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Five Ways to Get More from Your Merit Budget

Originally published in the May 2018 issue of WorldatWork's Workspan magazine, our authors suggest five ways to maximize the impact of a limited merit budget.

During the performance cycle, compensation and HR professionals spend a lot of time thinking about the size of the merit pool and who gets how much of an increase. However, less time is spent on considering the factors that go into how the pool is delivered: differentiating for exceptional performance, delivering increases in a fair and unbiased way and showing employees the connection between their performance and salary increases.

Little time is devoted to reflecting on these (and other) factors and whether they should be adjusted. But there are a few ways compensation and HR leaders can rethink their merit-budget pool to maximize its effect on the workforce

Idea No. 1: Differentiate for Top Performers

You can free up a considerable part of your merit budget by reducing the amount of merit increases for your “meets expectations” performers and by reducing the participation of those receiving a merit increase. Companies that award twice as much of a merit increase to top-rated performers as to their average performers gave merit increases to 87.2% of their workforce, according to Radford research. And companies that award a merit increase that is three times higher to top performers versus average ones saw participation in the merit increase drop to 77.1%. In other words, higher increases for top performers relative to average performers mean smaller merit-increase participation across the entire organization.

On the other side of the coin, some companies are moving from a merit increase to an annual salary review. The mindset changes from an annual base-pay increase being performance-based to that increase reflecting external or internal equity adjustments. Companies using this strategy emphasize cash and long-term incentives to differentiate for performance (and may have smaller annual salary budgets to accommodate for this). You also should assess whether some of the top performers identified might be ready for a promotion instead of a higher merit increase (see Idea No. 4).

Idea No. 2: Deliver Increases Fairly and Transparently

Delivering merit increases fairly doesn’t mean all employees get the same amount. It means employees have insight into how increases are determined and feel their performance is connected to their pay adjustment. Companies can promote transparency by sharing salary ranges and how they are derived as well as by educating

employees on how performance and experience determine their position in range. The wave of compensation transparency is a moving train and it's time to hop on board, if you haven't already.

Idea No. 3: Arm Managers with Decision Making and Communication Tools

Managers are the first line of communication to employees on how merit increases are decided. Just as it's important to ensure employees know how their pay is determined, having those systems in place doesn't do much good if managers aren't effective in explaining that connection to their direct reports.

Idea No. 4: Use Creativity when the Time is Right

In certain situations, you may need to break with protocol and take more drastic action to retain top performers. For example, if you're working with a smaller budget one year, consider whether certain individuals are ready for a promotion and can be compensated out of your promotion budget rather than merit budget. You don't want to promote individuals who aren't ready, but certain employees may show strong signs they are able and eager to grow into a new position with the right amount of coaching and mentoring. Another idea is to ask leaders to make sacrifices or delegate funds from unfilled job requisitions to the merit pool, which should be used in limited circumstances when your merit budget is stretched.

Idea No. 5: Know Your Merit Budget's Limits

Merit increases only come once a year, but recognition programs are used year-round. Consider using a small portion of your merit budget to institute a recognition program if you don't already have one, as they typically are highly valued by employees. Most companies with formal recognition programs only need to use up to 0.5% of their merit budget to fund them. When you think beyond the limits of your merit budget, it frees you up to think about the workforce's appetite for at-risk pay and the alternative ways to spend (part of) your merit budget. This can include 401(k) matching enhancements, student-loan repayment benefits or base-salary adjustments to address pay equity concerns.

A Tool, Not an Entitlement

The merit budget is an important tool for recognizing and rewarding employees' contributions throughout the year, but too often we see it being viewed as an entitlement. Companies that effectively differentiate the merit increase based on performance in a fair and transparent way are better positioned to maximize the efficacy of the overall salary budget.

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To speak with a member of our compensation consulting group about these ideas, please write to consulting@radford.com. To learn more about participating in a Radford survey, please [contact our team](#).

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