This increased value, as valence in expectancy theory, translates to greater motivation to perform. (Kahneman et al., 1990.)

Employees may also become more accustomed to salary increases spread across pay periods, or may perceive these two components (merit pay and bonus) differently in terms of organizational obligations. Employees may view merit pay as a common obligation that should be fulfilled, whereas bonus pay may be seen as a reward that needs to be earned yearly. In addition, the one-time bonus may give employees a more vivid goal to strive toward. Although an equivalent dollar value ought to be valued more by an employee when delivered via merit pay, due to the potential for compounding the increase in future periods employees may not respond as expected. There are naturally limitations to these research. For example, results may be partially driven by the size of PFP or relationships between different pay components can be influenced by job complexity. (Nyberg & al. 2013, 25-26.)

According to Park & Sturman (2012) both (a) the degree to which the reward links pay and performance and (b) the financial characteristics of the reward influence the effectiveness of a PFP plan. Consequently, all PFP plans are not equal. Their research results indicates that the effects of PFP for all three plan types (merit pay, bonus and long-term incentives) are positive. (Park & Sturman 2012, 83.) However, the amounts of different pay elemtns studied were relatively low (e.g. 1% raise compared to 1% bonus) and therefore further analysis would be needed to understand whether the results would be different in case the payout amounts were higher. For example, in their report “Using Targeted Incentives to Drive Sustainable Engagement”, TowersWatson argue that the impact of pay for performance on enablement and sustainable engagement is more pronounced in employee groups with higher bonus targets Many employees are not in positions where bonuses and other forms of incentive compensation represent a significant portion of their pay; for these employees, the overall effect of incentives on sustainable engagement is very limited. However, for employees with bonus targets greater than 15% of their base pay, pay for performance is the fourth most important driver of sustainable engagement (TowersWatson 2013, 3.)

Variety of theories supporting and criticizing extrinsic rewards suggests that the role of PFP as a motivator is complex and challenging. But whether a company used variable pay or not, Daniel Pink emphasizes that the baseline rewards have to be adequate and

equitable; otherwise the employees focus will be on the unfairness of the situation and anxiety of her circumstance (Pink 2009, 33). It is therefore important to remember that pay-for-performance is only one aspect of total employee compensation and thus the effects of variable pay plans will depend in good measure on this larger compensation context. (Milkovich and Wigdor 1991, 152.)

Money is not the only motivator and it is not the primary motivator. However, there is overwhelming evidence that money is an important motivator for most people. Further, there is ample evidence that surveys asking people to rank order money and other motivators do not accurately reflect the important effects that changes in pay levels or the way pay is determined actually have on people's decisions to join and leave organizations. Likewise, the often modest survey rankings are in conflict with behavioral evidence on the effects that monetary incentives have on the goals that people choose to pursue within organizations and the effort and commitment they exert toward those goals. Thus, while managers will (and should) consider both financial and nonfinancial tools for attracting, motivating, and retaining employees, it would be a mistake to conclude, based on general surveys, that monetary rewards are not highly important. (Rynes & al. 2004, 392.)

The success and failure of pay-for-performance compensation often depends on multiple factors and the environment it is being used in as well as other organizational processes and policies. According to De Silva (2012) it is essential to pay attention to aspects which are equally - perhaps even more - important than the rewards themselves, such as:

- reorganization of work processes
- training
- employee involvement and participative decision-making
- opportunities to contribute ideas and knowledge
- non-monetary recognition
- career development
- goal setting

(de Silva 2012, 10-11.)

OECD's report "Performance-related Pay Policies for Government Employees" (2005) emphasizes that performance-based systems should be used in an environment that supports employment build on trust. Such environment has a balance between formal and informal processes, constant dialogue, culture that enables sharing of information, negotiations, transparency and mutual respect. (OECD 2005, 6.)

3.4.5 Trust and fairness

Perception of fairness and justice is essential in compensation and can affect how satisfied employees are about their pay and the overall compensation system. In general, perception of fairness also affects employees' general commitment, work satisfaction and well-being. While perception of fairness and justice is in principle a subjective experience of a person, researchers have identified 3 types of fairness that can affect this experience: fairness of distribution, fairness of procedures and fairness of interaction. (Moisio & al. 2009, 37.)

Organizations want their pay systems to be viewed as fair by multiple stakeholders: employees, managers, owners, and top management as well as by unions, associations, and regulatory agencies and the public. Theories of organizational justice distinguish between distributive and procedural justice. The former predicts that the employee judges the fairness of pay level or pay raises in comparison with other people or groups considered similar in terms of contribution. Theories of procedural justice link employees' job satisfaction to their perceptions about the fairness of procedures used to design or administer pay, for example, the fairness of performance evaluation or the availability of mechanisms for appealing pay decisions. However, research examining distributive and procedural fairness theories in real-world pay contexts is scarce; there are no studies that can directly answer questions about the perceived fairness of different types of pay-for-performance plans. The existing research does however suggest that employee perceptions of fairness with regard to pay distributions and the design and administration of pay systems does affect their job satisfaction, their trust of management, and their commitment to the organization. (Milkovich & Wigdor 1991, 154-155.)

The overall fairness of the pay system as well as the capabilities of evaluators (often managers) the implementation and execution of a PFP system can impact the employee's experiences fairness (Glassman & al. 2010, 234). Trust is a fundamental requirement for a successful performance evaluation. Economic theory is founded on the assumption that individuals are self-interest, therefore an employee will trust his superior to take particular action (e.g., perform a careful evaluation) if he or she knows it is in his or her superior's self-interest to take the action. There is no well-developed economic theory of trust, but at its core trust is a set of beliefs about the accuracy, honesty, and length of horizon of an individual, and the predictability and reliability of his or her future actions. (Baker & al. 1988, 7-10.)

Beer & Cannon (2004) have specified the following barriers that can complicate efforts to link pay to performance in a manner perceived as fair and equitable by management and employees:

- Measurement of performance is very difficult, especially when small differences exist or fine distinctions are being made.
- Performance is affected by factors outside the control of individuals and groups being paid for that performance.
- When performance evaluation is based on judgment, managers (or peers) do not like to differentiate between employees, fearing damaged relations and de-motivation.
- Employees come to rely on the additional compensation that comes from pay-for-performance systems but perceive the system as unfair when it stops paying off.
- Employees compare their pay to others in making judgments about fairness of pay.
- Company's budget for incentives often limit payout. Therefore, payout amounts may not be seen as consistent with performance outcomes obtained.
- If contingent pay systems pay out more than management expected, company may lose commitment to the pay system, limit payouts or discontinue the system.
- Changes in performance standards due to changing technology, unanticipated learning curves, and changing circumstances cause perceptions of inequity and may reduce the perceived link between pay and performance.
  (Beer & Cannon 2004, 4-5.)

Considering the role of trust in running an effective pay-for-performance system it is also important to train managers not just about pay-for-performance in terms of goal setting or compensation policy, but in understanding the importance of trust as well (Creelman 2008, 9). The fear of employees experiencing performance evaluations or the overall pay system unfair, may lead managers to avoid rating employees as low or high performers, but rather rate most of the employees in the middle. This might also be affected due to the fact that rating someone in bottom or top group often requires additional justification or further actions from the manager. (Rock & al 2014.) Evenly spread compensation definitely alleviates the short-term pain of having to hold difficult conversations with employees or attempting to ensure assessment calibration across all reviews in an organization. However, the long-term effect is that top performers may lose motivation in their performance as they see their results rewarded in much the same way as lower-performing coworkers. (Oracle 2012, 3.)

