

Designing an Effective Pay for Performance Compensation System



A Report to the President and the
Congress of the United States by the
U.S. Merit Systems Protection Board

THE CHAIRMAN



U.S. MERIT SYSTEMS PROTECTION BOARD
1615 M Street, NW
Washington, DC 20419-0001

January 2006

The President
President of the Senate
Speaker of the House of Representatives

Dear Sirs:

In accordance with the requirements of 5 U.S.C. 1204(a)(3), it is my honor to submit this Merit Systems Protection Board report, "Designing an Effective Pay for Performance Compensation System."

Federal Government agencies are moving to better align pay with performance and create organizational cultures that emphasize performance rather than tenure. From our research, we have learned that agencies must invest time, money, and effort in the design and implementation of their pay for performance compensation systems in order to succeed. A credible and fair pay for performance system will require an effective performance evaluation system and supervisors who are able and willing to use it properly. Agencies will also need mechanisms such as training and systematic monitoring of pay decisions and outcomes to ensure that pay for performance systems operate as intended.

Although the requirements listed above are universal, we believe the long-standing principles of providing "equal pay...for work of equal value" and "appropriate incentives and recognition...for excellence in performance" are best met by agencies designing pay for performance systems to suit their individual missions, workforces, and circumstances with respect to uniform guidelines and principles. Accordingly, this report discusses the critical choices that agency leaders will make during the design and implementation of a pay for performance compensation system. This discussion is intended to help agency leaders better understand how they can adapt pay for performance systems to their organizations and to help them choose wisely among alternatives for measuring and rewarding performance.

I believe you will find this report useful as you consider the implementation of pay for performance across the Federal Government.

Respectfully,

A handwritten signature in black ink, appearing to read "Neil A. G. McPhie".

Neil A. G. McPhie

Designing an Effective Pay for Performance Compensation System

A Report to the President and
the Congress of the United States
by the U.S. Merit Systems Protection Board



U.S. Merit Systems Protection Board

Neil A.G. McPhie, *Chairman*

Barbara J. Sapin, *Member*

Office of Policy and Evaluation

Director
Steve Nelson

Deputy Director
John Crum, Ph.D.

Project Manager
Cynthia H. Ferentinos, Ph.D.

Project Analyst
James J. Tsugawa

Table of Contents

Executive Summary	ix
Background	ix
Purpose	x
Conclusions and recommendations	xi
Introduction	1
A summary of pay for performance	1
Benefits and risks associated with pay for performance	2
Pay for Performance Decision Points	3
Overview	3
Is the agency ready for pay for performance?	3
What are the goals of pay for performance?	7
Who should be paid for performance?	7
What should be the timing for implementing pay for performance?	8
What should be rewarded?	8
How should employees be rewarded?	14
How much pay should be contingent upon performance?	18
How should performance-based pay be funded?	20
How can costs be managed?	21
Who makes performance rating and pay decisions?	25
Who provides input to performance ratings?	26
How can agencies facilitate pay system integrity?	28
Summary	34
Conclusions and Recommendations	37
Summary	39
Bibliography	41

EXECUTIVE SUMMARY

Decisions that are made during the design and implementation of a pay for performance system are crucial. Therefore, agency decision makers should carefully consider their design options with full awareness of potential advantages and disadvantages. To assist agency leaders with these crucial decisions, we have prepared this report to address topics such as who should be covered, what should be rewarded, how to reward employees, and suggestions for preserving the integrity of the pay system. We hope that this discussion will assist agencies in anticipating important issues and tailoring their pay systems to their unique needs, which will facilitate their success.

Background

In the past, individual Federal Government agencies have obtained approval to introduce pay for performance systems in limited demonstration projects or in a few cases on an agency by agency basis. However, the transition of the Federal Government from the traditional General Schedule accelerated when the Department of Defense and the Department of Homeland Security obtained approval to implement performance-based pay systems. To further facilitate this shift from recognizing tenure to focusing on performance, legislation has been proposed to implement pay for performance across the Federal Government.¹

However, moving from a pay system that rewards tenure to a pay system that emphasizes and rewards performance, will require more than legislation. Performance-based pay systems present unique opportunities and challenges, and the transition from tenure-based pay systems will be neither quick nor easy. With that in mind, we have prepared this report to support agencies who are planning to use (or are already using) pay for performance. Specifically, we discuss how agencies can design, implement, and operate a pay for performance compensation strategy.

Past experience with the General Schedule suggests that in pay systems, “one size does not fit all.” Agencies need to customize compensation systems to their own unique circumstances. Based on this premise, readers should understand that although this report is presented as a “how to” guide, it is not our intent to prescribe a single solution. Instead, our goal is to help agency leaders anticipate and better understand some of the most critical decision points they are likely to face.

¹ Working for America Act (draft proposal) as of February 2006.

Purpose

As the guardian of the Federal merit systems, the U.S. Merit Systems Protection Board (MSPB) hears employee appeals of covered personnel actions and conducts studies to ensure that these systems adhere to the merit system principles and are free of prohibited personnel practices. In this report, we provide an overview of the options inherent in the design, implementation, and operation of an effective pay for performance system. For a summary of the primary questions that agencies should ask themselves and a sample of the possible answers, see **Table 1**. This table serves as a roadmap to preview the decision points that we discuss in further depth later in the report. We urge agencies to carefully consider each of these decision points because effective operation of the pay system requires agency leaders to make design choices that best suit their organizations.

Table 1. Key Decision Points When Considering Pay for Performance

(Including a sample of issues and/or options)

- | |
|---|
| <p>1. Is the agency ready for pay for performance?</p> <ul style="list-style-type: none"> ■ The organizational culture supports pay for performance ■ Management is committed to changing the culture |
| <p>2. What are the goals of pay for performance?</p> <ul style="list-style-type: none"> ■ Improved recruitment and/or retention ■ Increased individual and/or organizational performance ■ Greater fairness in pay |
| <p>3. Who should be paid for performance?</p> <ul style="list-style-type: none"> ■ All employees ■ Front-line employees ■ Top-level managers |
| <p>4. What should be the timing for implementing pay for performance?</p> <ul style="list-style-type: none"> ■ Wholesale ■ Stages |
| <p>5. What should be rewarded?</p> <ul style="list-style-type: none"> ■ Individual, team, and/or organizational achievements ■ Short-term and/or long-term goals ■ Efforts vs. outcomes when external constraints exist |
| <p>6. How should employees be rewarded?</p> <ul style="list-style-type: none"> ■ One-time cash bonus ■ Increase to base pay ■ Combination, such as control points |
| <p>7. How much pay should be contingent upon performance?</p> <ul style="list-style-type: none"> ■ Less than 5 percent ■ Approximately 30 percent |
-

Table 1. Key Decision Points When Considering Pay for Performance (Continued)

(Including a sample of issues and/or options)

<p>8. How should performance-based pay be funded?</p> <ul style="list-style-type: none"> ■ Existing funding (e.g., general increases, within-grade increases) ■ Additional funding
<p>9. How can costs be managed?</p> <ul style="list-style-type: none"> ■ Forced distribution ■ Reward only top performers (as a percentage of the workforce)
<p>10. Who makes pay decisions?</p> <ul style="list-style-type: none"> ■ First-level supervisor ■ Second-level supervisor
<p>11. Who provides input on the performance ratings?</p> <ul style="list-style-type: none"> ■ First-level supervisor ■ Second- or higher-level managers
<p>12. How can agencies facilitate pay system integrity?</p> <ul style="list-style-type: none"> ■ Improved performance evaluation process ■ Supervisor and employee training

Conclusions and Recommendations

Agencies must tailor pay for performance systems to their mission and environment.

Agencies have many options when designing a pay for performance system. These options include the coverage of a pay for performance system, the types of performance to be rewarded, how performance will be measured, the form that pay for performance will take, and the delegation and review of pay decisions. However, there is no universally correct choice for any of these options. A choice that is appropriate in one organization may be ineffective or counterproductive in another. For example, rewarding individuals who generate the greatest amount of output may be appropriate in some organizations that are very production-oriented. However, this approach could be problematic in an organization whose work demands close attention to *how* results are achieved, particularly in regard to matters such as quality, safety, or teamwork. Thus, an agency designing a pay for performance system must think carefully about its goals and how they are to be achieved to create measures and incentives that can orient its workforce toward meeting those goals.

For pay for performance to be effective, agencies need to meet several requirements.

Although agencies have options to tailor their pay practices, successful pay for performance systems do have some features in common. A pay for performance system can only be effective if employees: value the pay or recognition that the organization offers in return for high performance; understand what is required of them; believe that they can achieve the desired level of performance; and

believe that the organization will actually recognize and reward that performance. Those conditions are not likely to be achieved unless an agency meets certain requirements. These requirements include:

1. A culture that supports pay for performance;
2. Effective and fair supervisors;
3. A rigorous performance evaluation system;
4. Adequate funding;
5. A system of checks and balances to ensure fairness;
6. Appropriate training for supervisors and employees; and
7. Ongoing system evaluation.

Research and experience indicate that agencies need to attempt to meet *all* of these requirements. For example, well-designed performance measures are not a satisfactory substitute for trained, conscientious supervisors; similarly, a high level of funding does not compensate for a lack of checks and balances.

To make pay for performance successful, agencies need to make a substantial investment of time, money, and effort. To meet the requirements listed above, agencies will need to make investments that extend far beyond the money needed to fund bonuses and pay increases. For example, supervisors will need: training in designing performance measures and providing performance feedback; a performance evaluation system that enables them to accurately distinguish among levels of performance; and guidelines for determining pay increases or performance bonuses. The introduction of a pay for performance system can also identify weaknesses in other areas—such as training, communications, and employee relations—that should be addressed.

Performance evaluation serves as the foundation of a pay for performance system. A pay for performance system links an employee's pay to some measure of individual and/or pay organizational performance, usually through a formal performance appraisal. Consequently, performance standards and measures—and the application of those standards and measures—matter greatly to both the agency and the employee. Agencies should therefore ensure that (1) performance goals and measures are relevant, reasonable, and usable; (2) employees understand and participate in the performance evaluation process; and (3) performance is evaluated fairly and rigorously. Agencies considering a pay for performance system should be prepared to devote considerable effort to performance evaluation. One frequently cited challenge is that performance is often difficult to define and measure in public sector organizations. Even so, it is critical that this effort be made.

Agencies should select supervisors based on their supervisory potential, develop and manage them to function as supervisors rather than technicians or staff experts, and evaluate and pay them based on their performance as supervisors. Performance evaluation systems do not evaluate performance; supervisors do. Although agencies should take steps to define and measure performance as precisely and reliably as possible, they should recognize that it is not possible to predetermine or quantify every important aspect of employee performance. Therefore, agencies need to allow some room for supervisors to use discretion and judgment when evaluating employee performance—which is to say, some element of subjectivity. But they should also provide guidelines and training to equip supervisors to exercise that judgment responsibly because trust between supervisors and employees is critical to success.

Supervisors also perform other tasks that directly affect employee performance and how employees will fare under a pay for performance system. For example, supervisors assign work; they translate organizational goals into work unit and individual performance goals; they identify training needs and provide access to training opportunities; and they provide coaching and feedback. Consequently, any agency considering pay for performance needs to ensure that its supervisors are willing and able to perform supervisory duties and should hold them accountable for how they discharge their responsibilities.

Communication, training, and transparency are essential elements of a good pay for performance system. Pay for performance systems are most effective when they encourage employees to manage and improve their own performance—when they help employees to understand what is expected of them, to choose wisely among various courses of action, and to identify, seek, and obtain the resources (such as training and equipment) that they need to succeed.

A pay for performance system cannot have these desirable effects unless employees understand the organization's goals, their role in achieving those goals, and how the pay system works. Agencies should not assume that these matters are self-explanatory, but agencies should make a conscious effort to create this understanding. That includes describing how the pay for performance system operates; informing employees what behaviors and accomplishments will be rewarded; providing regular, constructive performance feedback; training employees on how they should present their efforts and accomplishments; and telling employees how they have fared under the pay for performance system and the reasons for the outcome.

Checks and balances are necessary. As discussed above, a pay for performance system requires that agencies allow supervisors to exercise some degree of discretion and judgment in evaluating and rewarding employee performance. However, a pay for performance system also requires fairness—both actual and perceived—for it to have any credibility or motivating power.

Consequently, agencies must also ensure that supervisory decisions concerning employee performance and pay are fair and reasonable. Training and guidance are necessary but not entirely sufficient. Agencies should establish internal checks and balances—such as limited delegations of authority, review panels, and internal appeals processes—to ensure that supervisors are, in fact, using their judgment and discretion appropriately.

A pay for performance system needs sufficient funding to provide high-performing employees with meaningful pay increases and bonuses. Pay for performance represents a commitment from the agency to recognize and reward excellence. A pay for performance system will lose all credibility if high performance goes unrewarded. Therefore, agencies should ensure that adequate funds are earmarked for performance awards.

Pay for performance systems should be evaluated regularly and modified when necessary. The General Schedule classification and pay system has remained in place, with relatively few changes, for more than 50 years. Although we expect that the practice of pay for performance will endure, the useful life of even the best-designed pay for performance system will most likely be measured in years, not decades.

Pay for performance systems need ongoing attention to keep them functioning properly. Organizational goals will change; performance goals and measures will become obsolete; performance may improve or decline; managers may make errors in evaluating performance or allocating rewards. For all these reasons and more, agencies need to monitor the operation and effectiveness of their pay for performance systems and modify them accordingly. Only by giving the pay systems and related organizational requirements the ongoing attention that they warrant will agencies be able to obtain optimal results from their pay for performance systems.

