The Toxicity of Pay for Performance

Donald M. Berwick

Despite their superficial logic, systems of merit pay or pay for performance have features that are toxic to systemic improvement. Contingent rewards doled out by supervisors cause decreased focus on customer needs, loss of accurate information about defects and improvement opportunities, avoidance of stretch goals, and decreased innovation. They may also erode teamwork. Pay for performance may mark a naive understanding of the complexity of human motivation.

She sat across the table from me, all ears--one of my very best employees. It was time for her annual merit review, and, according to the organization's policies, she was to be rated as "unsatisfactory," "satisfactory," "superior," or "outstanding" and receive a salary boost of zero, 4 percent, 5 percent, or 6 percent, respectively.

I had prepared carefully. Her work was promising indeed. Although she lacked formal training, she had clear leadership potential and enormous native talent for planning and organizing projects. To excel further, she would need to work on her writing and presentation skills, and some further study of simple statistical methods would strengthen her technical analyses. Tactfully, respectfully, pausing regularly for her questions, I explained my review and offered her guidance. She asked no questions but only nodded agreement with a friendly smile on her face.

I ended with a review of my advice and a handshake of congratulations for her fine efforts. I paused for her reflections.

" So," she asked, beaming--her first words since I had begun, "which is it ... 4 percent, 5 percent, or 6 percent?"

It took me a few moments to absorb the full import of her question. But, finally, I saw the truth: she had

Donald M. Berwick, *M.D., is a practicing pediatrician and is President of the Institute for Healthcare Improvement, Boston, Massachusetts.*

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not heard a word that I had said. "Four percent, 5 percent, or 6 percent?" That was her question, and that--and that alone--was what she was waiting to hear from me.

So embedded in our culture is the idea that "you get what you pay for," so familiar are the assumptions behind "pay for performance," so fair and obvious does it seem that people should be paid for their worth in American culture, that it may take a sledgehammer to ring a note of question. Indeed, in many corporate cultures, and most that I have worked in, to raise fundamental questions about these assumptions is inevitably to invite accusations of naivete and inexperience.

Linking pay to merit is an absolutely obvious instrument of proper management. Because it is absolutely obvious, it is difficult in the extreme to see that it is very nearly absolutely wrong. "Pay for performance" is as toxic to true organizational performance as any of the perfidious tactics of outmoded control-based management that enlightened organizations have long since, and much more readily, abandoned.

It is not necessary to recount here the classical arguments in favor of merit pay. They fall generally into two categories: arguments of *fairness* (good performance *deserves* its reward) and arguments of *incentive* (pay contingent on good performance generates more good performance).

In passing, we might note how thin is the empirical evidence for either of these arguments. There is little but logic or anecdote behind either assertion; in the entire volume of "classic" Harvard Business School papers assembled in a collection called "Appraising Performance Appraisal," only a single experimental study appears.[1] But, as it happens, little real evidence can be found on either side of the "pay for performance" debate. (Alfie Kohn, a popular author on management systems of reward and incentive, claims that the evidence that does exist weighs heavily against contingent pay as a support for organizational or group effectiveness.[2]) Indeed, it is remarkable that an issue of such consequence for the guidance of organizations and so hotly contested from time to time has not benefited more from proper social-scientific experimentation. We who debate pay for performance on either side must fall back on belief and logic for now for the bulk of our arguments.

Some clear definitions, first, may help. Our topic here is "pay for performance," a contingent relationship, enforced and implemented in an organizational hierarchy, in which supervisors judge the merit of the work of those below them in the hierarchy and, based on those judgments, give out variable and contingent financial rewards. "Merit" can refer to meeting any goals or standards, whether negotiated in advance with the employee or announced arbitrarily, whether financial or nonfinancial, whether specific or ambiguous, whether quantitative or qualitative, whether measured in terms of throughput (e.g., "patients per day") or internal process (e.g., "reliable"). "Rewards" (and their opposite, "punishments") can be purely financial (such as salary increases or bonuses), or they may consist of other forms of organizational currency (such as promotion or perquisites). A key and essential component of "pay for performance" is the notion of *contingency*, the "merit" and the "reward" are linked explicitly, and the ultimate judge of both is the supervisor. Paying assembly-line workers on the basis of their productivity is "pay for performance"; so is paying individual doctors on the basis of their "clinical performance," however defined.