Renewed performance review systems that now focus more on manager judgement and simplicity do seem friendlier and more streamlined at first glance. Lately, though, companies and researchers have drawn attention to another problem with performance reviews - one that may not be addressed appropriately in the new systems. Data shows that all kinds of personal quirks and biases, both conscious and not, influence our appraisals of other people. These prejudices, which are sometimes collectively referred to as “the idiosyncratic rater effect,” influence how managers think about and describe their employees. Studies suggest that more than half of a given performance rating has to do with the traits of the person conducting the evaluation, not of the person being rated. Organizations need to make sure their performance-evaluation process attempts to minimize bias and this often requires collecting more, not less, information and documentation, and having more, not fewer, people weigh in on an employee. Increased subjectivity in the new way companies review and compensate employee performance is somewhat in conflict with the requirement to reduce bias. (Vara 2015.)

Employers who track employee engagement or other similar satisfaction levels within their organizations often carefully monitor their staff’s perception of the fairness of the organizations’ policies and practices. Such organizations have often draw links between their positive employee engagement scores and decreased employee turnover, improved customer satisfaction and even increased financial performance. These employers believe that it is important for their employees to perceive that they are fair in their practices, including those related to compensation. Thus, from an equity perspective, pay-for performance plans may enhance employees’ perceptions of fairness by providing greater rewards to those employees who have expended greater efforts. (Bevilacqua & Singh 2009, 22.)

Organizations should aim at convergent evaluation of the job difficulty in order to guarantee equal pay. But equality in pay does also include equivalent job performance, meaning that better qualification (know-how) and performance should lead to higher reward. (Ikävalko & al. 2011, 62.) Fairness therefore does not necessarily mean equal absolute pay level but it’s more about the relative pay level within certain peer group. According to Hulkko-Nyman and Maaniemi (2016), Finnish employees consider job difficulty and performance as fair basis of pay. As long an employee considers his or her pay to be fair, inner motivation should suffer either. Companies should therefore be conscious about what fair and equal treatment means in their organization and ensure their management is able to execute and communicate the PFP system appropriately.

3.4.6 Costs and funding

Organizations use incentive programs to accomplish multiple objectives. Incentives enable companies, often in slow growth markets, to shift some of their fixed compensation costs to variable pay programs. Salaries and benefits represent fixed costs and in order to reduce these fixed costs in down times organizations may have to reduce the head count. In contrast, short- and long-term incentives tied to company performance represent variable costs. Because these incentive payouts typically decrease during tough times when a company's business is under pressure, they help to stabilize cash flow and reduce a company's cashflow volatility. (TowersWatson 2013, 2)

Cost efficiency in PFP plans is not automatic, especially when adding a PFP component with no reduction to base salary carries a risk of the plan not delivering expected results and thus just adding cost. (Gerhart & al. 2009, 41-42.) Since most employees are at least somewhat risk averse, many employers end up offering some sort of risk premium — that is, offering bonus plans that have a slightly higher expected payout than the incremental base pay they would need to provide. In order for this type of investment to have a positive return on investment (ROI), the use of incentive compensation has to accomplish its intended objectives, which can include improving employee engagement. But as long as a company cannot establish a clear link between pay-for-performance and employee engagement, it will not be able to gauge whether or to what extent its investments in incentive programs are paying off. (TowersWatson 2013, 2.)

It is safe to say that PFP systems fail when there isn't enough money to meaningfully reward all high performers. "Having enough money" includes the ability to provide meaningful rewards on an ongoing basis, provide the necessary resources and training to achieve performance goals, and provide training for those who will evaluate employees and administer the PFP system. PFP systems are more expensive when highly paid employees are involved. Whatever method is used to determine the reward, the amount should be noticeable in the paycheck and should give the employee greater purchasing power. The reward should be related to effort and accomplishment and therefore, the higher the performance goal, the more expensive the program. Furthermore, to be effective, a PFP system must be funded on an ongoing basis. If the bonus is reduced or eliminated, employees may see this as a pay cut. (Glassman & al. 2010, 233.) This is a risk with PFP as the main objective of such plans is often to adjust payouts according to overall company performance but in such case it faces the risk of employee disappointment. As discussed already earlier in this study, companies should try to prevent such negative reactions by open communication, employee engagement and by managing expectations.

Even if an organization has decided on the overall PFP budgets and HR has issued guidelines for increments or bonuses that are based on the performance rating and position in the pay range, managers usually wants a lot more data than that when making pay decisions. Person's salary and performance history and how their pay compares to that of other people in the group are all factors to consider. Managers should aim at distributing the money in a way that is fair considering all possible factors while making sure they are not going over budget or violating guidelines. Therefore a way to view data and try different options for adjusting employees' compensation is needed and future technology should focus on providing such possibility. (Creelman 2008, 3.)

3.4.7 The unintended consequences of pay-for-performance

Previous research shows that performance related pay generates increased effort and productivity at work. However, it may also generate a series of unintended consequences. (Bender & Theodossiou 2013, 21-22.) Money is a very powerful motivator and so powerful in fact, that one of the main challenges for companies is to make sure that their compensation systems are not motivating the wrong kinds of behaviors (Rynes & al. 2005). Baker & al (1998) also argue that "careful examination of the criticisms of monetary pay-for-performance systems indicates not that they are ineffective but rather that they are too effective: strong pay-for-performance motivates people to do exactly what they are told to do." According to them, large monetary incentives generate unintended and sometimes counterproductive results because it is difficult to adequately specify exactly what people should do and therefore how their performance should be measured. Understanding the counterproductive effects of strong monetary rewards is indeed useful: it focuses attention on how these unintended effects are generated and on their importance, rather than on arguments about whether people are motivated by money. (Baker & al. 1988, 7.)

3.4.7.1 Quality and ethics

Theories and empirical research generally concur that stronger PFP links increase motivation and performance. However, there are at least two offsetting disadvantages to strong PFP relationships: They may (a) worsen problems having to do with risk aversion and (b) be more prone to deficiency in performance measures (e.g., paying for quantity of production without adequate attention to quality). (Rynes & al. 2005, 584.)

Research has shown that using highly specific individual performance evaluations and incentives with jobs that are complex, interdependent, and have multiple and unstructured goals can result in employees ignoring important aspects of their jobs or distorting performance in order to meet the goals set (Milkovich & Wigdor 1991, 158-159.; Glassman & al.

2010, 235; Gerhart & al. 2009, 41). Adverse specialization can occur when workers perform only those aspects that are rewarded, while ignoring other aspects that are not. Thus, workers may stress quantity over quality or overuse physical capital in order to increase production. These unintended consequences of performance pay schemes have led some researchers to question whether these schemes actually increase profitability, despite the fact that they may increase worker productivity. (Bender & Theodossiou 2013, 3.)

EY's Global Fraud Survey on corporate misconduct (2016) revealed that 36 % of respondents, mainly CFOs and finance team members, appeared ready to justify unethical conduct when under financial pressure. This raises the concern that certain compensation arrangements could encourage such behavior. Therefore, when planning sustainability-related compensation schemes for example to executives, it is important to ensure that the criteria used for performance evaluation is well-managed and monitored. (EY 2016b, 13.) According to Milkovich & Wigdor, gaming is a particular danger with objectives-based appraisal systems while group incentives avoid some of the problem by recognizing the interdependent nature of work and focus on organization-level performance. However, group-based incentives suffer from unclear links between individual actions and organization-level results. (Milkovich & Wigdor 1991, 158-159.)

According to Daniel Pink, like extrinsic motivators, goals narrow our focus. While that can also make goals effective – by concentrating the mind – they can restrict our view of the broader dimensions of our behavior. The problem with focusing too much on the extrinsic reward, Pink states, is that some people will choose the quickest route, even if it means unacceptable behavior or actions. And even though goals and extrinsic rewards are not inherently corrupting and goals that individuals set for themselves to attain mastery are usually healthy, it is often the goals imposed by others that can sometimes have negative side effects. (Pink 2009, 48-49.)

Employee rankings may also prevent people from talking honestly to their managers. Many corporate scandals might have been prevented if employees hadn't been afraid to speak up. This may have an effect on the research results according to which employees' scores often aren't accurate reflections of their performance and only one-third of the employees who get the highest score in their performance review are considered organizations' top contributors. (Meinert 2015.)