Introduction

A summary of pay for performance

The term “pay for performance” refers to a pay strategy where evaluations of individual and/or organizational performance have significant influence on the amount of pay increases or bonuses given to each employee.

When a pay for performance system functions properly:

Pay for performance – a pay strategy where evaluations of individual and/or organizational performance greatly influence the amount of pay increases or bonuses given to each employee

1. Outstanding performers will receive the greatest rewards, to acknowledge their superior contributions and to motivate them to continue high performance.
2. Average performers will receive substantially smaller raises, which may encourage them to work harder to achieve larger raises in the future.
3. Poor performers will receive no increase, which is intended to persuade them to improve their performance or leave.

However, agencies should not rely only upon the motivational ability of money to improve individual or organizational performance because more employees are motivated by factors, such as “personal pride or satisfaction in my work” or a “personal desire to make a contribution” rather than a “monetary award.”² Additionally, conditions in the Federal work environment (e.g., limited funding to support performance-based increases or awards, skepticism about whether or not supervisors will reward high performance) have created a rather tenuous link from pay to performance.

In fact, focusing on pay in “pay for performance” may be misleading. Rather, it may be the associated emphasis on the performance evaluation process that produces the most significant gains. For example, the initial clarifying of organizational goals and translating them into individual expectations, the emphasis on ongoing communication and progress checks, and the careful assessment of individual accomplishments, which are used to justify the variation in rewards, may prove to be more critical than the rewards themselves in improving organizational performance. Similarly, rather than concentrating entirely on the monetary benefits, individuals may be more likely to join and stay with organizations where they witness effective

² U.S. Merit Systems Protection Board, “The Federal Workforce for the 21st Century: Results of the Merit Principles Survey 2000,” Washington, DC, September 2003, p. 25.

supervisory practices because this creates an environment where employees are more likely to have a sense of accomplishment and satisfaction.

Benefits and risks associated with pay for performance

Agencies often have many objectives for pay for performance. For example, they may aim to improve the organization's ability to attract and retain high performers. They may hope to improve individual effort and consequently, organizational performance. They may also be searching for a fairer way to pay since those who contribute more to the organization should receive a larger salary in return.

Unfortunately, researchers have found that pay for performance has not achieved these objectives in all instances.³ This should not be surprising: pay for performance is a complex process that demands a large investment from those who seek to use it. The effectiveness of a pay for performance system can be undermined by flaws in the design, implementation, and operational phases. For example, an adequate budget must be available to fund performance-based increases that are large enough to be meaningful. Additionally, for agencies to fairly determine who receives these increases, the performance evaluation system must be accurate and supervisors must be well-versed in its use. Checks and balances should be built in to help hold supervisors accountable for their decisions. Finally, the pay for performance system must be evaluated on an ongoing basis to detect when changes are needed as the organization and the pay system evolve. We discuss these requirements and more in the following section.

³ For example, the National Research Council's 1991 report, "Pay for Performance: Evaluating Performance Appraisal and Merit Pay," discusses problems encountered with pay for performance during the operation of the Merit Pay System and the Performance Management and Recognition System.

Pay for Performance Decision Points

Overview

Understanding the theory behind pay for performance and its potential impact is critical to understanding the role performance-based pay can play in an organization. Nevertheless, agencies also need to pay attention to technical design points to ensure that the mechanics of the system are sound. The effectiveness of pay for performance in facilitating recruitment, retention, and motivation (and the resulting improvements in individual and organizational performance) depends heavily upon matching the approach to the situation. Thus, agencies need to carefully consider numerous decision points, such as those discussed below. To make it even more challenging, the various choices often have both advantages and disadvantages. Although it is tempting to simply transplant compensation systems from other organizations where they appear to be functioning well, agencies need to tailor pay systems to fit their unique circumstances and needs. Fortunately, agencies can learn from the dilemmas others have faced and base their decisions on experience gained elsewhere combined with information they glean from within.

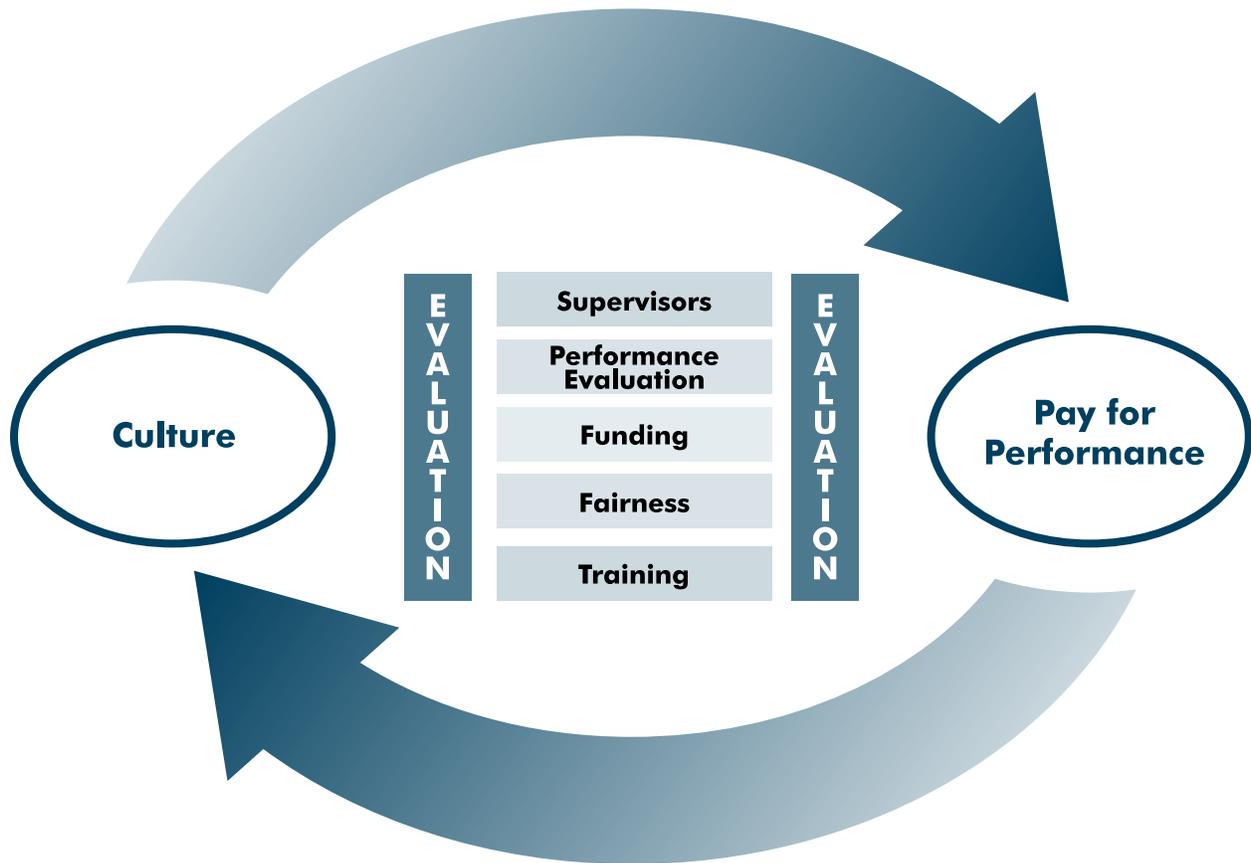
Questions agencies need to ask themselves range from the most basic—“Is the agency ready for pay for performance?”—to the more specific, questions such as who should be covered, what behaviors should be rewarded, and how bonuses should be distributed. Obtaining adequate funding and ensuring fairness can also challenge agencies, so these goals need to be pursued early in the planning process. Anticipating the substantial decision points and understanding the available options can help agencies make the best possible decisions. While exploring these issues requires some time and effort, it is worth the investment to avoid potential negative consequences in the long term.

Is the agency ready for pay for performance?

Given the appeal of paying for performance instead of tenure, many agencies have already moved past deciding whether to adopt a performance-based pay system and are rapidly moving towards implementation. Some of these organizations may already have in place an organizational culture conducive to pay for performance. However, many do not. Fortunately, these agencies do not have to passively wait for the conditions to improve. They can use pay for performance as a tool for organizational change to move the agency in the desired direction. For example,

agency leaders can drive major organizational change by demonstrating commitment to a performance-based pay strategy through their words and actions. As time progresses, the emphasis on performance perpetuates itself as the components of an effective pay for performance system facilitate further evolution towards a performance-based culture. **Figure 1** depicts the cyclical nature of this process.

Figure 1. Changing Organizational Culture With Pay for Performance



Since organizational culture may influence the ease with which pay for performance can be implemented, agencies may find it useful to do a self-assessment before deciding how to design and implement a new pay system. **Table 2** displays relevant dimensions of organizational readiness and selected indicators to help agencies gauge where they currently are.

Table 2. Assessing Organizational Readiness for Pay for Performance

Dimension	Indicator
Organizational Culture	<ul style="list-style-type: none"> ■ Open, two-way communication is valued and pursued. ■ Trust exists between employees and supervisors/managers. ■ Human resources management (HRM) systems such as selection, training, and performance evaluation have clear and consistent objectives and support pay for performance.
Supervisors	<ul style="list-style-type: none"> ■ Employee efforts support organizational goals. ■ Work assignment, evaluation of performance, and distribution of awards are fair. ■ Discretion and accountability go hand-in-hand.
Performance Evaluation	<ul style="list-style-type: none"> ■ Assessment of employees is fair and accurate. ■ Employees receive timely, accurate, and meaningful feedback.
Funding	<ul style="list-style-type: none"> ■ Appropriate pay increases and bonuses are given. ■ Top leadership is willing to make difficult choices when allocating funds and awards.
Fairness	<ul style="list-style-type: none"> ■ Checks and balances are in place. ■ Transparency is valued and ensured.
Training	<ul style="list-style-type: none"> ■ Training is provided to both supervisors and employees. ■ Training covers both pay system philosophy and mechanics.
System Evaluation	<ul style="list-style-type: none"> ■ The organization evaluates how the pay for performance system is being administered and whether the pay for performance system is accomplishing its goals. ■ Employee attitudes are tracked.

Agencies may use the results of their self-assessment on the dimensions above to determine what areas they need to improve. As we discuss in the following paragraphs, many of the indicators listed above will serve readily as tools for facilitating organizational change or for monitoring the progress of organizational change as pay for performance is implemented.

Organizational Culture. The concept of organizational culture covers numerous “values and ways of behaving that are common in a community.”⁴ Alignment among human resources management (HRM) practices is one aspect of culture that can greatly affect the success of pay for performance in an organization. Aligning the pay system with other HRM practices, such as selection, training, and especially performance evaluation, serves to focus employees on shared goals and values and delivers a consistent message regarding the value of performance. It also provides supervisors with the tools to move the workforce towards the desired performance-based culture. If agencies devote the proper attention to the supporting HRM systems, they can optimize the effectiveness of their pay for performance system and strengthen or create a performance-based organizational culture.

⁴ John P. Kotter and James L. Heskett, “Corporate Culture and Performance,” The Free Press, New York, NY, 1992, p. 141.

Another important indicator of an organization's culture involves communication. Open communication ensures that employees will understand the “what” and the “why” behind coming changes to the pay system and the organizational culture. However, the downward transmission of information is generally insufficient to achieve effective communication. Upward communication is also needed. By providing employees a means to voice their questions and concerns, management has an opportunity to address these issues and thereby, enhance employee trust.

Supervisors. As a linchpin between management and front-line employees, supervisors play a pivotal role in pay for performance settings. Not only do they translate organizational goals into concrete objectives for individual employees, but they also control employees' access to the resources they need to accomplish these goals. Although supervisors typically perform critical functions within any organization, pay for performance demands a higher level of supervisory skill than traditional tenure-based pay systems.

By granting supervisors more discretion to determine pay increases, pay for performance places more pressure on supervisors to perform their responsibilities well. For example, supervisors must treat employees fairly in terms of the assignment of work, evaluation of performance, and allocation of rewards—and they must be held accountable for their decisions. That may include linking supervisors' pay to how well they perform these duties, among their other responsibilities.

Performance Evaluation. Supervisors need an effective performance evaluation system—and adequate time to properly use it—to help them to monitor and document employees' performance on a regular basis throughout the assessment cycle. That system should enable supervisors to provide feedback that is timely, accurate, and meaningful—preferably on a continuing basis rather than simply once or twice a year. The absence of a fair and frequent interchange can jeopardize the trust between the supervisor and employees that is essential to an effective performance-based pay system.

Funding. The credibility of the new pay system can also be undermined if funding is inadequate to provide high performers with bonuses or pay increases that are commensurate with their contributions and that motivate others to improve their performance. In addition to having adequate funding, top-level decision makers must be willing and able to make difficult decisions to allocate resources among components of the organization. Most importantly, those who evaluate employee performance must be willing and able to allocate resources to make clear distinctions among different levels of employee performance.

Fairness. To ensure that supervisors' actions are justifiable, the pay system must include checks and balances. In addition to providing pay increases, supervisors must have the necessary discretion and judgment to appropriately deal with poor performers. While the first step is for supervisors to assist poor performers, through measures such as feedback and training, supervisors must also be able to withhold pay increases from or remove employees who cannot or will not improve.

