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Compensation plans that base pay on an individual's recent performance, such as merit pay, enjoy prominence in both the professional compensation literature and in the popular imagination. Such plans have the attraction of clear communication of performance expectations and give employees the opportunity to increase their incomes through their own efforts. That these plans have become synonymous with "fairness" is reflected in the widespread support for President Reagan's call for merit pay for schoolteachers. Compensation textbooks and journals reflect the general belief in these plans through their devotion of substantial space to discussions of the design and implementation of such programs, despite the fact that individual performance-contingent pay makes up a very small portion of most employees' total compensation.

In practice, however, we know that such pay programs are fraught with problems (see Winstanley 1982; Pearce and Perry 1983; Pearce, Stevenson, and Perry 1985). Edward Morse from Hay put it bluntly as 1986 drew to an end: "Our traditional reward systems have failed. The decline in U.S. productivity growth during the past 20 years signals loudly that our current [pay-for-performance] system is no longer meeting our needs" (p. 85). Although the limitations of these plans have been known for decades (see Sayles 1952; Whyte 1955; Meyer 1975), it is a rare author who does not end the list of "merit pay problems" with upbeat suggestions for the successful implementation of such programs (e.g., Hamner 1975).

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Here it will be suggested that advice concerning the improvement of the implementation of such plans has not substantially improved their success. Real organizations are messy, indeterminate places, and a compensation idea that is not feasible except in pristine laboratory environments needs to be reexamined. Further, it will be proposed that the failure of individual merit pay plans should not reflexively be blamed on the practitioners struggling to put these programs in place. Rather, it will be suggested that these failures are the result of a flawed theoretical assumption behind individually contingent pay. Practicing managers are aware of the deficiencies of their own organizations' performance-contingent pay systems, but they have an incomplete rationale to explain these inadequacies. The result is frustration. Individually contingent pay, as an idea, needs to be analyzed in its organizational context. Therefore, in this paper, the implications of "organizational theory" for individually based pay are developed.

It is important to emphasize at the outset that the present argument is concerned only with the problems of merit pay based on *individual* performance, not on group or organizational performance-based merit pay or bonuses. Advocates of individual performance-based programs suggest that to be effective, performance expectations need to be clearly stated in advance. These true pay-for-performance systems (rather than the ones based mostly on retrospective subjective judgments) are the focus of the present discussion.

These pay programs are based on the assumption that overall organizational performance is the simple additive combination of individual employees' separate contributions. Alternatively, it will be proposed that the greater the uncertainty, interdependence, and complexity of organizational work, the greater the cooperation among employees required for successful organizational performance, and that individual performance-based pay can provide powerful disincentives for cooperation. This is not the traditional suggestion that money is not a powerful motivator (Deci 1975). Quite to the contrary, individually contingent pay programs can be pernicious because they so effectively direct and sustain individuals' motivation; but such plans can direct motivation away from the actions that are most functional for organizations.

The idea itself seems to hold such power that these programs are usually explained as failures of implementation or intention that, at best, suggest additions to the list of moderating or limiting conditions. Most often managers are blamed for not implementing such programs properly. For example, Hamner (1975) states that "it is not the merit pay theory that is defective. Rather, the history of the actual implementation of the theory is at fault" (p. 220).

This is not to suggest that individually based incentive pay programs are always correctly implemented but that too often evidence of "failure" receives reflexive condemnation rather than thoughtful analysis. This unexamined belief in the idea of pay for individual performance has led to a straining for explanations. The dazzle of high individual motivation has deflected theoretical attention away from a focus on what actions are being motivated. The following arguments and testable propositions derived from them are more fully developed in Pearce (1985).

ORGANIZATION THEORY AND MERIT PAY

Individual performance-contingent pay derives from an assumption that the organization's effectiveness is the simple additive combination of individuals' separate performances. Such pay programs are based on the development of "compensation contracts" in which pay is linked to the employee's performance in an explicit agreement. The clarity, "fairness," and motivating potential of these compensation contracts distract us from the fact that the employee-employer relationship has not been based on such "fixed contracts" for the simple reason that this is a less productive relationship for the kinds of uncertain, interdependent, and complex work organizations undertake.