3.4.7.2 Teamwork and relationships

Relationships among employees can be casualties of the scramble for rewards. According to Kohn (1993), the surest way to destroy cooperation and, therefore, organizational excellence, is to force people to compete for rewards or recognition or to rank them against each other. Glassman & al (2010, 233-234) also point out that if a job requires teamwork, yet employees are rewarded based on individual as opposed to group output, then workers are more likely to maximize their own performance rather than be concerned about team performance and goals. This can lead to a drop in morale and jealousy and conflict among team members may increase.

In her doctoral dissertation, Hulkko-Nyman (2016b, 167) hypothesized that “a results-oriented pay system that appraised as fair important, and fits well with the organizational goals and is known by the respondents would have a positive influence on co-operation.” The results of her study show that fairness has a significant relationship with co-operation. This indicates that careful implementation and management of performance-based pay could lead to positive results. But understanding the possible effects on teamwork and co-operation is crucial, especially if both are required and preferred outcomes of a PFP system.

3.4.7.3 Effects on employee health

One of the unintended consequences generated by performance-based pay might be on the health of workers, although there is not a lot of empirical research available on this. A study by Bender & Theodossiou (2013) found that increasing the time in which employees’ pay comprises at least in part of performance pay generates higher odds of falling into bad health – either measured by subjective health or along one of three physical health dimensions. (Bender & Theodossiou 2013, 21-22.) Their results are robust to variations in variables or estimation procedure but similar findings have been reported also by the NeuroLeadership Institute. According to David Rock, director of the NeuroLeadership Institute, labeling people triggers a “fight or flight” response similar to what happens when one’s life is being threatened by. Rock has identified five factors that can have a significant negative effect on human emotion:

- Status. Am I considered better or worse than others?
- Certainty. Am I certain my hard work will get me a higher rating?
- Autonomy. Do I have any control over what will happen?
- Relatedness. How do I make myself look better than others?
- Fairness. Am I being treated fairly?

Most performance ranking systems prompt a strong negative reaction in at least four of the above areas, which can lead people to feel demotivated instead of motivated, in part because humans are social beings who crave the approval of others. Other research shows that rankings encourage a “fixed mindset,” which inhibits learning, as opposed to a “growth mindset,” which refers to the belief that people continue to learn and grow throughout their lives. But managers can minimize employees’ anxiety by learning how to make people feel comfortable enough to open up and by helping employees develop their own insights. Instead of telling employees what to do, managers should help them make their own connections. (Rock 2015.)

3.4.7.4 Creativity

A special aspect of how incentives match job design is motivation of creativity. Psychologists argue that pay-for-performance undermines creativity (Kohn 1993) but to an economist, such a claim seems strange. According to Gibbs (2012), when used properly, incentives do not necessarily undermine creativity but a distorted performance measure can do that. For example, rewarding a professor for the quantity of published articles can distort incentives toward publication in low-quality journals. Most examples of incentives undermining creativity stem from distorted numeric measures so where creativity is important, a company should consider broader, output-based measures and subjective evaluation. (Gibbs 2012, 24-25.)

According to Pink (2009, 64) a delicate use of rewards may enable performance boost for the future tasks. But extrinsic reward should be unexpected and offered only after the task is completed in order not to negatively affect creativity. Informational feedback and non-tangible rewards should also be considered as a means of promoting creativity and future performance.

Teresa Amabile, professor at the Harvard Business School has tested the effects of contingent rewards on the creative process. Amabile and others have found that extrinsic can be effective for algorithmic tasks (task that depend on following an existing formula to its logical conclusion. But for tasks that require more the use of the right side of the brain (tasks that demand flexible problem-solving, inventiveness or conceptual understanding) contingent rewards can be harmful. Amabile and her colleagues did however find that when used properly and carefully, extrinsic motivators can be conducive to creativity. In her study, artists that considered their commissions as enabling instead of restraining, their creativity increased as evaluated by the panel of experts. Enabling in this sense means that the commission made it possible for the artists to do something interesting or exciting. (Amabile 1996, 119.)

Creativity requires experimentation with new methods, which implies mistakes. Reducing the employee's downside risk from mistakes will counteract employee risk aversion, leading to more willingness to experiment (Gibbs 2012, 24-25.) While performance at work often require avoiding risks, certain level of risk might need to be accepted to enable innovation. Many companies have also introduced specific incentives for tasks requiring innovation, such as research and development or even specific rewards for innovations leading to patents. What kind of incentives should be used to motivate innovation depends on the organization. Before, R&D personnel were often left outside general compensation plans as determining rewards suitable for their work was considered too difficult. The special characteristic of innovative tasks may create challenges to incentive design but should not differentiate employees in a negative way. (Moisio & al 2009, 83.)

4 Research process

4.1 Research methodology

Research methodology is a systematic way to solve a problem, a science of studying how research is to be carried out. Essentially, the procedures by which researchers go about their work of describing, explaining and predicting phenomena are called research methodology. It is also defined as the study of methods by which knowledge is gained. (Rajasekar & al. 2013, 5.)

Saunders, Lewis and Thornhill. (2012, 128) represent the research methodology in the form of an onion (Figure 4). In the research onion approach, the researcher starts making research choices from the outer layers moving towards the core, where lies the actual research problem.

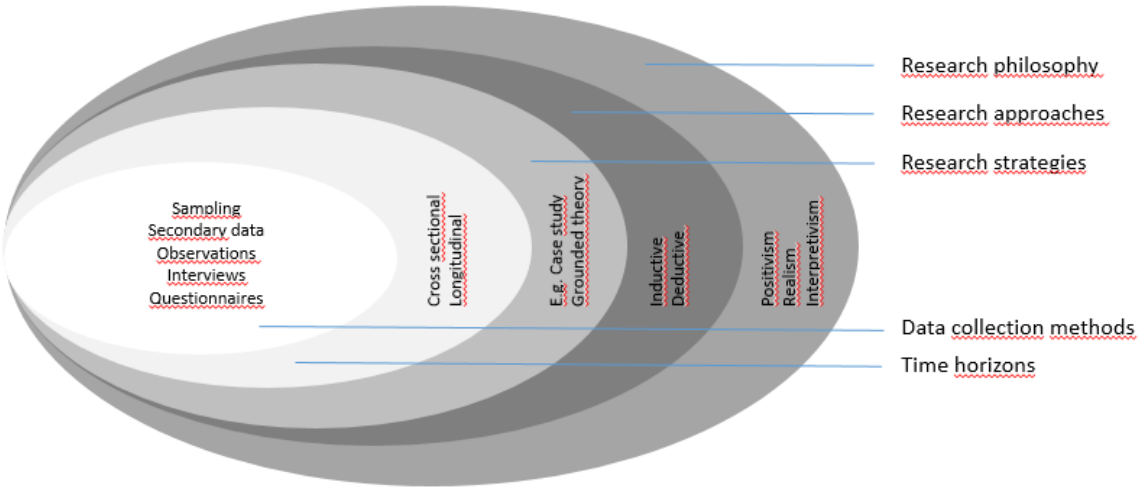

Figure 4. The research onion. Modified from Saunders & al. 2012, 128.

This research applies the qualitative research method. Qualitative research is a type of scientific research which, in general terms, consists of an investigation that:

- seeks answers to a question
- systematically uses a predefined set of procedures to answer the question
- collects evidence
- produces findings that were not determined in advance
- produces findings that are applicable beyond the immediate boundaries of the study

(Mack & al. 2011, 1)

Qualitative research approach was selected for this study mainly because quantitative approach assumable would not provide the possibility for an in-depth analysis, considering

the nature of the subject. Furthermore, it is expected that quantitative data might not provide sufficient way to discuss and analyze the subject unlike qualitative approach which is expected to be more suitable approach in terms of data and research methods.