No dispute exists here about the value and appropriateness of dialogue between workers and supervisors about goals and performance. It is useful--indeed essential--in an effective organization for information to flow freely about the extent to which needs are met, customers are satisfied, plans are implemented successfully, and goals are achieved. For many purposes, quantitative information is clearer and more instructive than mere narrative, and, accordingly, no dispute exists here about the great value of measuring performance in many dimensions and at many locations in the sequence of production.

Nor is there dispute here about the probability of and need for variation in compensation among individuals. There is a market for talents and experience, and an organization that tries to ignore the conclusions of that market will have trouble recruiting and retaining the people who can help it most. Changes in the cost of living, issues about the sharing of organizational profits, and employee demands that their compensation increase in accord with their skills will always be facts of organizational life, and compensation will therefore vary among people and over time.

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No dispute exists here either about decisive remedial managerial action for either egregious misconduct or ineptitude, or, for that matter, about the festival celebration of real heroes. Those who cannot or should not do a job should leave that job--and be removed by the organization if they do not leave of their own accord; the occasional gold medalist deserves her medals and our applause.

But "pay for performance" goes beyond any of these. It is necessarily contingent and usually one-directional (top down), while dialogue about performance is not. It involves, not variation in pay that is a fact of life enforced by the environment, but variation that senior leaders enforce by choice--and could change if they wished. It is not just a process applied to the occasional miscreant or the rare hero but one maintained in the very fabric of the organization, affecting all by design.

Under this definition, "pay for performance" is guaranteed to be toxic in any organization in at least the following ways.

1. "Pay for performance" makes the supervisor the customer. Organizations accountable to society or to markets must meet the needs of their customers in order to thrive--this is the central strategic message in modern quality management. Forget your customer, and, sooner or later, your customer will forget you. Modern management systems seek ways to help their employees at all levels to inquire about external needs and demands and to take initiative to meet those needs. A "customer-focused" organization has inverted the pyramid of accountability; employees who meet and know the external customer are the *internal* customers of the management system. In such an organization, every supervisor needs to know how to improve his or her own ability to help others meet customers' needs.

"Pay for performance" distorts this focus; it changes the direction of concern. Not in theory but almost always in fact the employee facing a supervisor about to dispense "4 percent, 5 percent, or 6 percent" has one question foremost in mind, namely, "How can I please the supervisor?" This is, simply stated, *not* the key question upon which organizational survival depends. It diverts energy away from the true interests of the organization. The interests of the organization lie outside its walls; "pay for performance" turns people inward.

2. "Pay for performance" deprives the organization of essential information. Because of this inversion of customer-supplier relationships within the organization, valuable information decays. Two losses are the most costly ones. First, supervisors learn less than they otherwise could about their own opportunities for improvement. Few employees facing merit reviews muster the courage to correct their supervisors or to ask for better help in meeting customer needs. The person best able to help the supervisor gain knowledge about needed improvements in management is the employee, who is placed by "pay for performance" in the worst possible circumstance for giving that help.

Second, in the setting of performance review, the organization loses valuable information about defects. Suppose, for example, the supervisor credits the employee with a successful result on the basis of which the merit pay will increase, while the employee knows that the apparent "success" is not at all what it is being cracked up to be. What the organization needs is the information that the result was not good and that the information system is flawed; what the organization will probably get is a silent smile, warm thanks, and an employee now trapped between honesty and ingratitude.