Training. To facilitate system integrity, one of the most fundamental steps is simply to ensure that supervisors and employees understand how the system is supposed to work. This objective can be achieved through training—not only on the mechanics of the system—but also on the underlying philosophy. By fostering transparency regarding the rules by which the system operates, the organization promotes a shared understanding of the expectations between supervisors and employees regarding behaviors and outcomes. This serves to build trust, provided that both sides can and will uphold their commitments.

Evaluation. Finally, ongoing evaluation of the new compensation system is necessary to determine whether it is accomplishing the desired objectives in a fair and cost-effective manner. Measures of employee attitudes, such as employee engagement and motivation, as well as outcome indices, should be tracked and analyzed to determine how rating and pay decisions and other factors are affecting employee satisfaction and performance. Such evaluation will also help agency leaders assess progress in changing the organization's culture.

What are the goals of pay for performance?

In order to guide themselves through the decision-making process, agencies should establish clear, realistic goals for pay for performance before taking any action to change their pay systems. Although recruitment, retention, and motivation (and resulting individual and organization performance) represent broad areas that agencies often wish to improve through pay for performance, agencies should also consider other goals and priorities. For example, another goal that agency leaders may have in mind when implementing pay for performance is to improve the equity of pay practices by providing more compensation to the highest performers.

It is also useful to keep in mind the impact that pay system changes will have on the organizational culture and the importance of maintaining alignment between agency values and pay strategies. For example, if the nature of the work requires collaboration, an agency may choose a team-based reward structure or at least incorporate teamwork into the reward structure to avoid pitting employees against one another in competition for individual rewards. Many of these issues are discussed in more detail later in this report.

Who should be paid for performance?

Pay for performance systems can be inclusive or exclusive. To choose the appropriate range of coverage, an organization needs to decide the message it wants the pay system to send to the workforce, including what is to be measured and how. Some organizations cover all employees with a single pay for performance plan to unify the workforce in pursuit of common goals. Other organizations limit performance-based pay to those employees with direct responsibility for the organization's core functions and results. For example, a pay for performance plan might be limited to front-line employees whose work is directly linked to mission accomplishment because their

work is more readily measured (and of more immediate importance to the public) than work performed by employees whose activities indirectly support organizational goals.

In other cases, performance-based incentives may be reserved for those employees at the top levels of the organization. The logic behind this strategy is that accountability should be limited to those with the most control over results. In other words, since executives exert substantial influence over organizational success, they are entitled to significant recognition or blame for what they do or do not accomplish. In the private sector, Chief Executive Officers often receive sizable bonuses or performance-based pay increases that are linked to organizational outcomes, such as attainment of profit or other financial goals. Likewise, in the Federal Government, Senior Executives are eligible for annual bonuses and pay increases linked to their achievement of organizational objectives.

Limiting pay for performance plans to select groups may enable the organization to highlight clearer links between employee behavior and outcomes, but doing so may create divisiveness. Depending upon the circumstances, such as whether the dual pay systems offer markedly different earning potential, coverage may be viewed as distinguishing between the “haves” and the “have nots,” creating some dissension between the two groups. This is particularly relevant if the benefits provided to one group are viewed as coming at a cost to the other group.

What should be the timing for implementing pay for performance?

Organizations often have the flexibility to decide whether the system should be implemented wholesale or in stages. If in stages, coverage can start with a single occupation or a limited group of occupations as a pilot test, and expand later to additional groups of employees once the system has proven itself. Starting with a small group of employees and later expanding coverage may enable the organization to demonstrate successes before rolling the system out to the entire organization. This also provides an opportunity to fine-tune the system and remedy any problems before they undermine its long-term success.

In contrast, wholesale implementation may be preferable when the agency’s intent is to convey a dramatic organizational change message and foster a sense of solidarity. Implementing the new pay system wholesale also avoids the confusion and increased difficulty associated with administering multiple systems within an agency.

What should be rewarded?

An essential point to keep in mind is that pay for performance is a powerful tool, which must be used wisely. The axiom that “what gets measured, gets done” has particular relevance when measures are reinforced by monetary incentives. For

that reason, organizations must be very careful when deciding what to measure and reward, because they are quite likely to get what they measure—which may or may not be what they really want. In other words, agencies must be sure they are reinforcing desired behaviors associated with the most critical outcomes and not encouraging counter-productive responses.

An effective performance appraisal system requires clearly defining expectations in advance, while recognizing that priorities may shift along the way. Enumerating specific goals gives employees a clear “road map” that they can use to decide how to allocate their time and efforts. Some jobs lend themselves more easily to this type of direction, while for others it is more difficult to specify in advance the precise accomplishments expected since the nature of the work is more complex or fluid. In these cases, flexibility regarding anticipated outcomes can be incorporated in the evaluation process. In the meantime, supervisors and employees should engage in continuing discussions so that expectations can be shared, despite necessary adjustments. Additionally, when circumstances outside the employees’ control determine outcomes, comparisons across employees in similar positions may assist the supervisor with evaluating employee performance. In such circumstances, supervisors’ subjective judgments necessarily play a role in evaluating performance. While subjective judgments cause some employees discomfort, supervisory discretion to evaluate performance is generally not something that can—or should be—orchestrated out of the process.

Use of multiple measures. Given the complexity of work, multiple measures are often necessary to adequately capture accomplishment. To decide what to measure, agencies need to ensure that they focus on important outcomes without excluding other critical aspects of individual or organizational performance. One common problem in this area involves organizations that set quantitative goals only to find a negative impact on quality because important qualitative aspects of performance were not included in the goals. In other cases, organizations accurately identified top objectives, but overlooked subtle, yet important, priorities or activities. For example, by focusing employees’ attention only on part of a work process, such as timeliness, an agency can unintentionally instigate cutting corners and unsafe activities, which may serve to speed up the work process production at an unacceptable cost. While granting flexibility to employees who are pursuing difficult goals may encourage innovation, safeguards may need to be built in to ensure that necessary steps have not been inappropriately sacrificed. Additionally, it is important that the reward system does not undermine desirable aspects of performance, such as teamwork, that may not be explicitly recognized yet are important to organizational success. In situations that warrant looking at multiple facets of employee performance, a “balanced scorecard”⁵ perspective may prove to be very useful. Although notable

⁵ A “balanced scorecard” typically provides managers with a “fast but comprehensive view of the business” by featuring “financial measures” complemented by measures on “customer satisfaction, internal processes, and the organization’s innovation and improvement activities.” Robert S. Kaplan and David P. Norton, “The Balanced Scorecard—Measures That Drive Performance,” Harvard Business Review, 70(1), 1992, p. 71.

differences between the private and public sectors impact what measures would be appropriate, a balanced scorecard approach for the Federal sector could include measures such as quantity and quality of output, teamwork, safety, and customer satisfaction, while focusing attention on the organization's overarching mission.⁶

Alignment of organizational goals and measures. Supervisors frequently derive employees' goals, at least in part, from high-level organizational goals. This "cascading" of goals is useful for aligning employee efforts with organizational objectives. To achieve this, employees need to understand how their individual performance supports organizational outcomes. However, supervisors should also recognize the value of a "bottom-up" approach that gives employees a voice in how they will be evaluated and some discretion in deciding how best to achieve the results desired. Excessive top-down control of goals, work methods, and job behaviors may stifle risk-taking and innovation by employees. In contrast, rewarding an open exchange of information may result in improved organizational outcomes over time as trust between the levels grows. Further, by aligning individual success with organizational success, there is a greater likelihood that agencies will be able to encourage employees to exert effort to achieve organizational objectives in concert with their personal goals.

Standardized (organizational) vs. tailored (individual) criteria.

Choosing between standardized organization-wide evaluation criteria and evaluation criteria tailored to individuals largely reflects an organization's philosophy regarding the relative priority of what should be rewarded. Having a clear, overarching mission facilitates the use of standard criteria. Evaluating everyone against a common set of standards, linked to high level organizational goals, also serves to focus the attention of all employees on the highest level priorities. Likewise, using an agency-wide competency model reinforces agency values and promotes consistency across occupations and organizations.

The downside of standardized criteria is that with their generality, the evaluation measures may not seem applicable to everyone. For example, front-line employees typically have a clearer line of sight to accomplishing mission objectives than administrative employees, who support the mission in a secondary manner. In other cases, the functions within an organization may be so diverse that it becomes difficult to use universal criteria. Providing leeway for tailoring criteria may be more appropriate in many organizations. This individuation of evaluation criteria may be by organizational subcomponent, occupation, grade level, or other categories.

Individual vs. team vs. organizational performance. Similarly, the level at which performance is assessed for award purposes should reinforce the desired breadth of collaboration, although this must be balanced with the need to be able to identify individual contributions. It is important to consider whether cooperation should be encouraged within a discrete work unit or across a broader context, such

⁶ Robert S. Kaplan and David P. Norton, "Transforming the Balanced Scorecard from Performance Measurement to Strategic Management: Part I," *Accounting Horizons*, 15(1), 2001, pp. 98–99.

as organizational components. For example, when employees work independently, it may make more sense to evaluate them individually. However, when high levels of interaction and communication are necessary, it becomes much more difficult to accurately measure the accomplishments of individual employees. Rewarding only individuals when mutual support helps advance the organizational goals may discourage cooperation and teamwork, to the organization's detriment.

In other cases, the connection between individual performance and organizational performance appears relatively clear and individuals tend to provide relatively similar levels of contributions. In these cases tying individual fortunes to the organizational outcomes rallies the entire workforce to work together. Discord may result if some people do not pull their weight, although peer pressure can often remedy these situations.⁷ Organizations may also wish to supplement group measures with individual measures, such as "teamwork," to recognize personal efforts. For example, the company Johnsonville Foods has team leaders and employees rate each member on "contribution to team goals, communication effectiveness with other team members, willingness to work with other team members, and attendance and timeliness at team meetings."⁸

Focusing on employees' overall contributions can increase flexibility and encourage employees to focus on outcomes rather than the process of how to get there. However, the best approach may be to include both specific individual goals and a broader view of contributions. Along these lines, the Government Accountability Office (GAO) (formerly the General Accounting Office) recommends linking individual performance with organizational goals to identify how daily activities eventually support high-level organizational goals.⁹ Maintaining the connection to the bigger picture provides employees with a bit more context than if they are only aware of their individual roles. The link to broader goals also enables consideration of additional behaviors that may not be explicitly described in a performance agreement,¹⁰ yet are important to the organization's overall functioning.

Ultimately, what works best in an organization will depend on the nature of the workers and the work, as well as the corporate philosophy. Some work groups are relatively homogeneous in their level of contributions, while the performance in others varies so much that individual differences should be recognized. Some work is clearly independent, while other projects require extensive collaboration and teamwork. Finally, some organizations want to promote active cooperation, while others may encourage a healthy level of competition.

⁷ Robert L. Heneman and Courtney von Hippel, "Balancing Group and Individual Rewards: Rewarding Individual Contributions to the Team," *Compensation and Benefits Review*, 27(4), 1995, pp. 63–68.

⁸ Heneman and von Hippel, p. 64.

⁹ U.S. General Accounting Office, "Results-Oriented Cultures: Modern Performance Management Systems Are Needed to Effectively Support Pay for Performance," GAO-03-612T, April 1, 2003, Washington, DC, p. 10.

¹⁰ A performance agreement is a document that describes what the employee plans to accomplish during a performance rating period or a given span of time. Generally, a performance agreement is confined to accomplishments and results, with little or no discussion of underlying tasks or work behaviors.

Possession vs. demonstration of competencies. Pay for performance plans may also vary depending on whether they reward possession of desired competencies or require the actual demonstration of these competencies. Some agencies forgo an outcome-oriented evaluation and instead focus on the development of competencies.¹¹ For example, an organization may reward employees for possessing or obtaining certain competencies that the organization values because it believes it is useful to have staff on-board who possess certain capabilities. As a result, once the employee has been certified as possessing certain competencies, the agency may increase the employee's pay whether or not the employee is called upon to demonstrate these competencies during the performance appraisal cycle.

Other agencies compensate individuals only for the time that they demonstrate the competencies. Agencies may take this strategy a step further by focusing on demonstrated competencies in relation to organizational goals and performance.¹² Under this strategy, employees must demonstrate that their increased competence enables them to perform more effectively to support achievement of organizational outcomes. For this system to be effective, an organization must clearly identify the competencies that are required for optimal organizational performance and measure employees' possession of those competencies. If done properly, advantages of this approach may include the opportunity for ambitious employees to be compensated for developing themselves, which in turn benefits the organization by increasing the depth and breadth of its talent pool. Consequently, career progression can be tied more closely to competencies that support organization goals rather than to tenure.¹³

Short-term vs. long-term goals. Performance appraisal cycles in the Federal Government are typically one year in duration. As a result, short-term goals may be more easily assessed than long-term projects, which may cross multiple assessment cycles. For assessments to be fair, the life cycle of projects should be taken into account and proper credit given for progress towards the end goal. Further, complex projects can usually be broken into intermediary steps to evaluate progress against these milestones. Taking both short and long perspectives into account helps ensure that employees on the extended projects will be rewarded for their achievements to date and not forced to wait until project completion years down the line. Without intermediate reinforcement, employees might gravitate toward quick-return assignments and neglect the more challenging endeavors.