Qualitative research shares the above-mentioned characteristics. In addition, it seeks to understand a given research problem or topic from the perspectives of the local population it involves. Qualitative research is especially effective in obtaining culturally specific information about the values, opinions, behaviors, and social contexts of particular populations. (Mack & al. 2011, 1.) Broadly defined, qualitative research means "any kind of research that produces findings not arrived at by means of statistical procedures or other means of quantification" (Strauss and Corbin 1990, 17). Unlike quantitative researchers who seek causal determination, prediction, and generalization of findings, qualitative researchers seek instead illumination, understanding, and extrapolation to similar situations (Hoepfl, 1997).

Sincovics et al. (2005, 11) suggests five research purposes for which the qualitative research is particularly useful in

1. understanding the meaning of events;
2. understanding the particular context
3. identifying the unanticipated phenomena;
4. understanding the processes by which the events and actions take place; and
5. developing causal explanations.

In qualitative research the data is typically gathered from a smaller sample with a discretionary sampling by using semi-structured, in-depth or group interviews, but also by using questionnaires. The intention of the interview is to ask concise and unambiguous questions to which the interviewee is willing to answer and the interviewer is able to establish rapport, in the aim of gathering valid and reliable data that is relevant to the research question(s) and objectives. (Eskola & Suoranta 2005, 60-61; Saunders & al., 162-163, 372.)

4.2 Ontology, epistomology and the research approach

According to Saunders et al. (2012, 130-132) ontology is about what is true (nature of reality) and epistemology is about methods of figuring out those truths (relationship between the researcher and reality). Ontology has two aspects, objectivism and subjectivism. In objectivism the social actors are considered as external and the researcher and the people researched are considered as objective and independent whereas in subjectivism the

social phenomena are created from the perceptions and consequent actions of social actors. As the personal perceptions and social actors of the people involved in the study will be present, the ontological aspect will be subjectivism.

Epistemology consists of pragmatism, interpretivism, realism and positivism. According to Saunders et al (2012, 129) different research philosophies are suited for achieving different things, and it all depends of the research question that the researcher aims to answer. Interpretivism focuses on the value of interpretation when creating knowledge and advocates that it is crucially important for a researcher to understand the differences between humans as social actors. In this research, the goal is to understand and interpret the meanings in human behavior rather than to generalize and predict causes and effects and therefore the research philosophy in epistemology is interpretivism. It is also argued that interpretivism suits best to the business situations because the situations are unique and complex in nature and it might be impossible to generalize the situations because they are caused by a particular set of individuals and circumstances. (Saunders et al. 2007, 106.)

4.3 Research method, confidentiality and data collection

The purpose of research interviews is to explore the views, experiences, beliefs and/or motivations of individuals on specific matters. Interviews are, therefore, most appropriate where little is already known about the study phenomenon or where detailed insights are required from individual participants. (Silverman, 2000.)

Research methods are the various procedures, schemes and algorithms used in research. All the methods used by a researcher during a research study are termed as research methods. They are essentially planned, scientific and value-neutral. They include theoretical procedures, experimental studies, numerical schemes, statistical approaches, etc. Research methods help us collect samples, data and find a solution to a problem. Particularly, scientific research methods call for explanations based on collected facts, measurements and observations and not on reasoning alone. They accept only those explanations which can be verified by experiments. (Rajasekar & al. 2013, 5.)

Semi-structured interviews consist of several key questions that help to define the areas to be explored, but also allows the interviewer or interviewee to diverge in order to pursue an idea or response in more detail. The flexibility of this approach, particularly compared to structured interviews, also allows for the discovery or elaboration of information that is important to participants but may not have previously been thought of as pertinent by the research team. (Britten 1999, 11-19.)

The interviews were conducted as semi-structured interviews. This interview method allows the interviewee to certain freedom to express their views in their own terms and also gives a possibility for two-way communication. Semi-structured method can provide comparable and reliable qualitative data but the interview questions need to be carefully planned to avoid leading the interviewee. (Cohen & Crabtree, 2006.)

In total six persons were interviewed for this research. The interviews were conducted over the phone and recorded to ensure interview data can be validated afterwards. The people invited to participate in the interviews were chosen together with the sponsoring company and they all represent high-level of expertise from the field of compensation and benefits. Interview invites were sent by email with an introduction to the research subject and the interview questions (appendix 3). The decision to attach the interview questions already in the invite was made to enable the interviewees to prepare for the questions in order to save their time and ensure the interview does not exceed one hour as promised in the invitation.

It is crucial to ensure confidentiality thought the research process. In this research interview data is analyzed anonymously and no personal or company information of the interviewees will be included in the report. Personal experiences and the current place of work assumably affect the opinions of the interviewees which is not viewed as a negative issue in this research. While the literature review of this research focuses on more neutral views and earlier research, the purpose of the empirical part of the research is to understand the personal views of the people who have extensive experience from the research subject and how the research problem possibly affects their everyday work.

4.4 Validity and reliability

Both validity and reliability need to be assessed to ensure good quality in research. The concept of validity is described by a wide range of terms in qualitative studies. This concept is not a single, fixed or universal concept, but “rather a contingent construct, inescapably grounded in the processes and intentions of particular research methodologies and projects” (Winter, 2000, 1). Validity evaluates how well the methods used for data collection measure the matters that they were intended to measure and whether the research findings actually respond to the research question. (Saunders et al. 2012, 684.)

To ensure validity, the research methodology was chosen by taking into consideration the nature of the subject and the interview questions were carefully considered to ensure the interview data actually helps to answer the research questions.

According Saunders & al. (2012, 192) reliability consists of the consistency of the findings from the data collection techniques and analytic procedures as well as the repeatability of the results. There are several possible threats to the reliability and to avoid these the researcher must seek ways to be methodologically rigorous in the way the research is planned and implemented. The research process must be clearly thought through and evaluated and it must be made sure that there are no false assumptions made nor does it contain logic leaps.

The similarity of the answers from the respondents and the linkage found between these answer and the theories discussed in the literature review indicate that the research results can be considered as reliable. However, as the interview data is based on the personal views of the respondents, repeatability of the empirical study cannot be guaranteed and it is possible that the results could slightly differ if the same interview questions were asked at another time.

5 Findings

In this chapter I discuss the research findings from the empirical study. Six semi-structured telephone interviews were conducted during March and April 2017. The interview questions were decided in advance and they were also sent to the participants prior to the interview. All participants are highly experienced in the field of compensation and benefits and the aim was to hear their personal experiences on performance-based pay, its possible challenges and benefits as well as best practices. All participants currently work with tasks related to compensation and/or employee performance, most of them in global positions. The participants represent 3 different nationalities; Finland, Sweden and the United Kingdom.

All participants were provided the same background information on the research subject and asked the same questions during the interview. The interview questions were divided into 3 sections; Respondent's professional background (1 question), use of pay-for-performance (4 questions) and measuring and evaluating employee performance (4 questions). Although all interviews were structured similarly and same questions were asked from all participants, there was also a possibility to continue the discussion on the subject also outside the pre-determined interview questions.

Analyzing interview data can be challenging. Considering the research subject, the aim of the empirical study and the nature of the interviews, the main challenge was to decide on the best way to analyze the interview data. A matrix of the key points was used to analyze questions 2-9. Responses to each question are further analyzed by describing the issues discussed in the interviews and by comparing the results to the theoretical background of this research. In addition, a word cloud analysis was used for questions 2-9 to demonstrate the themes, key words and issues discussed during the interviews. Although word cloud is a useful tool in recognizing key words and their frequencies, certain limitations need to be considered as world cloud for example does not recognize reverse meanings.

Question 1. How many years in total you have worked in compensation and/or HR related tasks?

The interview included only 1 question about the respondents' background. Although it is natural that the respondent's current work environment affects their views and opinions, the purpose of the interview was not to gather information on the company practices as such, instead focus on the respondents personal views on the subject.

The only background question focuses on the respondent's experience in HR and/or compensation related tasks and the average time the respondents have worked with HR/compensation related tasks is over 16 years.

Table 2. Respondents' professional background.