3. "Pay for performance" increases internal competitiveness and barriers. In the pursuit of quality, good fences make bad neighbors. A great organization today seeks constantly to cut windows between its functional areas and to help all employees feel more and more part of one team, with common pursuits and shared self-interest. "Pay for performance" never seems to hit this theme properly. *Either* the contingency is individualized and people come to worry that they must cling to the credit so they will not lose the pay *or* the contingency is set at such an extreme level of aggregation that the "congratulations for great performance" rings hollow to individuals, no one of whom ever can believe that he or she, alone, had much at all to do with the performance for which they are rewarded. The contingency upon which such variable pay is based tends therefore to be either fragmenting, at one extreme, or irrelevant, at the other. Either is damaging to the relationships within the organization. If merit pay is individual, and especially if it is distributed down functional lines of hierarchy, then employees will decrease the extent to which they share information and efforts across boundaries. One hospital CEO described to me his system of profit-center management, in which middle management bonuses depended on local budget performance. I asked him if one of his managers would transfer resources from his department to another's if it would help the organization as a whole. "Yes," the CEO answered honestly, "if he were crazy."

If merit pay appears in organization-wide bonuses, then employees tend to feet helpless in responding to the contingency. I recall one hard day seeing patients at one stage in my professional life, a day that had been a constant uphill battle against missed appointments, unannounced patients with extremely complex problems, battles for approval with an outside utilization review office, and a frustrating search for speech therapy services for a mute three-year-old. The world seemed arrayed in opposition to my effectiveness, and I was exhausted as I began to open my mail late in the afternoon. Therein was a check for a "productivity bonus" of $297 and a note of organizational congratulations for my fine efforts--as it were, "Keep it up, fella." The first thought I had is not publishable. My second was, "Somebody doesn't understand at all."

4. "Pay for performance" costs a great deal to administer. I know of no specific studies of the proportion of organizational energy that a "pay for performance" system consumes, but experience suggests that it is substantial. Elements of cost include the following: (1) supervisory training; (2) creating and managing forms and records; (3) supervisory meetings and upward reporting; (4) making decisions; (5) justification, revision, grievance, and reply; (6) administration of raises, bonuses, and rewards; (7) goal setting and goal negotiation; and (8) collecting and analyzing performance information. Greater still are the opportunity costs. Even at its best, "pay for performance" is still a system of "inspection" in a technical sense. Quality management theory counsels that the bulk of management energy should be devoted not to inspection of quality but to planning and improvement. Whatever time the management system is devoting to the inspection inherent in "pay for performance" is time denied to the much more significant management enterprise of quality planning and improvement.

Even if "pay for performance" produced benefit for the organization (and I dispute that it typically does produce benefit), the benefit would have to be great enough to outweigh the high costs of maintaining the system.

5. "Pay for performance" is inescapably unfair. Statistical specialists working in quality management study the proportions of variation in quality and occurrence of defect that turn out empirically to be due to *people* in a system of production compared with other causes in the system (such as the rules of procedure, the equipment, the raw materials, measurement error, and so on).[3] Even in service industries, and, to the extent it has been studied, even in health care, the preponderance of variation is not due to the people but is due instead to other sources. (The relevant mental experiment would be to substitute a new work force, randomly chosen from qualified candidates, in the current system and then to ask if basic performance levels would change.)

At a deeper level, even that proportion of variation in performance that *is* attributable to "human" attributes of the system of production is itself complex in structure. A worker brings many attributes to the work: skills, knowledge, attitude, mood, experience, ethnicity, nonwork constraints, and ambitions, to name a few. A "pay for performance" system, especially if maintained for purposes of incentive, can reasonably attach a contingent reward for an individual only to that portion of variable performance that is not only attributable to the individual but that is also, at least in principle, *under the control* of that individual. An "incentive" to make me a competitive downhill skier would have no chance of success; I have bad knees.

