

## The Myths of Merit Pay: How Manager Discretion in Pay Decisions Embeds Bias and Undermines Morale

Studies on merit pay systems show that many companies and managers strongly believe that to increase productivity, and to be competitive and fair, they must establish a merit based pay system. In fact, this approach can reduce morale and reinforce pay disparities based on gender, race and national origin.<sup>1</sup> The connection between merit pay and increased productivity is a myth. Expectancy theory, which has often been the basis for implementing merit pay systems, posits that workers are influenced by extrinsic motivators, and that external rewards, such as merit pay, will result in higher motivation.<sup>2</sup> The theory holds that individual performance can be shaped by linking “effort, performance, result, and reward.”<sup>3</sup> Yet studies have found that “most merit plans have limited ability to motivate productivity.”<sup>4</sup> What is often missing from an employer’s merit pay approach is consideration for the importance of a work environment that includes fair pay for everyone and allows workers to excel and do their best work.

### The Risks and Harms of Merit Pay

According to the Department of Labor, merit pay, or, pay-for-performance, is defined as “a raise in pay based on a set of criteria set by the employer.”<sup>5</sup> The 1992 book *Pay for Performance: History, Controversy, and Evidence* traces the history of pay-for-performance back to the industrial revolution when “increased demands for efficiency and performance by the factory system” led to incentive programs.<sup>6</sup> Authors E. Brian Peach and Daniel Warren explain, “Subjective performance standards and employer rate cutting made incentives objects of suspicion to workers.”<sup>7</sup> Against this backdrop, the book’s editor explains there is little empirical basis for merit pay because “[e]ven experts understand little about how to effectively use pay.”<sup>8</sup>

Pay systems in which the employer has unilateral discretion to decide the distribution of raises and bonuses have a number of damaging impacts. In many jobs, the employee review process is not designed to provide an objective measure of productivity or overall performance. The subjectivity of performance criteria can lead workers to view merit pay systems as unfair. Such systems often require workers to compete for a limited pool of money allocated for merit pay increases. Discretionary pay systems can also lead to a form of “valuative discrimination” which is bias against groups of workers

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<sup>1</sup> Emilio J. Castilla and Stephen Benard, “The Paradox of Meritocracy in Organizations,” *Administrative Science Quarterly*, Vol. 55, No. 4, pp. 543-576, Sage Publications, Inc. on behalf of the Johnson Graduate School of Management, Cornell University, (December 2010).

<sup>2</sup> Isaac, Robert G., et al. “Leadership And Motivation: The Effective Application of Expectancy Theory,” *Journal of Managerial Issues*, vol. 13, no. 2, 2001, pp. 212–26.

<sup>3</sup> Arie Halachmi, Tennessee State University and Marc Holzer, John Jay University of New York College City, “Merit Pay, Performance Targeting, and Productivity,” *Review of Public Personnel Administration*, Vol. 7, No. 2 (Spring 1987:80-91).

<sup>4</sup> Ibid.

<sup>5</sup> Department of Labor, “Merit Pay,” <https://www.dol.gov/general/topic/wages/meritpay> (accessed Jan. 19, 2024).

<sup>6</sup> Bill L. Hopkins, Thomas Mawhinney, Editors, “Pay for Performance: History, Controversy, and Evidence,” “Historical Context” E. Brian Peach, Daniel A. Wren, The Haworth Press, Inc., New York, London, Sydney, 1992, [https://www.google.com/books/edition/\\_/HnGkDwAAQBAJ?hl=en&gbpv=1](https://www.google.com/books/edition/_/HnGkDwAAQBAJ?hl=en&gbpv=1) (accessed Feb. 6, 2024).

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

based on gender, race, or nationality.<sup>9</sup> In non-union workplaces, employers can also choose to simply not provide raises on any particular schedule. These factors, combined with embedded biases, create distrust, sow discontent, and lower morale among workers, and reduce overall productivity.<sup>10</sup>

In a 2010 study of merit pay published by the American Association of University Professors, Professor Robert P. Engvall argues, “The idea of trusting those in power to do what is ‘right’ is central to the notion of merit pay.”<sup>11</sup> Engvall argues instead that corporate leaders are often misguided because they engage in short-term thinking and focus on profit above their employees. In the context of higher education, Engvall points out that administrators can use merit pay to ensure employees don’t get out of line, and to silence those who might otherwise voice their disagreements with administrators. Ultimately, the power dynamic created by discretionary pay systems further entrenches power imbalances between employers and workers, preventing progress towards equitable pay and undermining workers’ bargaining power.