Theme	***Respondent's professional background***
Question	1. How many years in total you have worked in compensation and/or HR related tasks? (years)
Interviewee 1	28
Interviewee 2	11,5
Interviewee 3	12
Interviewee 4	19
Interviewee 5	12
Interviewee 6	18

Question 2. In your opinion, what kind of role performance-based pay has/should have in the overall pay-mix?

Table 3. Key point matrix for question 2.

Theme	***Use of pay-for-performance***
Question	2. In your opinion, what kind of role performance-based pay has/should have in the overall pay-mix?
Interviewee 1	Variable pay. Lack of incentives should be compensated by higher base-salary. Cost efficiency. Important role. Supports coaching. Has motivational effect. If one pay component smaller, another component should be higher. Sharing profit. Symbolic value.
Interviewee 2	Two-folded: should differentiate pay size depending on performance. Should allow high performers to be rewarded higher but should also allow low performance (by employee or the company) to lead to lower pay. In case of functions where extra performance is visible in the results, variable pay is usually required to reward the performance. In favor on having some kind of variable pay structure. Cost perspective: variable pay enables managing cost.
Interviewee 3	Necessary, relevant.

Interviewee 4	Necessary, relevant. Important for differentiation.
Interviewee 5	Significant (important). Can be administratively easier. Companies are getting quite good with handling PFP. People are used to variable pay. Everything related to compensation creates feelings. People's understanding on PFP is has gotten better.
Interviewee 6	The portion of PFP depends on the role or position and how easy it is to recognize individual's role in the overall results. It can be difficult to find connection to performance especially in some specialist positions. However, hard to recognize jobs where PFP would not exist.

Question 2 focused on the general opinions on performance-based pay as a compensation element. The respondents considered performance-based pay to be a useful and necessary compensation element. However, the usability of performance-based pay and the proportions of PFP in the total compensation depends on the employee's position and whether or not the individual's performance is recognizable. In such cases base pay might be adequate form of compensation.

Most respondents connect PFP to variable pay and some also pointed out that PFP can be a way to share profit among employees but can also have symbolic value. PFPs role in differentiating employees based on their performance is also an important factor and this is also in-line with the results of the literature review. Some respondents also mentioned the role of PFP, especially variable pay, in creating cost efficiency. Variable pay can be linked to company performance enabling flexibility in payouts in case the financial results of the company does not meet the targets.

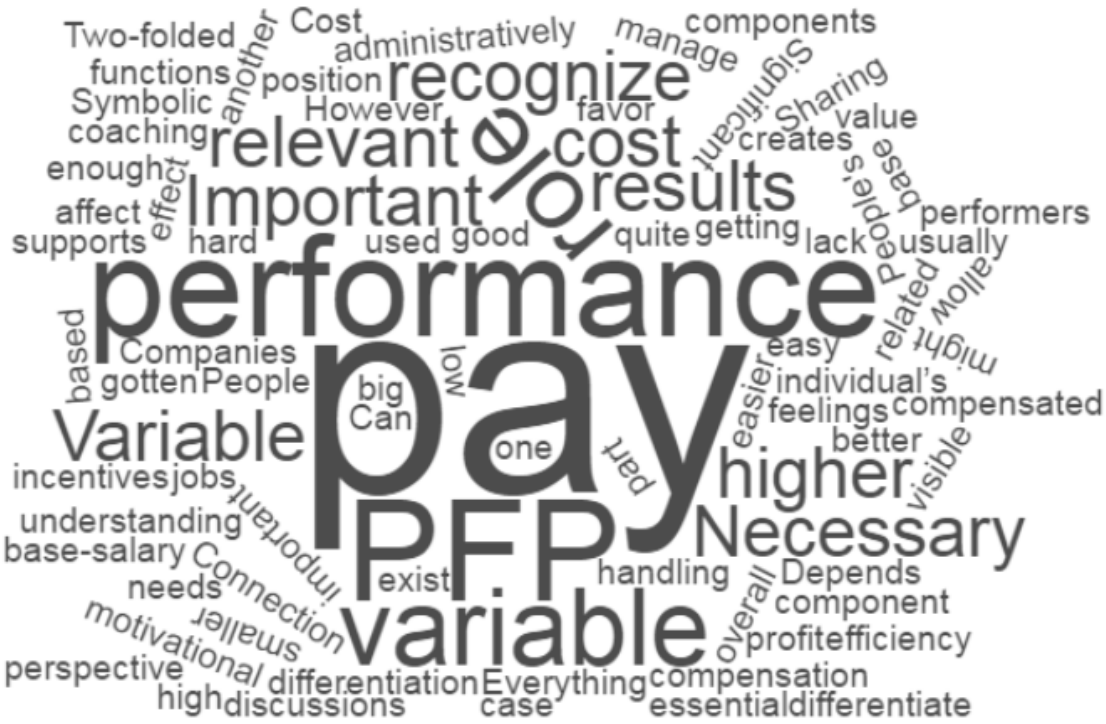

Figure 5. Word cloud in frequency in interview question 2.

Question 3. What kind of benefits (if any) you see in using performance-based pay?

Table 4. Key point matrix for question 3.

Theme	***Use of pay-for-performance***
Question	3. What kind of benefits (if any) you see in using performance-based pay?
Interviewee 1	No fixed costs or negotiations with unions in case of variable pay. Heavily connected with the financial results of the company: in case of low company result, variable pay enables lower pay. Aligns interests of management and (key) employees.
Interviewee 2	Aligning the objectives. Common KPIs for management can be used as a strong steering tool towards those KPIS. Can be used e.g. in steering management team towards preferred focus areas.
Interviewee 3	More motivating than same salary to all. Giving same increase to all not motivating for high-performers and does not provide incentive to perform better for low performers.
Interviewee 4	Recognition of high-performance. If not making an effort but receive pay increase, no incentive to perform better.
Interviewee 5	People focus on the right things (things which they are rewarded for)
Interviewee 6	Efficient way to communicate goals and what should be done. Motivational factor. Personnel expenses flexible according to company success.

The third question concentrated on the benefits of using performance-based pay. Some of the benefits mentioned were already identified in connection with question 1. The most frequently mentioned benefits are linked to steering employee performance to the preferred direction, aligning the goals of a company and its management and/or employees as well as using PFP as a way to communicate those goals.

As in question 1, cost efficiency was brought up as one of the possible benefits of PFP, in case flexibility in payouts can be reached. As variable pay is not usually under union-negotiations, this enables further flexibility in designing company-specific variable pay plans linked to employee performance.

Recognition of high-performance was also mentioned as a benefit of performance-based pay and all respondents also indicated that PFP in their opinion can have a motivational effect on employee performance.

Figure 6. Word cloud in frequency in interview question 3.

Question 4. What kind of challenges (if any) you see in using performance-based pay?

Table 5. Key point matrix for question 4.

Theme	***Use of pay-for-performance***
Question	4. What kind of challenges (if any) you see in using performance-based pay?
Interviewee 1	Communication, simplicity. Challenges if not transparent. Ambitions to be fair can sometimes lead to complexity. Hidden parameters. Forgotten focus areas. Backward looking systems do not motivate. More differentiation needed between top and middle performers.
Interviewee 2	Developing the right KPIs. Many have calendar based cycles, is that the right time horizon? Company's focus area may change mid-year, need to find right KPIs. If performance-based structure is not agile, people may focus on wrong KPIs.
Interviewee 3	Who is measuring may affect the evaluation. Setting targets that are measurable. Challenging if manager is not capable of setting measurable or relevant targets.
Interviewee 4	Complex organizations, reporting to many people. Economically, small budgets create challenges in decision making.
Interviewee 5	Companies in general are not very good at setting targets. Too much subjectivity. Too much feelings involved. Goal setting needs to be top quality. Managers may give higher evaluations if this leads to more flexibility in salary negotiations (e.g. wider merit increase scale). Need to determine what is good performance. Financial metrics are not enough anymore when organizations need to change and evolve. Need to be able to measure and describe qualitative metrics as well. Strategic targets important, not just KPIs such as cash flow, EBIT etc. but companies are not that good at describing them.
Interviewee 6	Setting goals. How to steer performance to the right direction (e.g. if individual goals, how does this affect cooperation). Fairness: have goals been set correctly? Free rider problem (do all people work the same amount)? Administration? Return on investment.

