10 WAYS TO REWARD PERFORMANCE DESPITE A LOW BUDGET

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Don't let a low budget keep you from properly rewarding your employees.

A lot of people are saying that you can't effectively reward performance with only a 3 percent compensation budget. This article represents the opposite viewpoint. It highlights 10 ways to reward performance despite low compensation budgets — 10 ways that organizations have used successfully over many years.

Modest salary budgets create challenges to differentiate top performers and high-potential employees, and budgets are likely to remain modest for the near- to mid-term. This is the result of a stable period in the economy. Modest growth, continuing significant unemployment despite some pockets of labor scarcity and low inflation create little pressure to raise wages.

TOP PERFORMERS

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Take Care of Top Performers

Top performers matter. They are critical to company success. They set the performance standard by which others are judged. How top performers are treated tells all employees how much the organization values performance. Many top performers are the company's future leaders. There is a danger that high-potential and high-performing employees are the most likely to leave because they have the greatest ability to find new employment.

Recent surveys by organizations like Accenture and The Conference Board estimate that up to half of organizations' top performers are considering leaving. Results of a 2012 IBM study of CEOs show that human capital is the single biggest contributor to sustained economic value. As one CEO said, "All of my competitors have access to the same technologies, markets and suppliers we do. The difference is in whose people use those resources best."

Top performers make up about 20 percent of the employee population in most organizations. High potentials are part of this group; estimates are between 4 percent and 10 percent of the total pool.

Top performers care about pay. "Retention of Key Talent and the Role of Rewards," an article in the fourth quarter 2012 *WorldatWork Journal*, reported that rewards represent four of the top five reasons for key talent leaving an organization. Top performers expect pay to accurately reflect their performance; that is, they use pay as a scorecard. Employee engagement increases when there is a clear understanding of compensation and a direct link to performance — and engaged employees are more productive.

For a variety of reasons, pay for performance is not happening in many organizations that want to do it. Some organizations can't figure out how to do it with small budgets or are reluctant to fully address pay for performance. Some employers seem to use the peanut butter approach — a thin layer spread evenly across the bread.

It is well established that outstanding performers should get increases at least two times those received by average performers. With salary budgets in the near future likely to be about 3 percent, that translates to a 2.5 percentage point difference. Although the ratio has been creeping up over the past few years, the "WorldatWork 2011-2012 Salary Budget Survey" reported that top performers receive about 1.4 times that of average performers. This translates to 1.1 percentage points.

There are ways that organizations can do better in delivering rewards to top performers. All of these are time-tested and proven approaches that the authors have used with clients over many years, and all of them respond to specific client needs and situations.

1 Carve out a special adjustment fund for the top 20 percent. Allocate 2.5 percent to merit increases. Communicate a 2.5 percent merit increase budget. Allocate the additional 0.5 percent to top performers and high-potential employees. Review special adjustments at the senior executive level. A 0.5 percent carve-out provides an extra 2.5 percent for the top 20 percent of employees. This approach is most useful in organizations that don't need a formal process, have an unsophisticated performance appraisal program, or want to ease into providing greater differentiation in pay increases. Challenges in making this approach successful include identifying top performers and ensuring consistent application.

2 Use a two-pool merit increase approach. Establish separate merit increase budgets for top performers and others. A 5 percent budget for the top 20 percent and a 2.5 percent budget for the remaining 80 percent results in an overall budget of 3 percent. This approach enables, or even forces, differentiation of increases for top performers. The organization can further differentiate individual increases within each pool based on performance, position-in-range or any other criteria. This approach is best used where the organization wants to force higher increases for top performers and ensure consistent application. To be successful, this approach requires an effective performance management system and a way to overcome the probable discomfort of managers who have not previously differentiated increases based on performance.