An all-knowing supervisor could adjust for this problem and make the contingencies apply only to the worker-controllable variation in performance. In practice, that is impossible. A back-of-the-envelope calculation shows the magnitude of the issue. Imagine, for argument's sake, that 30 percent of the variation in the productivity of physicians in an HMO is associated with individual characteristics (a proportion far greater than in most industries and unlikely to actually occur). Imagine, further, that half of that proportion is attributable to "controllable" characteristics (like effort level and learnable skills), with the

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other half being associated with relatively immutable traits (like the use of language, speed of calculation, and cautiousness in the face of risk). Thus, of variation in performance, 15 percent could be said to be susceptible to the motivation associated with merit pay and 85 percent not.

Now, imagine that a supervisor who observes variation in performance that is (in actual fact) not alterable by motivation reaches the correct conclusion (i.e., "Incentives cannot help"), say, four out of five times. Imagine, also, that the same supervisor, when observing variation that is (in actual fact) alterable through motivation reaches the correct conclusion (i.e., "Incentives can help") fully *half* the time. A simple calculation shows that, of all the instances in which the supervisor *thinks* that motivating the workers will produce better performance, fewer than one-third actually *are* of that type. [Here is the calculation: The supervisor attributes 0.2 x 85% = 17% of the observed variation to the worker when, in fact, the worker could not control the cause and the supervisor attributes 0.5 x 15% = 7.5% of the observed variation correctly to the worker's motivation. Thus, when the supervisor says, "This was controllable by worker motivation, and I expect that incentives can help," the statement is correct only 7.5/(7.5 +17) = 31% of the time.]

From the worker's point of view, this produces extraordinary irrationality in the reward structure. More than half the time that the supervisor "rewards" or "punishes" performance, for example, the worker is not in fact in control of that performance. The sense develops that the reward structure is blunt, arbitrary, and often unfair, because, statistically, it *is*, despite the best efforts of the supervisor to be fair. The unfairness comes from the statistical hazards of attributing cause in a complex causal system. Further, in the calculations used here in the example, I presume that the discrimination abilities of the supervisor (80 percent "specificity" and 50 percent "sensitivity" for detecting variation that is reachable by incentives) are considerably better than I believe these abilities to be in most performance appraisal systems.

6. "Pay for performance" reduces intrinsic motivation. Many tasks, especially in health care, are potentially intrinsically satisfying. Relieving pain, answering questions, exercising manual dexterity, being confided in, working on a professional team, solving puzzles, and experiencing the role of a trusted authority--these are not at all bad ways to spend part of one's day at work. Pride and joy in the work of caring is among the many motivations that do result in "performance" among health care professionals.

In the rancorous debates about compensation, fees, and reimbursement that so occupy the time of health care leaders and clinicians today, it is all too easy to neglect, or even to doubt, the fact that nonfinancial and intrinsic rewards are important in the work of medical care. Unfortunately, neglecting intrinsic satisfiers in work can inadvertently diminish them. Indeed, it has been possible in experimental settings to demonstrate a reduction in satisfaction from work by introducing extrinsic motivational factors. Students who will gladly work on a puzzle spontaneously when an experimental psychologist leaves them alone in a room will cease such spontaneous effort when the psychologist first offers to pay them to solve the puzzle.[4]

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It is too much to say that pay for work does not support work, but it is psychologically tenable to assert that contingent pay for better work may decrease the joy one feels in that work. W. Edwards Deming called this phenomenon "overjustification" and believed that paying people to achieve what they would want to achieve anyway tends to reduce their satisfaction in the achievement.[5] My seven-year-old daughter read book after book until her teacher began giving reading assignments and "stars" for completion, at which time completing reading "homework" became a nightly crisis.

7. "Pay for performance" "slows change. Especially in health care, breakthroughs in performance will require substantial changes in the way we do our work. We

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require an unprecedented level of innovation if we are to produce better outcomes at substantially lower cost. Innovation does not come without risk.