In the literature review, certain challenges were identified in designing, managing and executing performance-based compensation plans. Therefore question 4 focuses on the respondents' views on the challenges they have experienced or view possible. The most important and/or the most frequently mentioned challenges are listed below:

- Trying to be fair may lead to too much complexity

- Define what is good performance
- Developing right key performance indices (KPI) and targets, developing strategic KPIs
- Lack of transparency
- Only backward looking systems
- Not enough differentiation between low and high performers
- Too much subjectivity
- Too much feelings involved
- Complex organizations (reporting to multiple people)
- Small budgets can create challenges in decision making
- How to ensure and measure return on investment for pay-for-performance

Figure 7. Word cloud in frequency in interview question 4.

<u>Question 5. In your opinion, what are the key issues / focus points in designing and implementing pay-for-performance system?</u>

Based on the literature review, design and implementation of a PFP systems are key factors in the success of such plans and therefore it was particularly interesting to hear the participants' views on the main focus points in designing and implementing PFP compensation.

Table 6. Key point matrix for question 5.

Theme	***Use of pay-for-performance***
Question	5. In your opinion, what are the key issues / focus points in designing and implementing pay-for-performance system?
Interviewee 1	Stakeholder involvement (board, CEO, management, also employees up to some point). One size does not fit to all. Connection to business.
Interviewee 2	Communication. Usually companies can think of tax issues etc., can even link system to strategy but lack in communication.
Interviewee 3	Clear to everyone what the decisions are based on. Manager needs to be able to explain the review and basis of the decision. Manager needs to understand why PFP is used and what the benefits are. Fair treatment is not the same as paying everyone the same amount.
Interviewee 4	Communication, manager training. Managers to have knowledge on why PFP is used and why it's important. Not just internal measurement, external pay benchmark should be used as well.
Interviewee 5	Define good performance and what is the culture in your organization. Cannot copy a system from somewhere else. Determine to what extent behavior is considered. High-quality goal setting. True implementation of goals. Performance evaluation, understanding how performance should be measured in order for it to serve its purpose. Understanding what people are rewarded for. Follow-up, constant support (support needed in order to perform well). Constant steering of performance. What has been paid, has goals been met (data). Strong foundation! Methods and payments are easy (market references available) but ground work and creating the foundation is challenging.
Interviewee 6	To tackle the challenges mentioned before. The system should provide what is needed. To understand why the company has PFP system. Who are included, what type of system, what affects? Communication is key (why, what should be done).

Based on the interview data, communication is one of the most crucial factors to be considered. Making sure that the employees and managers understand why PFP is used, what is expected of the employees and what the decisions are based on. The respondents also emphasized stakeholder involvement, true connection between business and the PFP plan, building strong foundation for the plan and that "one size does not fit to all". Therefore, any plan needs to be designed individually for each company and this leads to the importance of goal setting.

Implementing high-quality goal setting may not be a straightforward task but necessary in order to ensure that performance-based pay is connected to the company strategy, steers

employee performance to the preferred direction and motivates high-performance. However, just setting clear goals is not enough but employees should also receive constant support in order for them to perform well and reach their goals.

Figure 8. Word cloud in frequency in interview question 5.

<u>Question 6. In your opinion, should performance-based pay be based on individual / group / company performance (or a mixture of some/all of these)?</u>

Table 7. Key point matrix for question 6.

Theme	***Measuring and evaluating employee performance***
Question	6. In your opinion, should performance-based pay be based on individual / group / company performance (or a mixture of some/all of these)?
Interviewee 1	Depends. Often multiple goals. Maybe more group measures for blue collar workers.
Interviewee 2	Depends on company culture, role, etc. Some group element should be good to implement.
Interviewee 3	Mixture, emphasis on individual. One needs to see how they can affect. Team-based KPIs are ok if here are relevant targets. Team-based KPIs are important for collaboration.

Interviewee 4	Mixture. Company performance sets the budget, otherwise individual. Variable pay: take into account company performance. In order to motivate: individual, simple, straightforward evaluation needed.
Interviewee 5	Pay mix. If goal setting is top quality, individual goals possible (not that realistic, therefore mixture is often most suitable). Instead of paying bonus on individual targets, group or team targets may be more appropriate. Company-level metrics should be included.
Interviewee 6	Depends on the person's role. Individual targets would be important but it may be difficult to set individual goals for PFP for certain positions. Most of the positions are not suitable for individual goals only but different emphasis can be changed according to the role. If goals are too high-level, motivating individuals can be challenging. Some sort of pay-mix often a good choice.

Employee performance is usually evaluated based on either individual, group or company performance or by using a mixture of these. According to the interviewees, the role and tasks of an employee should determine the most suitable targets and KPIs. Based on the interview data, emphasis seems to be on individual targets but these may not be suitable for all cases which is why e.g. group-based performance measures can be more suitable option in some companies or for some positions. Individual targets also require top-quality goal-setting to make sure they do not direct employee performance to a wrong direction. While company performance often sets the budget, a pay-mix of some kind is preferred by most respondents.

Figure 9. Word cloud in frequency in interview question 6.

Question 7. In your opinion, when or how often should employee's performance be reviewed?

Table 8. Key point matrix for question 7.

Theme	***Measuring and evaluating employee performance***
Question	7. In your opinion, when or how often should employee's performance be reviewed?
Interviewee 1	All the time, forward looking discussions. Dialogue! Purpose of performance review sometimes forgotten, more about process and systems but discussion is needed all the time. Overall performance should be discussed as well, not just what is in the goal plan.
Interviewee 2	Financial KPIs follow of course financial year etc. Otherwise more discretionary evaluation needed. Annual cycles are a bit tough.
Interviewee 3	Feedback more often (e.g. catch up). Structured discussions. Not just at the end of the year.
Interviewee 4	Feedback regularly, summary maybe twice a year.
Interviewee 5	Constant evaluation. Annual summary is ok, most companies might be going this way. But every element needs to be discussed during the year. Should be review of past performance but focus also on future.
Interviewee 6	Constant evaluation, daily "feeling" of performance. Rarely need for formal evaluation all the time but e.g. team performance should be evaluated constantly. Evaluation once per year not enough, but depends what has been discussed during the year. Annual cycle without constant discussions does not work.

The timing of performance evaluation has been a major topic in discussion on the usability and usefulness of performance-based pay. While annual reviews still seem to be a valid method, their meaning has changed and once a year evaluations are not seem adequate anymore. Instead, the respondents emphasize the need for constant evaluation and dialogue between managers and employees. Based on the interview data, annual or bi-annual reviews should summarize the discussions held throughout the year and be more forward-looking than what they have been before.

Figure 10. Word cloud in frequency in interview question 7.

<u>Question 8. In your opinion, what kind of role (if any) should numeric ratings play in evaluating employee's performance?</u>

Table 9. Key point matrix for question 8.

Theme	***Measuring and evaluating employee performance***
Question	8. In your opinion, what kind of role (if any) should numeric ratings play in evaluating employee's performance?
Interviewee 1	Discussion more important than rating. Dialogue! Motivate high performers, coaching for "the bulk" (no need to use too much time on them). Low performers: help them to next position somewhere else. Legal points: arguments needed for actions on low performers. Ratings may take focus from discussions. Should drive behavior. May distort focus (gaming, corruption). Managers need more support to execute new way of PFP, HR also pays a key role in supporting managers.
Interviewee 2	Can be used to evaluate non-financial performance. Good way to evaluate in case well-designed system is in place (need to determine what each rating means). Ratings sometimes criticized for too much subjectivity.