External constraints. A common frustration for employees involves the inability to control all of the factors that affect their performance and results. These include changing priorities; supervisor-controlled work assignments and resources; geographical variations in workload or other conditions; and access to

¹¹ Michael Armstrong and Duncan Brown, "Relating Competencies to Pay: The UK Experience," *Compensation and Benefits Review*, 30(3), 1998, pp. 28–39. Competencies are defined as "the skills, knowledge and behaviors which need to be applied for effective performance."

¹² Armstrong and Brown, 1998, p. 35.

¹³ Kathryn Tyler, "Compensation Strategies Can Foster Lateral Moves and Growing in Place," *HR Magazine*, 43(5), 1998, pp. 64–71.

equipment and information, as shown in the following examples. An employee may work diligently toward a goal, only to have the priorities shift just before project completion. Supervisors also exercise control over some of the parameters of what an employee can accomplish by allocating job assignments and training. Another external variable is location, which often drives workload and therefore, could be factored into performance-based pay decisions. For example, one location, such as a large airport, may have a greater volume of traffic than a smaller facility. Similarly, the work done at a headquarters office is usually quite distinct from that done at a field office. The unavailability of needed equipment or information can also prevent employees from working at their optimal level. Therefore, many of the variables that determine individual productivity operate outside of employees' control. Although some agencies may focus exclusively on outcomes, others may decide to keep external constraints in mind when making pay and award decisions to avoid penalizing high performers who are negatively impacted by circumstances beyond their control.

At a group level, work units are sometimes dependent upon another unit for a critical step in the process and cannot proceed until that entity completes its role. There may also be uncontrollable external events that hamper successful completion of objectives, such as budget limitations or technical failures. Therefore, individuals or groups may find that they have worked hard and have done everything they can, but are impeded by factors outside their control. Again, in these cases, raters must consider how to evaluate performance—whether to rely entirely on outcomes or to give at least partial credit for efforts—keeping in mind that it can be quite de-motivating to employees if the rating system is so rigid that it does not take external factors into account.

Should performance-based pay be tied to the performance appraisal system? Although annual award decisions in the Federal Government have often been tied closely to performance appraisal ratings, this is not always the case in pay for performance settings. For example, when going to a pay for performance system, the Federal Aviation Administration converted its performance appraisal process into an ongoing qualitative discussion between the supervisor and the employee regarding accomplishments and areas for improvement. Separate from the performance appraisal review, the supervisor's recommendation triggers individual pay for performance increases, while all eligible employees receive the organization-wide pay increases, dependent upon organizational goal achievement. The purpose of de-linking the performance appraisal process and monetary rewards was to defuse the emotionally-charged annual process of assigning a numerical value to performance. However, the Government Accountability Office (GAO) has expressed concerns that this approach is insufficient to “provide enough meaningful information and dispersion in ratings to recognize and reward top performers, help everyone attain their maximum potential, and deal with poor performers.”¹⁴

¹⁴ U.S. General Accounting Office, GAO-03-612T, April 1, 2003, p. 10.

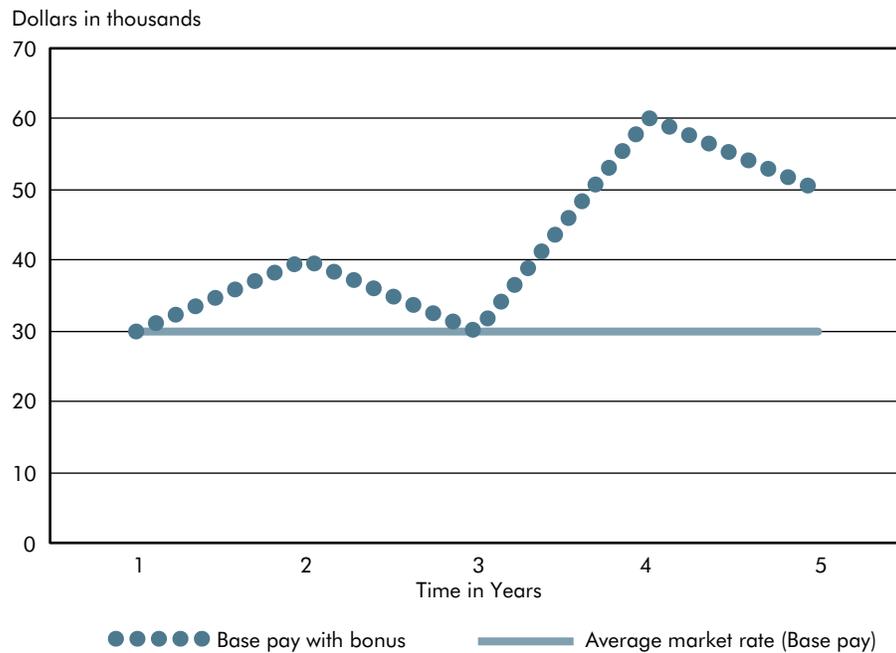
In other cases, agencies tie pay decisions tightly to the performance appraisal process. As an example, some organizations operate a point-based pay for performance system, assigning individuals a score on a 100 point continuum that correlates with a performance level. Those above a certain level receive salary increases, with the amount corresponding to placement along the range. Although these systems appear precise and rigorous, their ability to make such fine distinctions between employees is questionable. Even if it may be easy to separate the “stars” from the “average performers,” it tends to be much more difficult to make fine distinctions among average employees given the complex nature of job performance and the inexact and subjective nature of many evaluation systems. As a consequence, employees may feel that their ranking relative to colleagues is incorrect, which undermines confidence in the overall system.

How should employees be rewarded?

Pay for performance can encompass a variety of rewards for above average performance. The two most common are bonuses, which are one-time cash payments, and performance-based pay, which provides a permanent increase to base pay. Each of these has advantages and disadvantages, which are explored further below.

Bonuses. Bonuses represent an amount of pay that is “at risk” every year. In contrast to base pay, which is stable and primarily reflects an employee’s market value, bonuses should depend purely on performance and are not guaranteed. Employees in these types of systems frequently receive a base pay that is considered comparable to average market rate to facilitate recruitment and retention of a high-quality workforce, but additional dollars are distributed (often annually) on the basis of performance during the rating period. As a result, employees are guaranteed a certain salary, with the potential for earning more. The amount generally depends on a variety of factors, such as the available funding and the evaluation of the individual’s contributions, but the agency retains discretion over how much to spend each year.

As illustrated by the example shown in **Figure 2**, bonuses serve to raise an employee’s salary above average market rate but only on an annual basis. In other words, each year an employee must earn an amount above the base rate of pay. Since each year’s bonus is independent of the bonus earned in prior years, total salary can fluctuate dramatically from year to year. When the employee excels, he may receive a sizable bonus, but if the employee’s performance is “average” or lower, he may not receive a bonus and his salary drops to the base rate.

Figure 2. Impact of Bonuses on Total Salary

Advantages. Advantages of bonuses include the following:

- Employee performance may vary from year to year so an employee may deserve a bonus one year, but not the next. Since the increase resulting from bonuses does not carry over to subsequent years, agencies can distribute a larger pool of bonus money each year rather than continue to fund performance-based pay increases from prior years.
- Agencies may use bonuses throughout the rating period to facilitate timeliness, thereby strengthening the connection in employees' minds between efforts and outcomes.
- If agencies direct funding for increases into a bonus pool, they may provide sizable bonuses to top performers.

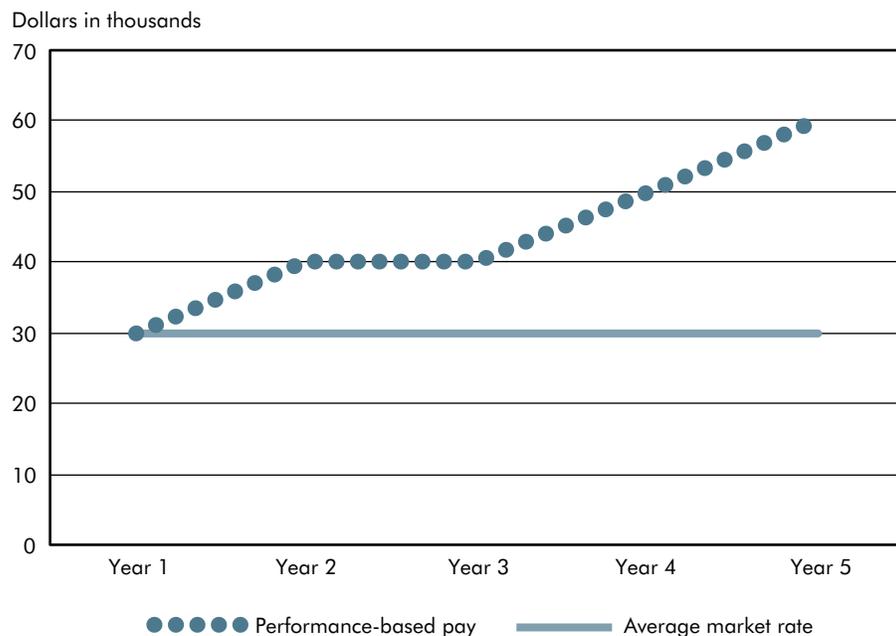
Disadvantages. Disadvantages include the following:

- Putting a large amount of pay "at risk" to be earned each year makes the employee's salary less predictable.
- If base pay levels are not fully competitive, reliance on bonuses as a reward may increase turnover.
- At this time, bonuses are typically small relative to base salary in the Federal Government (but not necessarily in the private sector). Therefore, a culture change will be required to view bonuses as a mechanism for providing substantial amounts of money to recognize high performers.

Performance-based pay increases. In contrast to bonuses, performance-based pay increases are incorporated into the employee’s base pay and are usually only adjusted upward. Organizations differ in how they move employees through the performance-based pay scales. Some pay systems include pre-determined levels, which employees step through in an orderly manner, while others allow the supervisors to determine salary amounts anywhere within a broad range.

Figure 3 demonstrates how performance-based pay increases can operate. As in the prior example, average market rate may be used to set a baseline for pay. The employee may be hired at this rate, but salary progression depends primarily upon performance. When the employee’s performance warrants a raise (during Years 2, 4 and 5), the employee receives an increase. The upward trend highlights the main difference between bonuses and performance-based pay increases: pay increases are typically treated as permanent increases.

Figure 3. Impact of Performance-Based Pay Increases on Total Salary



Advantages. Advantages for the employee include the following:

- Employees may perceive the continual increases (or at least a plateauing of salary) to be more desirable than the potential for ups and downs with individual bonuses.
- Employees may also view increases to base pay as more attractive than bonuses because salary increases enhance the dollar value of several benefits, such as retirement earnings, thrift savings plan, and life insurance. Although employees often realize that much of the value of a base pay increase is “hidden,” agencies may enhance the motivational impact of the base pay increase by making sure employees are aware of the total value of a salary increase.

Disadvantages. However, performance-based pay increases also have notable disadvantages. For example, they:

- Limit an agency’s flexibility to adjust pay to reflect an employee’s current level of performance. An individual may demonstrate outstanding performance in one year and base pay is increased accordingly. However, in the following years, the employee may decrease performance while continuing to receive an enhanced salary based on previous outstanding performance, resulting in overpayment. Very few pay for performance systems incorporate a mechanism for decreasing pay based on not performing at the same level in the years following the increase. Under current Federal regulations, a reduction in pay is an adverse action, and therefore, subject to the appeals process.
- Generate long-term costs. Not only do performance-based increases add to salary and benefits costs for the current year, but they also impact budgets in future years.
- Eliminate or at least greatly reduce the incentive of offering future pay increases based on performance for those who top out in a pay band.
- May be too small to be meaningful. Funding limits or formulas may result in small base pay increases for many employees.

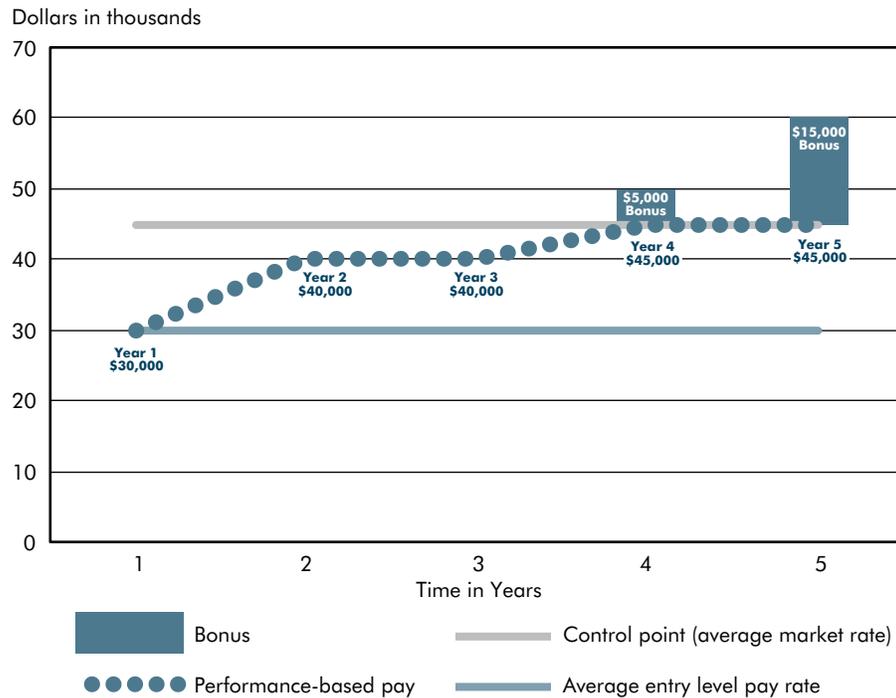
Combination strategies. As an alternative to choosing one or the other, agencies may use both bonuses and base pay increases. Combining bonuses and base pay increases enables organizations to realize the benefits of both while limiting the downsides. For example, agencies may use bonuses to recognize exceptional achievements, while pay increases may be reserved for longer term accomplishments.