Uncertainty in Organizations

The authority relationship between supervisors and subordinates has been a long-standing interest of organization and management theorists. Simon's (1957) definition of authority bears repeating: Subordinates accept authority whenever they permit their behavior to be guided by the decision of a supervisor, *without independently examining the merits of that decision.* When exercising authority, the supervisor does not seek to convince subordinates, only to obtain acquiescence. Organization theorists have argued that the authority of supervisors is accepted by employees in exchange for wages. It is important to recognize that this "employment contract" is an open-ended one. In exchange for pay, employees offer not specific services but their undifferentiated time and effort, which can be directed by the supervisors as they see fit. This is because, as Simon notes, from the viewpoint of the organization, there is no point in offering inducements to employees unless their actions could be brought into the coordinated system of organizational actions through their acceptance of its authority. Simon argues that open-ended employment contracts allow organizations the flexibility to respond to future uncertainty.

If performance requirements are indeed uncertain, the writing of a fixed-compensation contract restricts the ability of managers to respond to these changes. Pay for individual performance attempts to modify these traditional employment contracts so that they are less open-ended and more like the closed-ended (behaviors specified in advance) contracts of the marketplace. Simon (1957) implies that under circumstances of uncertainty, closed-ended performance contracts would be difficult to write. If conditions are genuinely uncertain, how can these contracts be detailed in advance?

In practice, these pay programs are frequently adapted to uncertainty by combining "subjective judgment" with objective measures (Lawler 1981). Such adaptions certainly help to retain open-ended authority relationships, but they have side effects of their own. For example, Carroll and Schneier (1982) note that the more subjective the rating criterion, the more rater judgment is required, not only regarding the degree to which the ratee meets the criterion but also regarding what the measure actually means. Therefore, as Lawler (1981) notes, subjectively based judgments require high levels of trust. Thus attempts to retain the authority relationship by using subjective supervisory judgments remove the clarity and fairness advantages of fixed contracts.

Recognition of the importance of uncertainty in organizational life helps us to understand otherwise inexplicable research findings. For example, researchers have found only a slight positive correlation between merit raises and performance ratings. Others usually interpret these data as missed opportunities to use a valued reward to increase motivation (e.g., Lawler 1971). Alternatively, supervisors may not tie such a salient reward to individually measured performance because they recognize not only that good performance is not completely represented in performance appraisals but also that these closed-ended contracts reduce their own ability to respond to unanticipated events. Supervisors face myraid uncertainties, requiring levels of flexibility that cannot be captured in individual performance contracts. Such supervisors use the discretion that merit raises afford to reward critical accomplishments, to cope with such concerns as inflation and salary compression, and to compensate for a particularly unattractive assignment or absence of an expected promotion. Pay does, in fact, serve a multitude of purposes in organizations, and mandating that it be dominated by an individual's measured performance in the most recent performance period impedes the ability of managers to manage.

Interdependence in Organizations

In describing the ways in which individually contingent pay interferes with the dependence of individuals on their organizations, it is useful to draw on Thompson's (1967) three-part categorization of dependence relations in organizations. First, individuals are most interdependent when they must work together, interacting during task performance, in order to complete their work. Individually contingent pay would rarely be advocated in the case of this "reciprocal interdependence," since credit and blame are virtually impossible to assign to individuals. However, Thompson's two other kinds of interdependence—sequential and pooled—are not readily seen as prohibiting individually contingent pay.

Sequentially dependent employees rely on others for either their inputs, for the disposal of their outputs, or for both. It is for this kind of interdependence that we have the most vivid descriptions of contingent pay dysfunctions (e.g., Whyte 1955; Babchuk and Goode 1951). Since the problems resulting from the use of individually contingent pay for sequentially dependent employees have been well documented, this discussion focuses on pooled interdependence.

Pooled interdependence is the collective dependence of employees on the continued success of the organization; Thompson argues that employees may not be directly interdependent with others for their task performance but are still jointly dependent with all other participants on their organization's ability to provide employment and other resources.

Individually contingent compensation contracts distract employees' attention from this more abstract dependence relationship and interfere with members' commitment to their colleagues and employer. By treating them as labor contractors, employees are encouraged to work only on activities represented in their contracts. Drawing on Kerr (1975), we might hope that they will cooperate with their colleagues and supervisors, but we are rewarding them for fulfilling the terms of a fixed contract.