Interviewee 3	Problems if ratings are given without discussions and explanation (if it is a surprise for the employee). Difficult if no rating/documentation. Verbal versions can be interpreted in different ways but number is a number.
Interviewee 4	Not a lot of negative feedback on numeric ratings in our organization. People want to understand how they are doing. More a question of how ratings are used than whether ratings should be used. Affects other processes as well. Delicate balance between coach/evaluator.
Interviewee 5	Difficult. Categorization often a result of not wanting to disappoint. Even rating 3 (meets expectations) is often seen as negative. Should focus on making 3 a very good rating. If there are no discussions during the year, rating may be surprise at the end of the year. Ratings are useful when wanting to increase understanding of one's behavior (where are we). Most companies may have kept some kind of evaluation even if they say they have removed ratings.
Interviewee 6	Ratings not used in our organization due to individual rewarding not being that significant. I do not support standard distribution in any situation (forced ratings). Numeric or verbal rating may be a good tool, can enable evaluation of individuals performance e.g. in projects.

Although certain challenges with numeric ratings were identified, the respondents also found them useful if used appropriately. Numeric ratings can be viewed as a tool to help in communicating performance evaluation and for employees to understand where they stand in terms of goal plan and performance. However, ratings without discussions may lead to employees not understanding the basis for the rating. Considering the risk that ratings may even distort focus and even encourage gaming or corruption, discussions and constant feedback are seen as more important than just numeric rating. Ratings should drive performance but using numeric ratings or removing them does not represent the whole system (e.g. some kind of evaluation often used even if numeric ratings are removed).

Figure 11. Word cloud in frequency in interview question 8.

<u>Question 9. In your opinion, what are the key issues / focus points for a successful performance review process?</u>

Table 10. Key point matrix for question 9.

Theme	***Measuring and evaluating employee performance***
Question	9. In your opinion, what are the key issues / focus points for a successful performance review process?
Interviewee 1	Holistic approach, not too detailed. Constructive and forward looking. Systems today not generally delivering the desired outcome. Simple, transparent. Don't be afraid to change the plan or terminate it if the plan does not work. One size does not fit to all.
Interviewee 2	Preparation, commitment, transparency. Structured process. All parties need to understand the process.
Interviewee 3	Targets need to be understood. Employees should take ownership of the targets (as well). Too high KPI's not motivating. High goals require coaching.
Interviewee 4	Employees need to drive the process more. People need to own their own performance. Managers need to be active. Clear goal setting. Goals need to be motivating. Feedback from different sources. Transparency.

Interviewee 5	Behavioral side more important when talking about culture. Company values - what is good behavior! Behavioral model - evaluation of behavior and performance. Still need to consider individual personalities as well.
Interviewee 6	Think about what is needed from the process. Are we steering individual, team, organization? Why do we have a process? Clear roles and responsibilities.

As discussed in the literature review, some researchers think that performance evaluations and pay decisions should be kept as separate processes. Whether or not pay decisions are communicated together with the performance reviews, successful PFP plans require well-developed performance management system. In question 9, respondents were requested to share their opinions on the key issues and focus points in developing performance review process and the main findings are listed in table 10:

Figure 12. Word cloud in frequency in interview question 9.

6 Discussion and conclusions

In this chapter I discuss the results of the study and evaluate how the goals of the research were met. I also provide suggestions for further research and evaluate the research process by reflecting my own learning and discussing the challenges faced during the research process.

6.1 Conclusions

The aim of this thesis was to understand the underlying theories behind performance-based compensation and the critical issues to be considered when implementing PFP systems. Furthermore, the aim was to understand the critique around performance-based pay and how companies have perhaps changed their approach to PFP in the recent years. The research question was:

- What are the critical issues in designing and implementing pay-for-performance systems?

Furthermore, the following sub-questions were investigated:

- What are the underlying theories of pay-for-performance systems?
- How can performance-based pay increase employee performance and productivity?

In order to answer the above questions, I first built the theoretical framework and reviewed earlier literature on the subject to present the most commonly used types of performance-based pay as well as the economical and motivational theories linked to it. In the second part of the study, the empirical research, I interviewed specialists with extensive experience from performance and reward management. Findings from the empirical study were analysed in chapter 5.

Many of the arguments on whether or not money motivates people seem to stem from the view that contingent rewards exist mainly as instruments of control and as means of getting people to do things they would otherwise not be motivated to do. Based on the literature review and the empirical research, this may be the case if a PFP system is not correctly linked to the company's strategy, does not ensure fair treatment and is not understood by the employees. The purpose and possibilities of incentive pay should not be exaggerated either. In case employees are not motivated by their work or committed to the company goals, it is unlikely that performance-based pay alone can enhance the situation.

Performance-based pay should be considered as one possible tool in the wider leadership agenda and successful execution of PFP system requires support from other HR and management functions as well.

What a well-functioning pay-for-performance system can do, is to influence the efforts and choices of employees who already have basic level of motivation, by steering their focus and attention on activities that create value to the company. If used properly, performance-based pay can even increase collaboration among employees but this requires high-quality goal-setting and careful consideration of the business targets and company culture. Based on the research results, financial rewards could undermine a company's ability to build trust and commitment if management and employees do not have an honest discussion on their expectations.

Many organizations have received positive feedback after eliminating performance ratings. However, in this research I aimed to understand if removing performance ratings is enough to create long-lasting positive effects or if the initial positive effect has more to do with not being satisfied in the overall performance management system. Therefore, rather than focusing on the debate around ratings, organizations should aim at improving their overall performance management and reward approach.

Based on the literature review and the empirical research, the following key issues and focus points in designing and implementing a successful pay-for-performance system were identified:

- A performance pay system should be designed to promote performance that supports the company objectives. Therefore pay systems should always be linked to the company's strategy and cannot be copied from company to company
- Define good performance and preferred company culture: Even if individual targets or e.g. team-based targets are used, these targets should always be based on the company-wide targets. Should any conflicts arise (e.g. individual KPI is contradictory to company targets or the preferred culture in the organization), this needs to be identified, discussed and changed, if needed.
- Pay policies and processes should form a part of the overall HR strategy: PFP system are less likely to succeed in case they are separated from the company strategy and other processes. Extrinsic rewards can steer performance whether or not they are linked to company strategy, but it is likely that such performance does not fully support the company objectives.
- Consider the frequency of the payouts (e.g. short-term incentive plans or long-term incentive plans, annual payouts or e.g. project bonuses): The timing of incentive

payouts was only briefly discussed during this research and further research would be beneficial. However, companies should consider how the timing of payouts possibly affects employee satisfaction and/or the motivational effects of incentives.

- Communication and simplicity: Throughout this study, communication has been one of the main focus points in ensuring successful pay-for-performance system. The motivational effect of performance-based pay suffers in case employees (or their managers) do not understand the purpose of the system and the basis of the performance evaluation. In addition to honest, two-way communication, understanding how the process and the system works is critical. If employees do not feel they have any role in the overall results (performance evaluation or the payout), the more difficult it will be to use PFP as a steering tool or as a motivational factor.
- Consider employees' risk awareness (i.e. the amount that can be "lost" due to poor performance) but retain flexibility to ensure cost-effectiveness and possibility to higher rewards when performance meets the targets
- Holistic view and overall evaluation (i.e. including numeric metrics and subjective evaluation): Financial measures are still widely used and often relevant. Companies should however consider what kind of metrics and KPIs are required in order to steer performance in the right direction. Subjective evaluation is sometimes criticized but based on this research, some level of subjectivity is often beneficial.
- Forward-looking discussions: Evaluating past performance is an essential part of performance evaluation but researchers and specialists are increasingly emphasizing the importance of including forward-looking discussions as well.
- Constant feedback: The results of this study show that at least part of the criticism towards the use of PFP and performance ratings could be mitigated by providing the employees with timely feedback on their performance and by clearly communicating the expectations of the company. The biggest conflicts seem to stem from situations where an employee does not have a clear view on his/her performance and results of the final evaluation come as a surprise. From the company point of view, it does not seem beneficial to wait a full year before providing feedback on employee's performance when timely feedback could enable the employee to take corrective measures right away. Furthermore, also employees who are performing well need feedback to remain motivated and to continue good performance.
- Stakeholder involvement and commitment: Involvement of the leadership team is crucial when implementing new policies and processes. Involvement is especially crucially in designing a PFP system, to ensure the system supports company strategy and goals.
- Evaluate the system; does it provide return on investment? If the system is not working, change it.