Another option that eliminates or at least reduces some of the disadvantages associated with the use of one-time cash payments and performance-based pay increases, involves building a “control point” into the pay band. Base pay increases enable the employee to reach a certain salary level, often the average market rate for the skills encompassed in the pay band, which then serves as a ceiling for base pay. If an employee reaches this level and his performance would otherwise warrant a pay increase, a one-time payment may be given in lieu of increases to base pay. Consequently, such employees must compete each year for a bonus above the established market rate for their skill set. Another strategy is to set a higher “control point” for high performers, so these employees continue to receive pay increases until they reach a point higher than the average market rate (at which point they may continue to receive bonuses to recognize superior performance). Using these flexibilities enables an organization to set policies to help them recruit and retain employees with critical areas of knowledge, skills, and abilities.

In the example shown in **Figure 4**, a control point has been set at \$45,000. The employee is paid at the average entry level pay rate of \$30,000 in the first year. During the second year, he receives a performance-based pay increase to \$40,000.

He does not receive an increase in the third year. In his fourth year, his performance warrants a \$50,000 salary, which would exceed the \$45,000 control point. Therefore, he receives a \$5,000 increase in base pay and the additional amount is paid as a bonus of \$5,000. In the fifth year, the control point holds his salary at \$45,000 and he receives a \$15,000 bonus.

Figure 4. Impact of Control Points on Total Salary



As the example helps illustrate, control points ensure that employees do not receive pay above a certain level unless they sustain high performance levels. Employees at the control point may see this as a downside, since they cannot accurately predict what their salary will be each year, but at least they can be confident that their pay will not slip below the control point once they reach it.

How much pay should be contingent upon performance?

Although Federal agencies have long had the legal authority to provide high-performers with cash awards, within-grade increases, and/or quality step increases, the total amount of these awards or increases has typically been quite small—generally less than 5 percent of a Federal employee’s salary.^{15,16} Pay for performance compensation strategies should offer a larger percentage to ensure that the increases are large enough to be noticed by both recipients and nonrecipients.

¹⁵ U.S. Office of Personnel Management, Central Personnel Data File, 2003.

¹⁶ U.S. Office of Personnel Management, website, www.opm.gov/ocal/pay/html/wgifact.htm.

The Senior Executive Service (SES) appears to be leading the way in terms of having more pay “at risk” based on performance. The SES pay for performance plan has eliminated pay levels within the SES pay band to create an open range and set a higher “aggregate compensation level.”¹⁷ Within this revised pay structure, the link between pay and performance will be emphasized, not only by tying pay increases to performance, but also by virtue of the size of the new performance-based pay increases. Whereas only a 2.2 percent increase was available for distribution to recognize performance by SES members in January 2004, future increases can draw from the sum of the general increase and locality pay increases.¹⁸ Therefore, future pay increase pools may contain more funding to appropriately recognize performance.

In the private sector, the amount of performance-based bonuses has also grown in recent years. The average amount that companies spend on performance-based bonuses as a percentage of payroll gradually increased from 3.8 percent in 1991 to 10.5 percent in 2002, before declining slightly to 8.8 percent in 2003 and rebounding to 9.5 percent in 2004 and 11.4 percent in 2005, with these fluctuations due primarily to economic constraints.^{19,20,21} However, the amount devoted to these incentives varies widely by job characteristics, such as job type, level, industry, and geographic location. For example, WorldatWork reported that bonuses range from an average of 5.4 percent of base pay for hourly workers and 11.7 percent for exempt salaried workers to 29.1 percent for executives, for whom bonuses can equal millions of dollars.²² Of course, since many employees may receive small bonuses or no bonuses, these averages may mask much larger bonuses for a sizable portion of the private sector workforce.

Several factors should influence the decision regarding size of the bonus or pay increase. First, the amount should be proportionate to the contribution of the employee. For example, those who contribute the most should receive the largest payoff. Those who made relatively minor contributions should receive little or nothing, to reinforce the message that rewards are reserved for those who exceed the evaluation criteria. Although many organizations like to spread bonuses over a large population, the resulting amount often ends up being insignificant and the failure to distinguish between high and low performers undermines the purpose of a pay for performance system. High performers may become demoralized and decrease their output, while the low performers have no incentive to change their behaviors. Second, bonuses should be large enough to get the attention of all employees,

¹⁷ U.S. Office of Personnel Management, Memorandum for Heads of Departments and Agencies From Kay Coles James, Director. Subject: New Performance-Based Pay System for the Senior Executive Service. December 16, 2003.

¹⁸ Stephen Barr, “Pay-for-Performance System Makes an Uneven Debut Among SES Corps,” Federal Diary column, the Washington Post, February 9, 2004, p. B2.

¹⁹ Hewitt Associates, press release, Sept. 9, 2003.

²⁰ Hewitt Associates, press release, Sept. 8, 2004.

²¹ Hewitt Associates, press release, Aug. 31, 2005.

²² WorldatWork, salary survey from the website www.worldatwork.org, 2003.

whether or not they received a bonus or performance-based pay increase. In other words, the amount of the cash bonus or pay increase should be sizable enough to be viewed as worth the extra effort and employees should understand what is required to earn such a reward. Finally, the organization must work within its short- and long-term budgets and communicate openly with employees to avoid creating false expectations regarding current and future salary levels.

How should performance-based pay be funded?

In the private sector, financial results (e.g., income and profits) frequently determine and fund bonuses and pay increases. In this manner, employees are able to share in the increased proceeds that their efforts have brought to the company. In good years, funding is readily available. In bad years, the employees often share the downturn in the company's fortunes by receiving little or no salary increase or bonus, whether or not the company's decreased profit is due to their efforts or to external economic factors over which they have no control.

Funding is dramatically different in the public sector. Few Federal agencies obtain financial returns from their work. Even when they do (e.g., revenue collection, law enforcement), it is rarely appropriate to allow Federal employees to directly benefit from these returns. Furthermore, most agencies are funded through appropriations, and the relationship between performance and appropriations is tenuous at best. High performance and mission accomplishment does not necessarily lead to larger appropriations, and mediocrity or failure may have few, if any, financial consequences.

Therefore, most Government agencies must allocate funding for performance-based salary increases and bonuses from their existing salary budgets (i.e., funds that might otherwise be used for pay increases that are not tied to performance) and prudently manage the long-range impact on salary costs when awarding increases to base pay. However, the amount available each year for pay increases is typically quite limited—regardless of whether agencies have met or exceeded their performance goals. For example, the general increase provided to Federal employees has varied from 2.1 percent to 3.8 percent over the past 7 years (2000 through 2006).²³ Within-grade increases (WGIs) for employees provide another source of funding for performance-based pay, but amount to only about 3 percent of annual pay for those who are scheduled to receive them.²⁴ Only employees in the first three steps can receive annual within-grade increases, while those at midrange steps progress every other year and those at the highest steps wait 3 years before their next within-grade increase.²⁵ Therefore, the total amount available through pooling the general increase and the WGI funding is still somewhat limited and subject to fluctuations over time. Nevertheless, employee groups and unions have strongly opposed eliminating

²³ U.S. Office of Personnel Management, website, www.opm.gov/oca/06tables/index.asp.

²⁴ U.S. Office of Personnel Management, website, www.opm.gov/oca/pay/html/wgifact.htm.

²⁵ 5 CFR 531.405.

standard increases.^{26,27,28} One of the primary reasons for their opposition is employee concern that supervisors will abuse the additional discretion over pay increases and unjustly reward their “buddies.”

It is important to note that reallocating existing funding sources as discussed so far creates a win-lose situation in the organization. A pay for performance system funded by money earmarked for the general increases and WGs typically results in some employees obtaining more than they would have otherwise and others receiving less. This may create resistance among those who perceive that their incomes are falling behind and heighten competition among employees in a negative way. This discrepancy appears most problematic for the “good, solid employees” who may no longer receive regular, though modest, increases to recognize their contributions.

An alternative strategy to relying upon the existing salary budget would be for agencies to increase the total amount available for performance-based pay increases by tapping other sources of funding. For example, the Human Capital Performance Fund (HCPF) provides managers with additional funds (not drawn from within their agency budgets) for rewarding outstanding performers. However, agencies must cover any future increases in personnel costs and benefits resulting from such rewards.²⁹ It may also be possible for agencies to pursue other funding options, such as through a working capital fund or through a supplemental appropriation to support the implementation of a pay for performance plan.

Greater budget creativity and advance planning will most likely be necessary to appropriately fund pay for performance systems because such systems represent a shift away from the predictable pay increases and salary budgets associated with the General Schedule pay plan. More budget flexibility may also be needed to allow agencies to carry over funds when organizational performance does not warrant paying out the full amount of available salary dollars. Similarly, it would be advantageous for agencies to be able to carry over any excess funding to support adequate bonuses during lean years. Since insufficient funding has seriously undermined performance-based pay in the past,³⁰ long-term financial support under a variety of scenarios should be carefully planned before implementing pay for performance.

²⁶ National Coalition for Equity in Public Service, briefing presented by Julius Crouch at the Diversity Summit, Washington, DC, April 8, 2004.

²⁷ Jacqueline Simon, Statement by Jacqueline Simon, Public Policy Director, American Federation of Government Employees, AFL–CIO, before the House Committee on Government Reform Subcommittee on Civil Service and Agency Organization regarding replacing the General Schedule with Pay for Performance, April 1, 2003.

²⁸ Stephen Barr, “Pay Parity Amendment’s Rejection Complicates Debate Over Raises,” Federal Diary column, the Washington Post, March 18, 2004, p. B2.

²⁹ U.S. Office of Personnel Management, Memorandum for Human Resources Directors from Ronald P. Sanders, Associate Director for Strategic Human Resources Policy. Subject: Recent Legislative Changes, December 24, 2003.

³⁰ National Research Council, “Pay for Performance: Evaluating Performance Appraisal and Merit Pay,” National Academy Press, 1991, Washington, D.C., p. 27.

How can costs be managed?

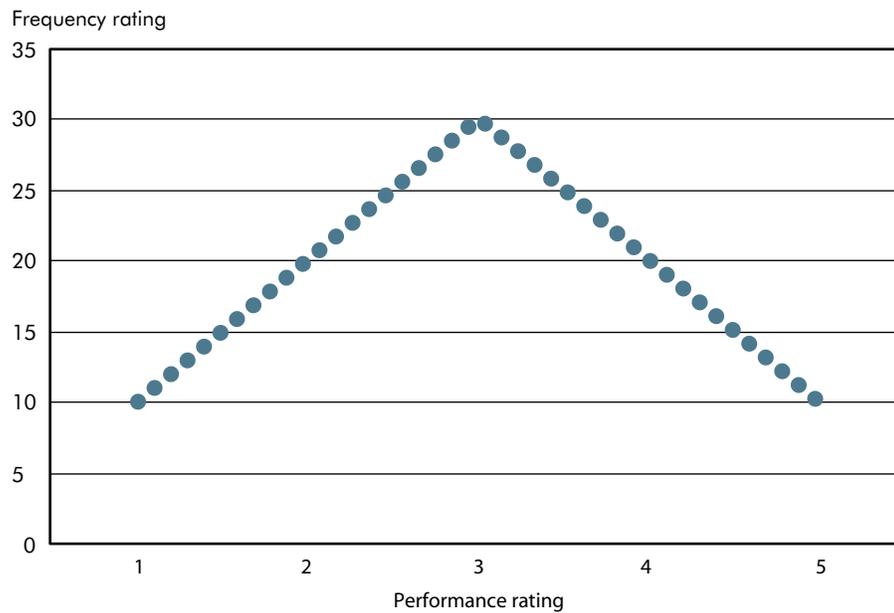
Historically, the performance appraisal process has been linked to cash awards. Consequently, managers felt pressures that often conflicted with their responsibility to accurately evaluate employee performance. Instead of focusing exclusively on employee behaviors and the results of those efforts, raters sometimes considered the potential impact of their ratings on outcomes for the individual, such as whether the employee would receive a cash award (and the amount). As a result, the process often became corrupted by inflated ratings, which made it difficult or impossible to distinguish among levels of performance. In addition, since a limited pot of award money was available, the awards produced by simply dividing the money among many employees often became insignificant—too small to motivate individuals to improve their performance and too small to motivate supervisors to draw distinctions among their subordinates.

Some agencies have attempted to preserve the integrity of the performance appraisal process by separating rating decisions and award decisions. Such efforts have generally been ineffective. Separating appraisals and awards decisions removed one potential barrier to accurate performance appraisal, but did nothing to ensure that supervisors actually used the system as intended. In some instances, the already-compromised appraisal process further degenerated into a paper exercise that produced neither accurate ratings nor constructive feedback to employees.

It is important to keep in mind that implementing a pay for performance plan will not solve such fundamental problems as inadequate funds, inaccurate evaluations, a lack of commitment to providing meaningful performance feedback, and reluctance to reward employees appropriately. In many cases, these problems have reflected the inability or unwillingness of supervisors and managers to properly use the tools available to them, rather than any constraints of the compensation system. For example, in some cases, such as very limited pools of awards funding and relatively similar levels of performance, supervisors may have judged it not worth the potential strife to provide substantially different awards to employees.