Thus employees are seen by the organization and come to view themselves as "contractors," with a written "track record" provided by the compensation system that can be marketed to another employer. It can be speculated that it is this growing use of performance-based compensation contracts for professionals and managers, rather than massive changes in personal values, that has led to the popularly perceived shift among American managers and professionals from "organization men" (Whyte 1956) to "job-hopping professional managers" ("The Money Chase" 1981). Therefore, it should be no surprise to find that that recent advocates of Japanese-style concern with fostering employee loyalty advocate abandoning individually contingent pay in favor of organizationwide bonuses (Ouchi 1981).

It is further suggested that pay for individual performance, since it provides incentives that run counter to the pooled interdependence among organization members, can actually undermine the quality of employer-employee relationships. Numerous scholars have attempted to articulate the positive attitude that frequently emerges among employees in their relationship with their employing organization (e.g., Pearce and Peters 1985). For example, Barnard (1938) describes the importance of "cooperation," and recently there has been a renewed interest in "organizational commitment" (Mowday, Porter, and Steers 1982; Wiener 1982).

These pay plans can damage organizational commitment, since they treat the employee as a labor contractor. Such contracts communicate that the employer is only concerned with the employee's performance as it is reflected in the "contract measures" and is, in effect, indifferent to past contributions and experience (since the employer pays only for the recent performance period), to the employee's potential for other kinds of work, and to any extenuating circumstances that may have influenced the recent performance measures. There is recent evidence that merit pay programs do have significant and long-lasting (fifteen months) negative effects on organizational commitment (Pearce and Porter 1985).

Complexity in Organizations

The work of Williamson (1975) illustrates the complexity of organizational work and helps to clarify why the fixed contracts of individually contingent pay can be dysfunctional for overall organizational effectiveness. This economist has sought to understand the conditions under which economic activity takes place either in markets—in which transactions involve exchange between autonomous economic entities—or in organizations. He suggests that organizations are more efficient than marketplace contracting under conditions of future uncertainty, complex transactions, and dependence on individuals willing to exploit their advantage.

Under these circumstances, employment contracts in organizational settings have certain advantages over labor market contracting that makes employment more efficient. Particularly relevant to the present discussion, Williamson argues that organizations are better able to encourage cooperation among opportunistic specialists (employees). Thus organizations are the more efficient forms under certain circumstances because they can more easily compensate individuals for cooperation.

Williamson's work has important implications for the design of pay systems. It suggests that despite its advantages of clarity and apparent fairness, market contracting is not suited to all types of economic exchange. Employment relationships dominate the labor market today because work has become more complex, more dependent on particular individuals, and must be conducted under conditions of future uncertainty. If such conditions are not present, Williamson suggests that it is more efficient to use marketplace contracting for services rather than employment.

Therefore, individually contingent pay, by tying an employee's pay to his or her performance during a specific time period, is an attempt to reformulate the employer-employee relationship into a pseudocontract between buyer and seller. Under conditions of uncertainty, interdependence, and complexity, such pseudocontracts cannot be completely specified. They can, at best, cover only a portion of the desired actions and become a forced and artificial representation of the kind of performance that would be most effective for the organization (a familiar problem for those who have had experience with merit pay programs). Further, since pay can be such a powerful motivator, all the problems in the use of pseudocontracting in organizations are made worse when pay is attached to fulfilling the terms of the contract.

Pay-for-individual-performance systems, despite their motivating power, would not, then, be expected to result in enhanced organizational effectiveness. Such systems build in disincentives for the management of uncertainty, interdependence, and complexity and so discourage the kinds of cooperative actions that lead the organizational form to be more efficient than labor contracting. If the organization does, in fact, have individual tasks that are predictable, simple, and independent, this analysis suggests that it would be more efficient to hire contractors than employees. Pay for individual performance is neither a labor contract (since the authority relationship remains) nor a conventional employment relationship (with rewards allocated based on *post hoc* judgments of overall employee historical and potential contributions). Thus organizations that use such forms of compensation would be expected to have less effective performance than those not using such systems, since their compensation system is working against the advantages of the organizational form. We certainly could not expect the greater overall organizational effectiveness implied by pay-for-performance advocates.