In addition, performance metrics should be

- objective, although some level of subjectivity is usually applied
- measurable and achievable
- proportionate to the maximum reward (the higher the target, the bigger the reward)
- designed to provide employees with feedback on their performance
- easily understood
- related to what is controllable

Employee's intrinsic motivation should also be strengthened through

- consultation, communication, participation
- coaching and training
- job satisfaction and responsibility

In summary, performance-based pay is not just about systems developed by the management that employee's simply follow. There are key psychological and emotional realities that have to be considered to ensure successful implementation and execution of performance-based pay.

6.2 Challenges of the study

Throughout this research, careful consideration has been applied in the collection and analysis of data in order to ensure validity and reliability of the research. As the subject is highly multidimensional, determining the research scope was perhaps the most challenging task. Pay-for-performance is linked to numerous other processes, issues and phenomena and thus, "sticking to" the research scope required constant focus.

Some additional challenges were faced with the timing of the research and the original schedule was delayed by months due to the researcher's lack of resources (time). However, building the theoretical framework and the literature review seemed to benefit from the longer time used, as it enabled further consideration around the scope and longer time for material collection. As the theoretical part of the study was well-established by the time empirical research started, it was easier to determine the interview questions, research scope and research method. Although the time for the empirical study was somewhat limited, an adequate number of interviews were conducted and these interviews contributed greatly on the overall results of this study.

6.3 Suggestions for future research

This research has identified multiple possible subjects for further research. For example the use of recognition as a tool to motivate, engage and reward employees would be an interesting research subject in order to understand the wider possibilities in building a total reward framework for an organization.

Flexibility in pay and benefits has been a hot topic recently and companies are trying to understand better how to reward especially new employee generations to ensure motivation and employee retention. Increasing diversity in terms of e.g. employees' age and culture, creates further challenges in designing reward strategies that are motivational enough but on the other hand enable cost-efficiency. The possibility to offer flexible benefits plans (employees can choose the benefits they prefer most) is still somewhat limited by their complexity and e.g. tax regulations, but it would be interesting to further study the possibilities and benefits of such flexibility.

Possible motivational differences between merit increase and bonus pay as well as possible effects of payout timing should also be studied further. Some conflicting research finding were identified from the earlier literature in terms of the motivational differences of merit increase and bonus pay. As employee's individual preferences and personal circumstances have an effect as well, it is likely that this questions does not have a "right answer". However, the better organizations understand the complexities and differences between different pay elements, the better they are hopefully able to develop their own approach and reward strategy.

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Appendices

Appendix 1. Interview invitation

Dear xxx,

This is an invitation to participate in a study I am conducting as part of my Master of Business Administration degree at Haaga-Helia University of Applied Sciences.

The objective of this study is to understand how pay-for-performance (PFP) is used in organizations, the underlying theories behind such compensation systems and the critical issues to consider when using performance-based compensation. This study also aims to understand the critique around pay-for-performance systems by describing the possible unintended consequences but also the benefits that can be reached by performance-based pay. Further information on the research subject can be found in the attachment.

For the empirical part of the study, I wish to interview HR and compensation & benefits professionals on their personal views on PFP and the possibilities and challenges linked to performance evaluations and designing performance-based pay elements. While the study aims to understand how PFP is used in organizations, the interviews focus on your personal experience and thoughts on the matter and thus no company-related information is requested as such.

I would appreciate if you would participate in a telephone interview (0,5 – 1 hour) or alternatively provide your comments on the attached questions by email. With your permission, the interview will be tape-recorded to facilitate collection of information. All information you provide is considered completely confidential. Your name or the name of your organization will not appear in the thesis or any report resulting from this study. However, with your permission, anonymous quotations may be used. If you wish, I am happy to provide a copy of the final report once finalized.

This master's thesis is a development project for my employer EY. I work as a Senior Consultant in the People Advisory Services team, supporting companies with performance and reward management. If you have any questions regarding this study, or would like additional information please contact me at [phone number] or by e-mail at [email]. You can also contact my supervisor, [name] at [phone number] or by e-mail [email].

I very much look forward to speaking with you and thank you in advance for your assistance in this project. If you wish to participate, I would appreciate if you would confirm your availability (preferably during the next 3 weeks) for the interview or provide your comments by email.

Sincerely,

Laura Kalén

Appendix 2. Background information on the research subject for the interviewees

Linking pay to performance – Critical issues to consider

Background on the research subject:

In recent decades, growing proportion of firms has included incentive pay schemes in their compensation packages, linking pay to employee or company performance.

Pay for performance plans are designed to deliver pay increases to employees based on some measure of performance. In theory, such plans offer several potential benefits:

- They can support the organization's personnel philosophy by helping to communicate the organization's goals to its employees.
- Goal theory suggests that performance-based pay plans can support a certain level of performance that is consistent with the organization's mission.
- They can help ensure consistency in the distribution of pay increases. For example, under a plan that ties pay increases to a specific goal, payouts are distributed only when that goal is met.
- Motivation theory suggests that pay for performance can positively influence individual's performance and effort to achieve goals that are rewarded.

(Milkovich & Wigdor 1991.)

Despite the appeal of PFP systems, challenges exist. According to some studies, one of the problems is that management practices, including the use of a PFP system, are rarely based on good academic evidence about what really works and what does not work (Glassman & al. 2010). So the popularity of PFP systems does not suggest that either scholars or managers are in agreement as to if and how PFP compensation is an efficient tool to enhance employee performance (Beer & Cannon 2004). PFP and variable pay in general has raised much debate recently and especially the popular press emphasizes the detrimental effects of performance-related pay (EY 2016, Nalbantian & al. 2014). But the need to cut back on compensation expenses puts greater emphasis on differentiation of performance ratings and pay and even more emphasis on variable compensation.

Pay-for-performance systems have been criticized for the possible destructive effects that PFP can cause on creativity, intrinsic motivation, teamwork, and self-esteem (Kohn 1993; Amabile 1996; Meyer 1975). Some scholars also argue that incentives may work too well, motivating employees to focus excessively on rewards instead of working comprehensively for the benefit of the organization (Beer & Cannon 2004). Research findings on PFP

systems and their effects on employee motivation and performance have been somewhat conflicting but some scholars feel that PFP research findings have sometimes been ignored, causing a “knowing/doing” gap between what science knows and what business does. But despite concerns and arguments against the use of PFP, most organizations use it in some form.

The purpose of this study, therefore, is to understand how pay-for-performance compensation can affect employee motivation and performance and to have a wide overview of the underlying theories behind pay-for-performance compensation and also to understand the benefits and possible challenges in applying performance-based pay.

Appendix 3. Interview questions

Respondent's professional background

1 How many years in total you have worked in compensation and/or HR related tasks?

Use of pay-for-performance

2. In your opinion, what kind of role performance-based pay has/should have in the overall pay-mix?

3. What kind of benefits (if any) you see in using performance-based pay?

4. What kind of challenges (if any) you see in using performance-based pay?

5. In your opinion, what are the key issues / focus points in designing and implementing pay-for-performance system?

Measuring and evaluating employee performance

6. In your opinion, should performance-based pay be based on individual / group / company performance (or a mixture of some/all of these)?

7. In your opinion, when or how often should employee's performance be reviewed?

8. In your opinion, what kind of role (if any) should numeric ratings play in evaluating employee's performance?

9. In your opinion, what are the key issues / focus points for a successful performance review process?

Appendix 4. Implementation plan and evaluation of the developmental aspect of the thesis

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