The approaches discussed below have frequently been adopted in attempts to preserve the integrity of the performance evaluation process. However, these techniques do not necessarily solve all of the issues mentioned above and may also present some additional challenges to supervisors and employees.

Forced distribution. Forced distribution refers to constraining the number of employees who can achieve a certain performance rating, such as by establishing a predetermined number of employees to receive each level of rating (and corresponding pay increases or bonuses). (See **Figure 5** for a 5 point rating scale.) Using a forced distribution often assumes a somewhat normal (“bell-curve”) distribution of performance levels, so a small percentage receive the largest increases or awards, a larger percentage receive smaller amounts, and the rest receive nothing. Some allocation strategies even require a certain number of employees to receive below average ratings that could result in a pay freeze, reduction in pay, or (eventually) termination.

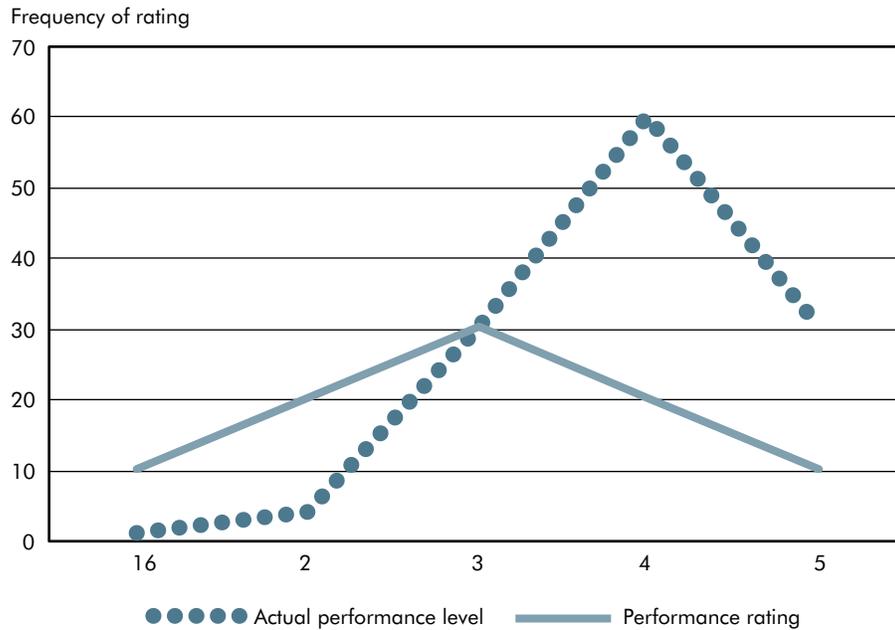
Figure 5. A Forced Distribution of Performance Ratings

An advantage of the forced distribution system is that it forces supervisors to make distinctions among employees rather than taking the easy way out and rating everyone the same. The impact on employees may also be useful when the work environment is conducive to competition because this strategy increases the incentive to outperform one's peers.

However, the forced distribution approach has a number of flaws.³¹ First of all, performance in organizations rarely fits a normal distribution. Although everyone cannot mathematically be “above average,” one would hope that a distribution of actual performance levels using an anchored rating scale would be positively skewed—that is, the vast majority of employees would perform at an acceptable or higher level. See **Figure 6** for an illustration of this scenario.

³¹ Edward Lawler, “Rewarding Excellence: Pay Strategies for the New Economy,” Jossey-Bass Inc., Publishers, San Francisco, CA, 2000.

Figure 6. A Forced Distribution of Performance Ratings Contrasted with Actual Performance Levels



Under this scenario, rather than preserving the integrity of the system by limiting the number of employees who receive the highest rating, a forced distribution may undermine the accuracy of ratings by requiring a set number of employees to receive each rating. Consequently, their ratings will not necessarily correspond to their actual performance. For example, in some organizations, there are many who excel and should receive the highest ratings, but when the number of “outstanding” and “exceptional” ratings is limited, supervisors must make arbitrary distinctions between employees. In response, some supervisors resort to having employees “take turns” receiving the top ratings, which creates a situation where an individual’s excellent performance may not be recognized in the appropriate timeframe. This is de-motivating for the employee and fails to serve the purpose of recognizing role models. At the opposite end of the performance spectrum, it would seem illogical to specify a minimum number of very low ratings (i.e., a number of poor performers on board) because poor performers should have improved their performance to an acceptable level or been dismissed.

Another potential drawback of the forced distribution model for ratings is the fact that it pits employees against one another as they compete for scarce resources. Since many organizational cultures value teamwork, the net impact may be decreased organizational performance as employees become less likely to cooperate with one another since they view each other as “competition.” Employees may also withhold information from supervisors if they are concerned that this feedback may result in negative ratings.

Reward top 5 percent, 10 percent, 20 percent, etc. Another method to limit performance-based pay costs requires designating only the top percentage to receive increases. Such exclusivity may be driven by a number of considerations. Choosing a larger percentage translates into more people sharing the wealth, while a smaller percentage means that fewer people will be recognized, but they will be likely to receive sizable increases. The organization's culture often drives the decision regarding how many people should be included. In a strong team environment, broader coverage may make more sense, while more stringent limits may work in an individualistic culture.

Some private sector corporations have begun implementing a restrictive policy to reward only the very top performers. Research into return on investment in these companies has found that the cost of providing sizable monetary incentives to the "stars" can be recouped as a direct result of their subsequent improved outcomes. Nevertheless, such elitism may leave the majority of the workforce demoralized. Federal agencies should carefully consider the implementation and effects of such a strategy, lest they turn the large group of average and above average performers into disgruntled employees. This is especially true since it is likely that the employees at the very top of the distribution will often be there year after year and others will never see positive monetary feedback no matter how hard they try.

Control points in pay bands. As discussed earlier, control points in pay bands limit individual pay progression and thus serve as a "brake" on growth in total salary costs. Since they are frequently established in the middle of the pay band (i.e., below the band maximum) and usually correspond to the average market salary for the relevant job family or occupation, they help keep costs down although employees at this level are still eligible for annual cash bonuses to recognize their outstanding contributions.

Who makes performance rating and pay decisions?

Although supervisors typically rate employee performance and those ratings are usually linked with the actual distribution of pay increases, organizations may choose to retain higher-level control over both decisions. For example, at one extreme, control over rating and pay decisions may be centralized at the top level. This strategy works best in small organizations, and may be used to focus attention on the organization's values, especially when all components and/or employees are rated on the standardized criteria or when organizational components are evaluated on whether they accomplished their unique objectives (and everyone within the component then receives the same award). A central board of senior managers may also exercise sole discretion over pay decisions when rating criteria are not standardized (i.e., a variety of individual competencies and outcomes are assessed), consistent treatment of all employees remains a primary goal, and the senior managers have enough perspective to be able to accurately judge performance across the organization. However, a potential hazard inherent in centralized evaluation of performance and distribution of pay increases relates to the likelihood that senior managers will not be knowledgeable about performance within subunits of the

organization. Lacking first-hand knowledge of each employee's accomplishments, senior managers may have a tendency to over-value highly visible employees and undervalue the quiet, behind-the-scenes, high performer.

In contrast is the model of decentralizing performance rating and pay decisions to the lowest possible level: first-line supervisors. In this manner, the organization defers to the knowledge of the supervisors and assumes that they will make correct rating and pay decisions and treat all employees fairly. Some organizations provide for higher-level review by a pay panel or other decision-making authority to assure consistent evaluations for comparable performance and contributions. However, any review typically takes place before ratings are communicated and rarely results in overturning supervisors' decisions because that would undermine their authority.

One danger of delegating rating authority to the lowest levels involves the natural tendency of supervisors to protect their employees' interests rather than objectively assessing accomplishments against a standard. Explanations abound regarding why this would occur, but two of the most likely are: (1) supervisors rate their employees highly to ensure that they will receive at least a fair share of the pie, believing other supervisors are also going to embellish performance evaluations to help their employees receive increases, and (2) supervisors realize that superior accomplishments by their employees will be rolled up to support their own achievements and subsequent rewards.

Other organizations choose approaches between these extremes to balance the advantages and disadvantages of complete centralization or delegation. For example, some distribute authority at a mid-level, such as by allocating resources to major organizational subunits. In this case, the organization's top level may designate which subunits will receive discretionary salary dollars and the amount based on organizational accomplishments. Managers and supervisors within the subunits may then have discretion regarding how to subdivide the pot.

Other organizations involve separate entities to promote fairness in rating and pay decisions. One technique is to have pay review panels that examine trends across the organization to determine if there are any patterns of concern. Pay panels can also serve to mediate disputes between employees and supervisors over what pay increase (if any) is warranted.

Who provides input to the performance ratings?

Given that various perspectives often offer a more complete view of an employee's performance, it may be worthwhile to consider input from a variety of sources, including the first-level supervisor, the second-level manager, and the employee's colleagues and customers, as well as directly from the employee. A 360 degree feedback instrument that includes input from higher levels, peers, and subordinates, and/or a balanced scorecard that includes business results and customer feedback can help to ensure that important input is not overlooked. See **Figure 7** for a summary of potential sources of input on employee performance ratings.

Figure 7. Potential Sources of Input on Employee Performance



Supervisor. In most pay for performance systems, supervisors have the greatest influence on employees’ pay increases because they make the assignments and evaluate performance. However, relying exclusively on supervisors may increase a pay for performance system’s vulnerability to errors and abuse, as discussed previously. The risks are increased when some employees are experts at “impression management” and can convince a supervisor that they are performing above their actual level, while other employees achieve more but do not tout their accomplishments as well. Some supervisors may also be more effective at identifying and presenting their employees’ accomplishments. In other cases, supervisors may skew their ratings to unfairly reward favored employees at the expense of those who may be more deserving of pay increases.

Manager. Involvement of higher level managers in rating and pay decisions may introduce a “reality check” whereby their perspective may be used to calibrate ratings and pay increases. For example, supervisors may accurately or inaccurately believe that their employees are above average. However, the next-level manager has the advantage of being able to compare accomplishments across work teams and may be able to provide feedback to bring a supervisor’s ratings in line with those for the rest of the organization. Another advantage may be that any intentional or unintentional biases that a supervisor has may be noticed if a second-line manager reviews the recommendations. Involving someone outside of the employee’s management chain may further increase perceptions of fairness, though it also probably reduces first-hand knowledge of performance that such a reviewer will have.

Employee (Self-rating). With increasing supervisory ratios and the need for supervisors to devote time to tasks other than observing the work of their employees, it is understandable that supervisors may not be familiar with all of an employee's accomplishments during a rating period. Hence, it is advantageous for employees to provide their supervisors with a summary of accomplishments during the rating period. This enables employees to explain extenuating circumstances that prevented achievement of all the established objectives and to highlight accomplishments supervisors may otherwise overlook. Although some employees may embellish or underestimate their achievements, effective supervisors will use this exchange of information as an opportunity to clarify actual accomplishments and discuss with employees past, present, and future goals and ways the employees can improve their performance.

Peers. Peers often occupy a position that provides them with insight into the day-to-day performance of their coworkers. Peers see coworkers on a regular basis and may be best able to judge the effort a colleague makes. Since their work is often very similar, peers are able to assess whether the outcomes reported by the employee are reasonable and if other constraints are operating that prevented the employee from accomplishing the desired objectives. However, peer input must be given weight cautiously, especially in a pay for performance setting where employees may view each other as competition because this may lead employees to undermine others to build themselves up or to establish mutually beneficial pacts with colleagues to rate each other positively. Further, opinions may be clouded by irrelevant biases if employees do not receive extensive training in proper evaluation techniques, which should raise their awareness of any discriminatory tendencies.

Customers. Many Federal agencies have customers outside the Government, although the definition of customer may not correspond with what we typically view as a customer in a retail or service environment. In these agencies, employees need to treat their customers in a way that accomplishes the desired interaction in a professional, effective, and efficient manner. Additionally, Federal employees who work in support functions, such as human resources, finance, and information technology, have customers within their agency. In some cases, customer satisfaction can be traced directly to individual employees and may be an appropriate factor to consider in evaluating performance.

How can agencies facilitate pay system integrity?

Organizations can take a number of steps to evaluate the integrity of their compensation systems, even when significant supervisory discretion has been built into the structure. Differential treatment of employees—which, in the Federal Government, will require abandoning the practice of basing individual pay decisions on tenure and a low threshold level of performance—is both a primary strength and a potential weakness of a pay for performance system. Therefore, building safeguards in the system from the very beginning is critical to the acceptance and long-term viability of a performance-based pay system. Possible safeguards are discussed next.

Employee/union involvement in the development process. To obtain input from those who know the work best, agencies should consult their in-house experts—employees and the representing unions and other employee groups—early in the process. A truly collaborative process enables the organization to benefit from the perspectives of those who will be most affected by the new pay system and also facilitates buy-in by having all levels involved from the outset, rather than trying to pull everyone onboard after the plan has been finalized. Such involvement also sets the stage for participation in the future evaluations, revisions, and other steps that will be needed to fine-tune the pay for performance system.

