Use performance-aligned compensation programs to offer a meaningful salary increase.
For a growing number of employers, the annual salary or merit increase process is becoming an anachronism, illustrative of broken compensation models. The process can be tedious and the results are often less than fulfilling, leading some managers, employees and HR professionals to ask: “Is the juice worth the squeeze?”

By Juan Pablo Gonzalez, Axiom Consulting Partners
WorldatWork characterizes 3 percent base pay increases as “the new normal” and its 2014-2015 Salary Budget Survey research found that awards for top performers average 4.1 percent (less than one and a half times the average). This is hardly a material difference in income on a paycheck-to-paycheck basis.

Consider an employee with an annual salary of $50,000. An average performer getting a 3 percent increase would get $1,500. Divided by 26 pay periods, that’s about $58 per pay period before taxes, or $43 after taxes. A top performer who receives an increase of as much as 4.5 percent would see an annual base salary increase of $2,250, a pre-tax premium of only $750, or less than $29 per pay period (approximately $22 after taxes) over what an average performer would receive. Is $22 per paycheck really enough to recognize superior performance? Does the time invested to create, collect, review, revise and negotiate performance ratings, merit matrices and force ratings distributions every year generate real value? Perhaps, there is an opportunity to deliver compensation that better aligns with the nature of performance itself.

Throw out processes that destroy more value than they create. Instead, pay for results and capability growth by eliminating the traditional merit increase process and by keeping performance management.

Figure 1 | Performance-Aligned Compensation Matrix

<table>
<thead>
<tr>
<th>Performance vs. Expectations</th>
<th>Below</th>
<th>Meets</th>
<th>Exceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Demonstrated competency growth</strong></td>
<td><strong>Significant</strong></td>
<td><strong>Meaningful</strong></td>
<td><strong>All others</strong></td>
</tr>
<tr>
<td><strong>Above budget raise</strong></td>
<td><strong>2x “typical” raise</strong></td>
<td><strong>2x “typical” raise</strong></td>
<td><strong>Above target bonus</strong></td>
</tr>
<tr>
<td><strong>No bonus</strong></td>
<td><strong>Target bonus</strong></td>
<td><strong>Above target bonus</strong></td>
<td><strong>No bonus</strong></td>
</tr>
<tr>
<td><strong>Raise = budget</strong></td>
<td><strong>Target Bonus</strong></td>
<td><strong>Above target bonus</strong></td>
<td><strong>No bonus</strong></td>
</tr>
<tr>
<td><strong>No bonus</strong></td>
<td><strong>Target bonus</strong></td>
<td><strong>Above target bonus</strong></td>
<td><strong>Counseling</strong></td>
</tr>
<tr>
<td><strong>Performance</strong></td>
<td><strong>No raise</strong></td>
<td><strong>No raise</strong></td>
<td><strong>Above target bonus</strong></td>
</tr>
</tbody>
</table>

*Budget may = 0%
merit increase process and by keeping performance management, compensation budgets and simple variable pay programs. If you conclude that your pay levels are creating barriers to attracting and retaining key talent, make appropriate market-based adjustments where necessary that are supported by facts.

A Higher Return on Rewards Investments
Start by introducing rewards that reflect the nature of the performance being rewarded. Competency growth creates the capacity to add value and should be rewarded accordingly. A concern is regarding how and when competency growth is rewarded. Many employees are not likely to demonstrate material increases in competency during 12-month increments because many organizations increase salaries as if this were the case. Individual growth patterns differ based on personal interest and commitment, opportunity, business need and other factors.

Instead of relying on an arbitrary schedule, increase base salaries once employees demonstrate they have acquired new skills or levels of competence. This won’t happen every year, but when it does, the rewards should be noticeable — potentially two to three times the traditional merit increase. Increases of this nature resemble promotional raises and this is appropriate because it suggests that recipients are contributing at a higher level. Further, since base compensation increases build upon each other, it is important that they are not linked to short-term performance. They should reflect demonstrated growth in the capacity to perform.

Short-term performance is best rewarded through variable pay. Simple programs make it possible for employers to reward their employees for their achievements in one performance period without increasing fixed compensation costs for the next. Not only do variable pay programs link compensation investments to organization results, they have the potential to deliver more visible, meaningful rewards that create better line of sight for plan participants.

The previously mentioned employee making $50,000, paid a 10 percent incentive, could earn a meaningful one-time payout of $5,000;
substantially more than the 4.5 percent annual base salary increase for high performance mentioned previously. While this is obviously more money, the award could be self-funded and not add to fixed costs in the long term. In an economy where employee productivity holds steady while wage growth is stagnant, using incentive compensation that links pay to results from employees making the greatest contributions helps employers manage fixed costs.

What makes this approach different? First is a change in participation. Applying this approach will result in a much smaller number of people receiving salary adjustments every year. Second, those who do receive increases will receive more noticeable increases than in the past. Also, for variable pay to have its intended effect — and to deliver competitive rewards in an environment where most employees don’t receive annual salary increases — variable pay program eligibility will need to be extended and target award amounts may need to increase. Once these conditions are true, employers can apply a more integrated performance matrix (See Figure 1 on page 58.) to guide how compensation is distributed.

Note that the vertical axis measures demonstrated competency growth. That’s different than a traditional matrix that plots performance versus market competitiveness. The horizontal axis, which shows performance versus expectations is an indicator of annual results. By combining demonstration of capability and demonstrated results, this approach makes it possible to more appropriately distinguish and reward different types of performance within an integrated system.

The result is replacement of a cumbersome process that blends and dilutes messages and compensation investment with a process that better communicates what’s important through targeted messages and more material rewards for performance. Employees who demonstrate significant competency growth will be rewarded when they do so, as will those who meet or exceed their annual performance expectations. Sometimes this will result in meaningful salary increases or above-target bonuses, other times the opposite will be true. And most often, annual compensation actions will be some combination of the above, reflecting the nature of the performance being rewarded.

### Benefits of Meaningful Rewards
A performance-aligned compensation approach that rewards high levels of competency and provides significant incentives for delivering results has several advantages:

- More effective communication about the nature of performance expectations.
- Better allocation of compensation investments by aligning type of pay with type of performance.
- Increase in meaningfulness of rewards.
- More productive use of manager, employee and human resources time in managing, rewarding and increasing performance.

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