This suggests a reinterpretation of the research reporting that executives' pay is uncorrelated (Redling 1981; Perham 1971) or, at best, weakly associated (Patton 1961; Gomez-Mejia, Tosi, and Hinkin 1984) with their organizations' financial performance. Instead of deploring this evidence as representing a lack of "the will to pay for performance" (Redling 1981), it may more accurately reflect attempts to pay for performance that simply have no influence on corporate performance. Booz-Allen and Hamilton (1983) reported that while the "shareholder value" of Standard and Poor's 400 corporations declined 10.5 percent from 1970 to 1982, the use of performance-based bonuses for these firms' chief executive officers nearly doubled (from 23 percent of total compensation in 1971 to 41 percent in 1981). This appears to reflect an increasing effort to tie a larger proportion of executive pay to measures of performance. These compensation committees were apparently trying to pay for individual performance, despite the fact that organizational performance was declining during this period. This certainly doesn't prove that individually contingent pay caused the decline in firm performance, but it does suggest that the absence of a strong positive relationship between executive pay and firm performance does not necessarily reflect a lack of "the will to pay for performance." Rather, perhaps, corporate compensation committees have been using the wrong model of the ways in which individuals' performances contribute to overall organizational performance.

IMPLICATIONS

The argument developed here has implications for both research and practice. Research hypotheses derived from these arguments need to be tested empirically; a discussion of possible tests appears in Pearce (1985).

Regarding compensation practice, this article was intended to help explain the gap between the popular belief in the power of merit pay and the actual track record of these programs by examining one of the relatively neglected assumptions behind individually contingent pay. At this point one could reasonably ask, Since virtually no compensation system is actually dominated by individual performance-contingent compensation, what practical difference does it make if an important assumption is flawed?

Such a large discrepancy between compensation practice and popular theory is demoralizing to practitioners and can lead to poor practice. Professional compensation specialists are led to feel uncomfortable that their own organization's actual system deviates so far from "accepted advice," and they have no way to explain coherently *why* true pay for performance plays such a limited role in their employees' overall compensation. This discussion is intended to confirm that there is no need to feel guilty about the small role of merit pay.

Virtually all compensation textbooks note that pay is intended to attract and retain employees as well as motivate greater individual performance (Nash and Carroll 1975; Ellig 1982; Wallace and Fay 1983). Wallace and Fay argue that compensation systems must meet employees' expectations for equity or fairness and that individual job performance is only one of many factors—including prevailing labor market wages, the responsibility of the position, and skill and knowledge requirements—that contribute to perceived compensation fairness. Pay systems are already burdened by spiraling labor market demand, pay compression, demands for comparable worth, inflation, and the like, and advocating that they also be harnessed as the primary short-term performance-contingent incentive is not realistic.

In conclusion, individually contingent pay plans are based on a false assumption. These plans attempt to mimic marketplace contracts under conditions of uncertainty, complexity, and dependence for which they are not appropriate. Pay can be a powerful incentive, but compensation specialists need to ensure that the dazzle of high performance motivation doesn't distract from a concern with *what* performance is being motivated. Paying people on the basis of their recent measured individual performance simply does not build on the relative advantages of the organizational form. Most kinds of organizations succeed because of cooperation among their members, not because of members' discrete, independent performances. Such cooperation is particularly critical among employees with either valuable expertise (which may be the basis for the organization's competitive advantage) or the discretion to commit the organization's resources (i.e., managers). It is simply not in the organization's interest to encourage short-term single-transaction expectations among such important employees. Pay is important, and the ways in which organizations dispense it tell us a lot about the actions they expect from their employees. Compensation theory could reflect organizational realities better if it had as great a concern for the organizational context in which employees must work as it does for their levels of individual effort.

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basically means eliminating time clocks and giving all individuals the same benefits package. It can be, and often is, extended to include many of the perquisites that are allocated according to management level (e.g., parking spaces, office size). An egalitarian approach can be combined with flexible benefits so that, although individuals have different total compensation levels, they have access to all benefits in the organization if they are willing to pay the price.

SUMMARIZING PAY CHANGES

The new management practices and strategies that are evolving in the United States require new pay practices. Pay needs to be characterized by egalitarianism, local control of decision making, individual choice, and, most important, a strong performance-based system that ties in to the business itself. The strategy of installing multiple pay systems that reward organizational performance represents a potentially effective approach to improving organizational performance by using pay as an incentive. The alternative of essentially abandoning pay as a motivator is always there, but it represents the abandonment of a very important potential incentive, something that most organizations cannot afford to do.

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