Supervisor's role in the performance evaluation process. Having a fair and effective performance evaluation process is absolutely essential to preserving the integrity of a pay for performance system. However, a great process is meaningless without capable first-level supervisors who are able and willing to properly evaluate performance. Unfortunately, many supervisors do not feel prepared for the demands of the supervisory role, particularly those relating to performance evaluation. This is not surprising since some supervisors have been selected for technical ability rather than supervisory skills and have not been subsequently trained for significant components of their new role. Complicating matters further is the tendency for some of these supervisors to gravitate toward what they do well—serving as technical experts—leaving little time for the important responsibility of effectively managing their employees.

Implementing a pay for performance system often magnifies the demands of the supervisor's job because of the greatly increased significance of the supervisory responsibilities. Those responsibilities include communicating with the employee throughout the appraisal cycle, observing and documenting employee behavior, assimilating those details, and evaluating the employee's performance in comparison to established standards and to other employees. Often, these responsibilities must be discharged in an increasingly complex and fast-paced work environment, for an increasing number of subordinates.

Although none of these responsibilities is new, basing pay on performance evaluations ups the ante for employees. That, in turn, ups the ante for supervisors. Supervisors may experience even greater trepidation about the already contentious appraisal process, knowing that their decisions will affect employees' livelihoods. Supervisors need the training, the tools, and the time to be able to function effectively in this difficult role.

In general, change often creates an uncomfortable degree of uncertainty for everyone involved, but challenges to the status quo regarding pay can be particularly unsettling. Over time, supervisors and employees may develop mutual trust as both sides become more familiar with the pay for performance process. Holding supervisors accountable for their decisions can encourage them to make the right decisions despite the discomfort associated with efforts to change their own behaviors and those of their subordinates.

Supervisor and employee training. Training serves as a critical though often overlooked step in the transition process of implementing a pay for performance system. Organizations must be willing to invest the necessary resources, even though training often seems superfluous compared to the need to fund the pay pool. Supervisors and employees need to be trained in the mechanics of the pay for performance process. Even more important, they should be educated on the philosophical underpinnings of the new pay system so they understand what the organization is trying to accomplish through it. Effective supervisor training is particularly essential, since the success of the system depends upon the ability of the supervisors to effectively communicate with employees, whether setting performance expectations, sharing ongoing feedback, or providing feedback during performance evaluation discussions.

Training should be delivered via a variety of media to ensure that everyone understands the message. For example, when Honeywell's Commercial Avionics Division implemented an incentive compensation plan, it educated their employees with two major training tools: a traditional HR manual to explain the new system to employees and a comic book that showed employees discussing pay.³² These two tools provided employees with information in the formal language needed to explain the details of the system, plus a more user-friendly version to which employees may have been better able to relate.

Since rating performance usually relies heavily on subjective appraisals, learning how to fairly rate employee performance remains one of the most critical skills for supervisors (and for employees when they provide input on themselves, their peers, or their managers). Given that Federal Government work generally does not involve piecework or sales, rating Federal employee performance typically requires a great deal of judgment. Training is essential to ensure that judgment is not impaired by the failings described below:

Leniency. In order to maximize benefits for their staff, supervisors may be inclined to be lenient and rate their employees too favorably. When a team is competing with other teams for a fixed pot of money (and especially if the team accomplishments are rolled up to reflect the supervisor's accomplishments), a supervisor is likely to rate all of his employees as "outstanding." Even when money has been divided among teams and the supervisor must decide how to allocate a limited amount of money among team members, many supervisors find it less stressful to rate everyone as basically the same to ensure that everyone receives a benefit. It may actually make sense to do this if the amount of money at stake is small, because to do otherwise could engender ill feelings without a good reason. However, there are downsides of spreading around award money, including: (1) each individual receives an amount so small it is not influential, and (2) it fails to distinguish between "average" and "better than average" performers, which means the motivational message is lost.

³² Shari Caudron, "How Pay Launched Performance," *Personnel Journal*, 75(9), 1996, pp. 70-75.

“Halo”. Another common tendency of raters is to succumb to the “halo” effect by generalizing their overall opinion based on familiarity with one characteristic, particularly a noticeable trait, of the employee. For example, if an employee is knowledgeable in one content area, the supervisor may assume the employee is equally competent in another content area although that may not necessarily be the case. Supervisors must be careful to evaluate employees on each critical quality independently, without being influenced by the employee’s performance in another area.

Discrimination. A more insidious form of rater inaccuracy is discrimination, often based on gender, race, or other factors not related to the job. Unfortunately, supervisors are not always aware of biases that may result in their treating employees inequitably.

Proving that discrimination is sometimes more subtle than the consistent mistreatment of a particular group, research has shown that context also matters. For example, in cases where women work in nontraditional roles, supervisors with traditional sex role stereotypes tend to rate females less accurately, and often more harshly, when the ratings are to be used for performance-based pay and promotion decisions.^{33,34} In male-dominated fields, females tend to be paid less for the same work, a pattern that is exacerbated by what some research has identified as a tendency of women to settle for a lower salary than men at career entry and career peak.³⁵

In other cases, females receive higher than average ratings (although this does not automatically translate into monetary outcomes). There are a number of explanations for this. Since stereotyping may result in lower expectations for women,³⁶ ratings may be overly lenient, especially for supervisory accolades that can be freely given, such as compliments and perhaps even high performance ratings that are often linked with nominal cash awards. However, when competing with men for scarce resources (e.g., promotions or performance-based pay increases), males may be more likely to reap the greatest rewards.³⁷ An even more significant impact of these shifting standards involves the confusion that this contradictory feedback conveys to women. Positive feedback suggests that the employee is doing what she needs to do in order for her career to progress. Yet, if a supervisor is saying only that the employee is doing a better job than expected from a woman, the feedback is neither truly positive nor helpful: the employee’s performance may be less competitive than she has been led to believe, and she does not learn of areas where she could improve.

³³ Gregory H. Dobbins, Robert L. Cardy, and Donald M. Truxillo, “The effects of purpose of appraisal and individual differences in stereotypes of women on sex differences in performance ratings: a laboratory and field study,” *Journal of Applied Psychology*, 73(3), 1988, pp. 551–558.

³⁴ Deborah E. S. Frable, “Sex typing and gender ideology: Two facets of the individual’s gender psychology that go together,” *Journal of Personality and Social Psychology*, 56(1), 1989, pp. 95–108.

³⁵ Linda A. Jackson, Philip D. Gardner, and Linda A. Sullivan, “Explaining gender differences in self-pay expectations: Social comparison standards and perceptions of fair pay,” *Journal of Applied Psychology*, 77(5), 1992, pp. 651–663.

³⁶ Monica Biernat, “Toward a broader view of social stereotyping,” *American Psychologist*, 59(12), 2003, pp. 1019–1027.

³⁷ Biernat, 2003.

Given the growth of diversity in the workplace, communicating with others of a different race or gender has become a common issue. Unfortunately, supervisors may feel uncomfortable providing constructive criticism to employees who are visibly or culturally unlike them—perhaps because they fear that a discrimination complaint might be lodged against them. Yet, as suggested above, the damage done by neglecting or avoiding coaching may be significant, even if that damage is not immediately obvious.

To avoid inadvertent discrimination, supervisors should be aware that “perceived similarity” (the degree to which people see others as resembling them) can be a critical determinant of how frequently and effectively they interact with their employees.³⁸ Supervisors are more likely to communicate well with the employees they view as most like themselves. This open exchange of information and feedback may result in improved performance by the similar employees and a greater likelihood that the supervisor will be aware of their accomplishments. In return, these employees are more likely to feel positively toward the supervisor and the organization, and consequently, may be inclined to work even harder.³⁹ In response, the supervisor rates the “in-group” employees higher than “out-group” employees.

This helps establish a self-perpetuating pattern of “in-group” employees who have more rewarding relationships with the supervisor than the “out-group.” As noted above, the inception of these groups may lie in unintentional, but subtle distinctions supervisors make among employees based on how similar the employees seem to themselves. However they arise, the existence of these groups may ultimately produce sizable differences in outcomes for the affected employees and the organization.

Another likely outcome of having “in-groups” and “out-groups” is that employees may suspect a supervisor of playing favorites when it comes to pay decisions. Since these biases are not necessarily based on sex, race, age, or other obvious characteristics, anyone may feel that they are being passed over for performance-based increases due to favoritism.

Transparency. Rather than being a one-dimensional concept, transparency has several different aspects. The first aspect of transparency is systemic: how the pay system operates. The General Schedule features an obvious, orderly system of pay progression which makes its operation quite transparent. Since pay for performance offers greater flexibility in pay progression, making a pay for performance system transparent requires some effort.

The second aspect of transparency relates to individual performance expectations and rewards: whether supervisors tell employees what is required (e.g., behaviors,

³⁸ Daniel B. Turban and Allan P. Jones, “Supervisor-subordinate similarity: Types, effects, and mechanisms,” *Journal of Applied Psychology*, 73(2), 1998, pp. 228–234.

³⁹ Sandy J. Wayne, Lynn M. Shore, William H. Bommer, and Lois E. Tetrick, “The role of fair treatment and rewards in perceptions of organizational support and leader-member exchange,” *Journal of Applied Psychology*, 87(3), 2002, pp. 590–598.

outcomes) to obtain bonuses and pay increases. While most organizations provide some direction to employees, clarifying what is expected and what the organization will provide in return is absolutely essential in a pay for performance system if the bonuses are to have any value in motivating employees or focusing work efforts across the organization. The necessary communication must be at the organizational and individual supervisor level so employees receive a consistent message. Employees also need to understand the basis for pay decisions and how those decisions are made to bolster their perceptions of fairness, which is critical to job satisfaction.⁴⁰

The third aspect relates to openness about pay outcomes: the disclosure of pay data at the organizational and individual levels. Some organizations publish information on their intranet websites regarding the distribution of performance ratings and accompanying bonuses and pay increases, without revealing any identities. Employees can view the data to see how they compare to others on the performance continuum and to learn the full range of monetary consequences associated with improving their performance (or allowing it to decline). Even fuller disclosure would reveal pay increase amounts by individual, although this appears to be a much less common practice despite the fact that the specific details on Federal employees' pay and awards are considered public information. Revealing individual outcomes may generate jealousy and misunderstandings, especially when employees are not in a position to accurately evaluate their peers' contributions. Releasing information on the aggregate level enables organizations to manage the message by clarifying what needs to get done to achieve a certain level of reward and demonstrating that the organization delivers what is promised.

Ongoing evaluation of the system. To ensure that the pay for performance system is operating as intended, organizations should conduct ongoing data analyses to evaluate the system's impact. These analyses should provide a comprehensive perspective on the effects of the pay system at various points in time, comparing, for example, pre-implementation measures with data for the system as it progresses and when it becomes firmly entrenched in the organizational culture. The focus of the analyses will vary according to organizational emphases, but issues such as fairness, cost, and the distribution of funds should be relevant to every agency.

At a minimum, organizations should conduct some basic analyses of data from the human resources management data files to ensure that the system is operating in a fair, efficient, and effective manner. For example, agencies should compare performance ratings, salary levels, and pay increases by various demographic groupings, while keeping other factors in mind, such as employees' tenure, education, and job series. They should also monitor the frequency (as a percentage of the population) of bonuses or increases and their amount to ensure that the distribution is consistent with organizational philosophy. Finally, agencies need to develop objective measures to help examine the impact of the pay system on outcomes.

⁴⁰ L. Alan Witt and Lendell G. Nye, "Gender and relationship between perceived fairness of pay or promotion and job satisfaction," *Journal of Applied Psychology*, 276(4), Dec. 1992, pp. 910-917.

To assure the fairness of pay for performance systems, organizations should also evaluate the relationship between performance-based pay increases (and other pay increases) and sex, race and national origin (RNO), grade, occupation, and similar variables.⁴¹ Assuming that these analyses do not reveal patterns of apparent discrimination, publicizing them should further bolster employees' perceptions that the process is fair.

Review process. To facilitate consistent treatment of employees, some organizations have instituted a review process to examine ratings (and anticipated pay increases) within work groups or across parts of the organization. The reviewers may utilize demographic data, especially on sex and RNO, to identify disparate treatment of individuals by group membership. Managers may be required to justify individual ratings with summaries of employee accomplishments, although review panels are generally hesitant to overrule ratings because this would undermine the rater's authority.⁴² The review panel may also question patterns of ratings that show a higher average for one group or organization than for others. In response, a manager may need to demonstrate that the team has made above average contributions to organizational goals, thus warranting greater bonuses.

Appeals process. The credibility of a pay for performance system may be greatly enhanced by establishing an appeals process to provide employees a means to challenge rating or pay decisions that they believe to be unfair. That process could involve employees presenting their cases before an impartial panel tasked with reviewing these disputes.

Summary

Clearly, no one model exists for how to design, implement, and operate a pay for performance system. While agencies can learn from the experience of others, ultimately, each organization must consider the issues carefully in order to make the best decisions given their unique circumstances.

Although paying for performance requires attention to an extensive list of serious issues, considering them in advance of implementation enables organizations to lay the groundwork for a successful performance-based compensation system. Since many of the decisions are interrelated, it is critical that they be considered simultaneously. While one best answer may not be readily apparent, agencies must consider the best information that they can gather during the design phase. Upon implementation, an ongoing effort to evaluate results and adjust the system as necessary should be viewed as a logical and critical aspect of supporting the system.

⁴¹ Michael M. Harris, Brad Gilbreath, and James A. Sunday, "A longitudinal examination of a merit pay system: Relationships among performance ratings, merit increases, and total pay increases," *Journal of Applied Psychology*, 83(5), 1998, pp. 825–831.