Logically, I see no reason why contingent pay should decrease risk taking; in theory, one ought to be able to rig it to support change. In actual practice, however, "pay for performance" seems almost always to exert a highly conservative, "antichange" influence. When goals that will be the bases for variable compensation are set in advance, employees argue not for higher aspirations but for lower ones. The conversation about performance is a debate about what is possible, not about how to make something unprecedented possible. Long arguments take shape about how, exactly, performance will be measured--arguments that do not focus on the processes of work but rather on the processes of *counting* work. Usually, failed experiments (the inevitable result of the willingness to take risks) result in deductions from "peformance" scores, even if the risks were undertaken with the interests of the organization firmly in mind. Efforts in innovation, learning, and the satisfaction of curiosity--enormous assets in any organization that wants to accelerate improvement--are rarely counted as "performance," and even training and education, being nowhere reflected on the balance sheet, tend to be treated as "benefits" instead of as forms of "performance." Thus, "pay for performance," often introduced to assist an organization whose overall performance is unsatisfactory, tends to impede exactly those forms of systemic innovation and learning that are, in the long run, most likely to dig it out of trouble.

8. "Pay for performance" is disrespectful of human relationships. In most of adult social human interaction, contingency rewarding is rude. Who would accept a dinner invitation offered “in return for your good behavior”? We solve problems together in sports teams, families, clubs, and neighborhoods, not by explicit, contingent economic exchange, but rather by building on our shared purposes, our common curiosity, our love, our sense of duty, or even by identifying the same enemy. "Pay for performance is, with a few minor exceptions, generally reserved for only two settings: commercial contracts and work.

This segregation of work as *different* from other forms of human interaction is so common as to seem inescapable. But any student of the interior life of organizations knows that the social relationships--the noneconomic forces--endure nonetheless. Our employees help each other; affection develops and matures; teamwork counts on its own merits; people share their curiosity; and tribes emerge bound by common rituals and common enemies. When one looks closely, the contingent reward system--"pay for performance "--is as dissonant and distorting of the real life of the work setting as it would be at a dinner party. People hate it; it feels wrong; it has little to do with their valued relationships; it is an unwelcome game. Most of all, it erodes the potential for the true, interpersonal, adult-to-adult relationship of equals among all of the parties to organizational life. Fundamentally, as a human being, the CEO is not different in worth, character, or dignity from the lowest-level employee. In the final analysis, we either believe that or we do not and our actions reveal our beliefs far better than our words. Contingent pay down the line of hierarchy enforces the erosive fiction that we are *not* all of the same stuff.

This point echoes of course in religion, ethics, and values. But it echoes also in organizational performance. I cannot name a great team I have known in which an *internal* structure of contingent pay, doled out by one team member to another, seemed at the root of its greatness. Relationships mattered, purpose mattered, but "pay for performance" was not in the picture.

If "pay for performance" was not superficially logical, it would not have survived in the face of its obvious defects and in the face of the dearth of good evidence to support it. It takes courage in organizations openly to doubt its worth, and even more courage to abandon it in favor of less well-described approaches to both pay and performance.

Defenders of merit pay will ask what the alternative is. There are no superb answers. Any viable system of compensation must respect market forces, employee demands for growth, and numerous other real-world factors. In addition, there are now strong pressures for various forms of gain-sharing, in which employees as a group benefit as stakeholders in overall organizational performance. Clever recognition and celebration systems, sometimes including financial reward, can apparently help support morale and energy for improvement. Some companies report success with "pay for learning" systems, in which growth in skills is recognized in the pay structure. These are all ideas worth developing further, but, for the present, the answers remain incomplete to the question, "If I do not pay people according to their performance, upon what other basis will I vary their pay?"

I find myself an extremist and therefore suspicious of my answer. But it is, nonetheless, the best answer I have yet found regarding merit pay for doctors or any group of workers; namely, "Stop it." Merit pay, "pay for performance," and their close relatives are destructive of what we need most in our health care industry--teamwork, continuous improvement, innovation, learning, pride, joy, mutual respect, and a focus of all of our energies on meeting the needs of those who come to us for help. We can find better ways to decide on how we pay each other and better uses for our energies than in the study and management of carrots and sticks.

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