Sociologist Emilio J. Castilla presents evidence that employers who adopt merit-based pay systems that lack transparency and accountability can increase bias and reduce equity in the workplace. In a study of a large service company that used a performance-based pay system, Castilla found that gender, racial, and nationality differences in salary growth persist even after controlling for performance evaluations.<sup>12</sup> The company implemented a merit pay program in 1994 in response to employee complaints about poor management by their supervisors. Castilla explains that the employer’s intention was to “facilitate constructive dialogue between employees and supervisors, to encourage the employee’s professional development, to clarify job duties and performance objectives, . . . and to make compensation decisions.”<sup>13</sup> He found that instead, this evaluation and merit pay process introduced what he refers to as “performance-reward” bias. According to his analysis of the company’s pay data, he found that race-related bias was introduced at the performance evaluation stage, and at the second stage of the merit pay process, which linked performance evaluations to employee outcomes. Castilla found that merit raises were rejected more often for people of color and this resulted in a growing disparity in pay over time. Not surprisingly, the turnover rate for people of color was higher than for white male employees.

Merit pay is also problematic because employers have the sole discretion to decline to give merit pay raises at all, leaving workers uncertain about their future economic security. An article in the Massachusetts Institute of Technology (MIT) newsletter, *The Tech*, provides an example of this. In 2020, MIT suspended all merit-based raises during the pandemic, but did not make the policy permanent. Years of uncertain discretionary raises meant employees were economically insecure, with sixty percent

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<sup>9</sup> Emilio J. Castilla, “Gender, Race, and Meritocracy in Organizational Careers,” Massachusetts Institute of Technology, University of Chicago Press, <https://ideas.wharton.upenn.edu/wp-content/uploads/2018/07/Castilla-2008.pdf> (accessed Feb. 1, 2024).

<sup>10</sup> *Ibid.*

<sup>11</sup> Robert P. Engvall, “The Corporatization of American Higher Education: Merit Pay Trumps Academic Freedom or, More Discretionary Power for Administrators Over Faculty: You’re Kidding Me, Right?,” AAUP, *Journal of Academic Freedom* Volume One, 2010, <https://www.aaup.org/sites/default/files/files/JAF/2010%20JAF/Engvall.pdf> (accessed Feb. 2, 2024).

<sup>12</sup> Emilio J. Castilla, “Gender, Race, and Meritocracy in Organizational Careers,” Massachusetts Institute of Technology, University of Chicago Press, <https://ideas.wharton.upenn.edu/wp-content/uploads/2018/07/Castilla-2008.pdf> (accessed Feb. 1, 2024).

<sup>13</sup> *Ibid.*

of MIT staff feeling stress over the cost of living. The author argues for eliminating merit pay altogether, and asked the MIT community:

Do we want MIT to be an environment that merely pays lip service to issues of diversity, equity, and inclusion or one that demonstrates its commitment to DEI through strong action? Do we want an administration that supports the economic security of its employees through the toughest of times or one that treats them as just another budget line item to be slashed without the input of those who are affected? Do we want a compensation policy that is fair, transparent, and unbiased or one that is shrouded by an opaque and questionable meritocracy?<sup>14</sup>

Today, workers continue to endure the negative impacts of merit pay systems, which are widespread in the United States.

### **Equitable Approaches to Pay; How Unions Help Workers**

Research shows that bias is less likely to occur when “decision makers are held accountable for making fair decisions.”<sup>15</sup> When managers know that they will have to explain and be accountable for their decisions, they are more motivated to make those decisions in an analytical and objective manner.

Unionized workers have more tools to build transparency and accountability into the system, which is why union workers experience greater pay equity than their nonunion counterparts. For example, women workers who are non-union make approximately 81.6 percent of what their white male counterparts earn, whereas women workers in unions make 88.0 percent. Latina, Black, and Asian women who are unionized workers also experience smaller wage gaps.<sup>16</sup>

Joining a union provides workers a voice in their workplace. When workers come together and unionize, they have rights that other workers don’t have. These include the right to engage in collective bargaining, the right to organize and mobilize around issues that matter to them. These rights give union members power at the bargaining table, where they can insist on fair pay and transparency through measures such as uniform wage scales, objective standards for hiring and promotions, and elimination of harmful management practices like pay secrecy requirements.<sup>17</sup>

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<sup>14</sup> Caleb Larson, Gabby Ballard, and Brandon Milardo, “How merit-based raises hurt DEI, MIT must make a stronger commitment to DEI through its pay practices,” MIT The Tech. February 18, 2021, <https://thetech.com/2021/02/18/merit-based-raises-hurt-dei> (Accessed Feb. 1, 2024).

<sup>15</sup> Emilio J. Castilla, “Gender, Race, and Meritocracy in Organizational Careers,” Massachusetts Institute of Technology, University of Chicago Press, <https://ideas.wharton.upenn.edu/wp-content/uploads/2018/07/Castilla-2008.pdf> (accessed Feb. 1, 2024).

<sup>16</sup> Kayla Patrick & Sarah David Heydemann, National Women's Law Center, “Union Membership is Critical for Equal Pay” Fact Sheet, March 2018, <https://nwlc.org/wp-content/uploads/2016/02/Union-Membership-is-Critical-for-Equal-Pay-2018.pdf> (accessed Feb. 7, 2024).

<sup>17</sup> Center for American Progress, “Combating Pay Gaps with Unions and Expanded Collective Bargaining,” June 28, 2018, <https://www.americanprogressaction.org/article/combating-pay-gaps-unions-expanded-collective-bargaining/> (accessed Feb. 7, 2024).