3 Set the bar higher for increases. Give no increases to employees whose pay is higher in the salary range than their performance warrants. Give no increases to employees whose performance is in the bottom 5 percent. This was typical more than 20 years ago, but less so now. Companies say that after reductions in force they have no low performers, but the authors believe there's still enough performance variation to differentiate. This approach is best used in situations in which the organization can clearly identify cases of pay higher than performance warrants and where there is clear agreement among management to shift increase funds from higher-paid, lower-performing individuals to lower-paid, higher-performing individuals. To be successful, this approach requires an effective performance-management system, effective communication and training for managers who will probably be having uncomfortable conversations with affected employees.

4 Vary increase timing. Many organizations give all merit increases on one date and every 12 months. It doesn't have to be this way. There is no rule that requires increases every 12 months. There is no rule that requires all increases to be given on one date. It used to be common to vary increase date (anniversary dates were typical) and timing. Varying increase timing changes the effective size of the increase:

- 3 percent increase every 6 months = 6 percent annually
- 3 percent increase every 18 months = 2 percent annually
- 3 percent increase every 24 months = 1.5 percent annually.

Varying increase timing and size has an even greater effect.

- 5 percent increase every 6 months = 10 percent annually
- 5 percent increase every 8 months = 7.5 percent annually.

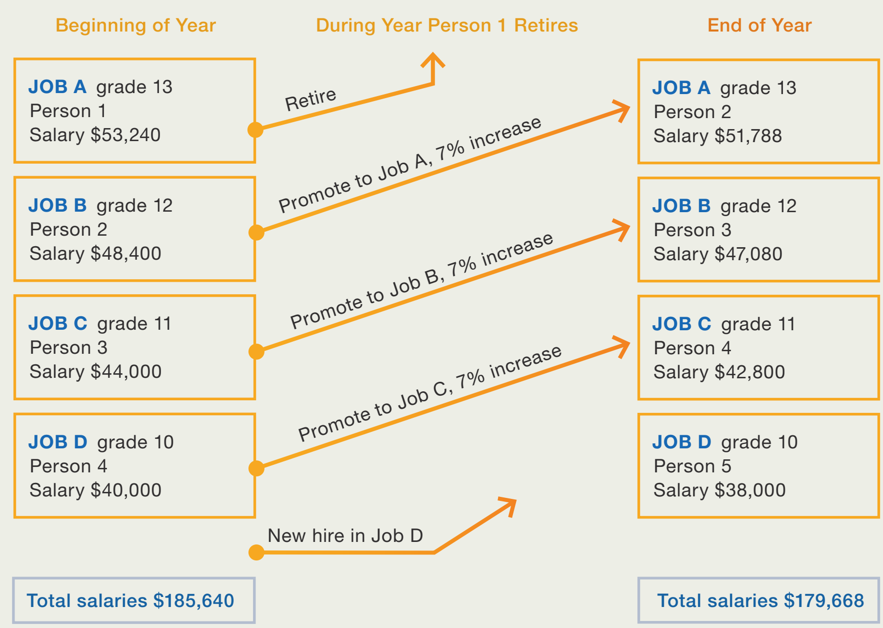
(These larger increases can be funded within a 3 percent budget by increasing the timing of other increases as shown previously.)

This approach is best used in situations in which the organization has a history of minimal increase differentials and wants to break that pattern without giving visibly large increases. This approach also helps break the tradition of entitlement to annual increases. Changing increase dates and frequency adds administrative complexity. This approach also may be seen as conflicting with budget cycles.

5 Manage filling vacancies. Instead of replacing the retiring employee with a new hire, promote from within and hire at the entry level. The longer the chain of promotions, the greater the number of employees whose performance gets rewarded — by both the new, higher-level work and the pay increase. This can be done without adding to salary costs in many cases. If you create move chains, whether the moves are promotions or lateral moves, and allow each position to be vacant for one month, you can save significantly with minimal pain. (See Figure 1.) A number of companies do this very effectively; mid-level hires in those organizations are rare. This approach rewards top performers with both higher-level roles and increased pay without adding cost. It is very useful with job families or other clear career progressions. For this approach to be successful, the organization needs to develop employees and recognize their readiness for higher-level roles. There is some perceived risk in promoting employees rather than hiring someone who has already done the higher-level job in another organization.

6 Give discretionary bonuses. Separate from any other bonus or incentive plans, give discretionary bonuses to top performers. A 5 percent discretionary bonus pool for the top 20 percent costs about 1 percent of payroll. It can be new money or funded by reducing merit increase budgets. In either case, the bonus pool is reusable each year without further funding; the bonuses are one-time payments and do not roll into salaries. This approach is most useful when the organization

Figure 1 | Create Move Chains



Source: Sperling HR LLC

wants to reward significant achievements as they occur without adding that reward to base salaries. Challenges include clearly defining criteria for identifying achievements and employees to reward, ensuring consistent application and potential resentment by other employees if achievements and roles are not clear.

7 Give retention bonuses. Target top performers, high potentials and perhaps employees in critical-skills jobs. Give a bonus to employees who stay until the end of the year. This defers promised compensation and expense. Organizations can add vesting for additional retention. They also can use a series of retention bonuses to renew the retention incentive over time. This approach is best applied to key talent, top performers, high-potentials and employees in critical jobs. It is a useful way to discourage unwanted turnover without increasing fixed costs (salaries). Challenges of this approach are determining which employees or jobs should be included and ensuring consistent application.

8 Give lump-sum merit payments. This is a merit payment rather than a merit increase. Because these one-time payments do not roll into salaries, the merit payment pool is reusable each year without increased cost. This approach often has been used for employees paid high in the salary range, but it can be used for all employees when money is very tight or salaries are above market levels. Lump-sum merit payments can be paid at year end or earlier; earlier in the year offsets the negatives of receiving a lump sum rather than a salary increase, but has risk to the company if an employee leaves before the end of the year. Lump sums can be split into multiple payments. They should be paid in a separate check or separate line item on a paycheck to make clear that they are not part of salary.

9 Use incentive pay effectively. Incentive pay serves multiple purposes: it links employee and employer interests, reduces fixed costs and shares organization success with employees. There are three key elements to effective incentive plans:

- Incentive payouts need to be clearly linked to organization results.
- The number of measures should not exceed three. Using more leads to loss of participant focus. Using more, narrower measures often creates conflicting interests.
- Employees need to understand how their performance influences the results being measured. Without this link, a variable pay plan will not drive desired behaviors.

It is worth noting that incentives typically are based on organization performance (enterprise, business unit and/or team) rather than individual performance. If desired, incentives can be linked to individual performance by using an individual performance multiplier or by making employees with low performance ratings ineligible.

10 Use discretionary stock. Most organizations that give stock options and restricted stock grants do so based on level in the organization. Some, however, vary grant size based on individual performance or give additional grants to top performers and high potentials. Typically, discretionary stock is used only for employees who already are eligible for stock options or restricted stock. Discretionary stock serves three major purposes. It reinforces the alignment of the employees' interests with the market success of the company, recognizes and rewards exceptional performance, and helps retain high-performing employees. Discretionary stock does not use cash, which makes it a particularly appropriate approach in times of tight finances. There are challenges to using discretionary stock successfully, including the need to identify performance and employees deserving grants, and ensuring consistent application. There may be some resistance to this approach because it adds to stock dilution.

Choosing the Best Approach

Each of these 10 approaches to reward performance despite low compensation budgets have been used successfully by many companies over many years. The tough question is, "Which of these approaches is best for your organization?" It depends on your organization's business, reward strategy, culture, needs and circumstances. Success here comes not from knowing these approaches but from choosing the best one or combination to use. Comparing your organization's needs to the situations explained here and considering the advantages and challenges of each approach will help you choose the best approach(es) for your organization. ws

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