⁴² Michael O'Donnell, "Creating a performance culture? Performance-based pay in the Australian public service," *Australian Journal of Public Administration*, 57(3), 1998, pp. 28–40.

Change—especially change as momentous as introducing pay for performance—creates stress in an organization. When agencies embark on significant changes with low levels of trust in place, employees frequently experience anxiety about how they will be impacted. However, properly building, implementing, and operating a pay for performance system can actually serve as a tool for developing trust between supervisors and employees. For example, a review of the Department of Defense demonstration projects typically found that after a few years, many employee concerns regarding pay for performance were proven unfounded as employees became comfortable with the new system.⁴³ Therefore, the fear of the unknown may be overcome if the right approach is taken.

⁴³ U.S. General Accounting Office, “Implementing Pay for Performance at Selected Personnel Demonstration Projects,” GAO-04-83, Washington, DC, January 23, 2004, and U.S. Office of Personnel Management, “Summative Evaluation 2002 DoD S&T Reinvention Laboratory Demonstration Program,” Washington, DC, August 2002.

Conclusions and Recommendations

Because of the longstanding practice in the Federal Government of basing pay primarily on position tenure, shifting to pay for performance will require careful planning, implementation, and operation to facilitate the organizational change that produces a performance-based organizational culture. Such organizational change impacts readiness for implementing pay for performance, but agencies need not wait for the ideal organizational culture to be present before they move forward. Pay for performance can serve to drive an organizational culture in the desired direction.

Agencies must tailor pay for performance systems to their mission and environment. Pay for performance focuses attention on the monetary aspect of the relationship between employees and organizations. However, the greatest changes that pay for performance effects in individual and agency performance are probably those stemming from increased emphasis on defining and communicating goals to employees, providing concrete feedback, and heightening employees' sense of responsibility for contributing to well-defined portions of their organization's goals. To ensure that employees' efforts are aligned with agency priorities, supervisors need to take the agency's unique goals, needs, and environment into account when defining employee objectives.

For pay for performance to be effective, agencies need to meet certain requirements.

These include:

1. A culture that supports pay for performance;
2. A rigorous performance evaluation system;
3. Effective and fair supervisors;
4. Appropriate training for supervisors and employees;
5. Adequate funding;
6. A system of checks and balances to ensure fairness; and
7. Ongoing system evaluation.

While many of these requirements relate to effective human resources management practices that are important to any organization, pay for performance further increases their necessity. Attending to these human resources management issues provides agencies with a much greater likelihood of achieving a fair and effective pay for performance system.

To make pay for performance successful, agencies need to make a substantial investment of time, money, and effort. Pay for performance systems require substantial initial and continuing investment. These resources must be carefully spent on building and maintaining a system that suits the organization's mission and objectives.

Performance evaluation serves as the foundation of a pay for performance system. An effective performance evaluation system is a fundamental prerequisite of pay for performance. Agencies must be able to communicate with employees regarding what the organization values and how it will accurately measure employee contributions to these goals. Without this information, agencies would be unable to appropriately distribute performance-based pay increases and bonuses.

Agencies should select supervisors based on their supervisory potential, develop and manage them to function as supervisors rather than technicians or staff experts, and evaluate and pay them based on their performance as supervisors. Because supervisors play a pivotal role in pay for performance systems, it is essential that they be able and willing to perform the important supervisory functions inherent in performance-based pay systems. To achieve this goal, agencies must select, train, and pay supervisors based on their demonstration of qualities that are suited to a pay for performance environment.

Communication, training, and transparency are essential elements of a good pay for performance system. The key to the effectiveness of a pay for performance system rests with clarifying the mission and objectives of the organization, how these are linked with employees' efforts, and consequently, what competencies, behaviors, and/or outcomes the organization values. Open communication regarding goals and progress; training in the philosophy and mechanics of the pay system; and transparency regarding how the system operates can mobilize the workforce in the desired direction.

Checks and balances are necessary. Agencies can greatly facilitate the real and perceived fairness of the pay system by building in appropriate checks and balances. Although knowledge about the agency's pay for performance plan and transparency regarding its outcomes can help supervisors and employees understand how the system should work, other mechanisms to ensure fairness are needed to further raise and maintain confidence in the system.

A pay for performance system needs sufficient funding to provide high performing employees with meaningful pay increases and bonuses.

Being able to provide high performers with meaningful pay increases is critical to operating an effective pay for performance system. Therefore, agencies need to have adequate funding to support pay increases for those who deserve them.

Pay for performance systems should be evaluated regularly and

modified when necessary. Agencies should conduct an ongoing evaluation of the compensation system to help them ascertain whether organizational goals are being met and identify ways to improve the process.

Summary

In this report, we have discussed requirements of a successful pay for performance environment. **Table 3** summarizes the characteristics that organizations should demonstrate to most effectively support pay for performance. However, taken as a whole, these qualities represent an ideal setting that exists in few, if any, organizations. Given that organizations cannot (and should not) wait for perfect circumstances to begin to implement pay for performance, agencies should keep these features in mind as a goal, and work towards them.

Fortunately, if done correctly, implementing a performance-based pay system can also help agencies move in the direction of these critical success factors—if they understand how pay for performance can help them reach these goals. Agency leaders need to understand that they have enormous discretion and can select from a multitude of options to build a performance-based pay system that will work well under their unique circumstances. The greatest challenge for many decision makers is likely to be making the choices that will best enable their pay system to help them to achieve their goals.

Table 3. Features of a Successful Pay for Performance Environment

Organizational culture	<ul style="list-style-type: none"> ✓ Organizational culture supports the concept of pay for performance. ✓ Organizational leaders demonstrate commitment to a performance-based pay strategy through their words and actions. ✓ Open communication is present. ✓ A high degree of trust exists between supervisors and employees. ✓ Human resources management systems support pay for performance. For example, an effective performance management system is critical to support a pay for performance system, and both should be built on the same values.
Training	<ul style="list-style-type: none"> ✓ Supervisors and employees receive advance and ongoing training that covers both the mechanics of the system and its underlying philosophy.
Supervisors' role	<ul style="list-style-type: none"> ✓ Supervisors treat employees fairly when assigning work, evaluating performance, and allocating rewards. ✓ Supervisors monitor and document employees' performance on a regular basis throughout the assessment cycle and provide feedback that is timely, accurate, and meaningful. ✓ Supervisors assist poor performers, through measures such as feedback and training, to help them to improve their performance. If their performance does not improve, the employee may be subject to an adverse action, such as a pay reduction. ✓ Supervisors have the necessary discretion to make personnel decisions.
Performance evaluation	<ul style="list-style-type: none"> ✓ Supervisors and managers are held accountable for ensuring that performance ratings distinguish between levels of performance. ✓ Performance measures have been carefully designed to encompass the most critical outcomes. ✓ Performance is evaluated at the appropriate level. ✓ Employees understand how their individual performance supports organizational outcomes.
Fairness	<ul style="list-style-type: none"> ✓ The system includes checks and balances to ensure fairness. ✓ Pay and bonuses are distributed according to performance.
Funding	<ul style="list-style-type: none"> ✓ Adequate funding ensures that employees receive compensation that corresponds to their contributions.
Evaluation	<ul style="list-style-type: none"> ✓ The compensation system is evaluated on an ongoing basis to ensure that it is accomplishing the desired objectives in a fair and cost-effective manner. ✓ Measures of employee attitudes, such as employee engagement and motivation, as well as outcome indices, are tracked and analyzed to determine the impact of pay and other factors on employee satisfaction and performance.

Bibliography

5 CFR 531.405.

Armstrong, Michael, and Brown, Duncan. (1998). "Relating competencies to pay: the UK experience." *Compensation and Benefits Review*, 30(3), 28–39.

Barr, Stephen. (2004). "Pay parity amendment's rejection complicates debate over raises." Federal Diary, the *Washington Post*, March 18, 2004, p. B2.

Barr, Stephen. (2004). "Pay-for-performance system makes an uneven debut among SES corps." Federal Diary, the *Washington Post*, February 9, 2004, p. B2.

Biernat, Monica. (2003). "Toward a broader view of social stereotyping." *American Psychologist*, 58(12), 1019–1027.

Caudron, Shari. (1996). "How pay launched performance." *Personnel Journal*, 75(9), 70–75.

Dobbins, Gregory H., Cardy, Robert L., and Truxillo, Donald M. (1988). "The effects of purpose of appraisal and individual differences in stereotypes of women on sex differences in performance ratings: A laboratory and field study." *Journal of Applied Psychology*, 73(3), 551–558.

Frale, Deborah E. S. (1989). "Sex typing and gender ideology: Two facets of the individual's gender psychology that go together." *Journal of Personality and Social Psychology*, 56(1), 95–108.

Harris, Michael M., Gilbreath, Brad, and Sunday, James A. (1998). "A longitudinal examination of a merit pay system: Relationships among performance ratings, merit increases, and total pay increases." *Journal of Applied Psychology*, 83(5), 825–831.

Heneman, Robert L., and von Hippel, Courtney. (1995). "Balancing group and individual rewards: rewarding individual contributions to the team." *Compensation and Benefits Review*, 27(4), 63–68.

Hewitt Associates. (2003). "Hewitt study shows record lows for salary increases in 2003 with only slight improvement slated for 2004." Press release, September 9, 2003.

- Hewitt Associates. (2004). "Salary increases remain at record lows in 2004 with moderate improvement projected in 2005, says Hewitt." Press release, September 8, 2004.
- Hewitt Associates. (2005) "Hewitt study shows base pay increases flat for 2006 with variable pay plans picking up the slack." Press release, August 31, 2005.
- Jackson, Linda A., Gardner, Philip D., and Sullivan, Linda A. (1992). "Explaining gender differences in self-pay expectations: social comparison standards and perceptions of fair pay." *Journal of Applied Psychology*, 77(5), 651–663.
- Kaplan, Robert S. and Norton, David P. (1992). "The Balanced Scorecard—Measures That Drive Performance." *Harvard Business Review*, 70(1), p. 71.
- Kaplan, Robert S. and Norton, David P. (2001). "Transforming the Balanced Scorecard from Performance Measurement to Strategic Management: Part I," *Accounting Horizons*, 15(1), pp. 98–99.
- Kotter, John P., and Heskett, James L. (1992). "Corporate culture and performance." The Free Press, New York, NY.
- Lawler, Edward. "Rewarding Excellence: Pay Strategies for the New Economy," Jossey-Bass Publishers, San Francisco, CA.
- National Coalition for Equity in Public Service. (2004). Briefing presented by Julius Crouch at the 2004 Diversity Summit, April 8, 2004, Washington, DC.
- National Research Council. (1991). "Pay for Performance: Evaluating Performance Appraisal and Merit Pay." National Academy Press, Washington, DC.
- O'Donnell, Michael. (1998). "Creating a performance culture? Performance-based pay in the Australian public service." *Australian Journal of Public Administration*, 57(3), 28–40.
- Simon, Jacqueline. (2003). Statement by Jacqueline Simon, Public Policy Director, American Federation of Government Employees, AFL-CIO (AFGE) before the House Committee on Government Reform Subcommittee on Civil Service and Agency Organization regarding replacing the General Schedule with pay for performance, April 1, 2003.
- Turban, Daniel B., and Jones, Allan P. (1998). "Supervisor-subordinate similarity: Types, effects, and mechanisms." *Journal of Applied Psychology*, 73(2), 228–234.
- Tyler, Kathryn. (1998). "Compensation Strategies Can Foster Lateral Moves and Growing in Place." *HR Magazine*, 43(5), 64–71.

- U.S. General Accounting Office. (2003). "Results-Oriented Cultures: Modern performance management systems are needed to effectively support pay for performance." GAO-03-612T, Washington, DC, April 1, 2003.
- U.S. General Accounting Office. (2004). "Implementing Pay for Performance at Selected Personnel Demonstration Projects," GAO-04-83, Washington, DC, January 23, 2004.
- U.S. Merit Systems Protection Board. (2003). "The Federal Workforce for the 21st Century: Results of the Merit Principles Survey 2000." Washington, DC.
- U.S. Office of Personnel Management. (2002). "Summative evaluation 2002-DoD S&T Reinvention Laboratory Demonstration Program." Washington, DC.
- U.S. Office of Personnel Management. (2003 and 2004). Civilian Personnel Data File (CPDF).
- U.S. Office of Personnel Management. (2003). Memorandum for Heads of Departments and Agencies from Kay Coles James, Director, Subject: New Performance-Based Pay System for the Senior Executive Service, December 16, 2003.
- U.S. Office of Personnel Management. (2003). Memorandum for Human Resources Directors from Ronald P. Sanders, Associate Director for Strategic Human Resources Policy, Subject: Recent Legislative Changes, December 24, 2003.
- U.S. Office of Personnel Management. (2004). General schedule within-grade increases from the website www.opm.gov/oca/pay/html/wgifact.htm.
- U.S. Office of Personnel Management. (2006). Salaries and wages from the website www.opm.gov/oca/06tables/index.asp.
- Wayne, Sandy J., Shore, Lynn M., Bommer, W. H., and Tetrick, Lois E. (2002). "The role of fair treatment and rewards in perceptions of organizational support and leader-member exchange." *Journal of Applied Psychology*, 87(3), 590-598.
- Witt, L. Allen, and Nye, Lendell G. (1992). "Gender and relationship between perceived fairness of pay or promotion and job satisfaction." *Journal of Applied Psychology*, 77(6), 910-917.
- WorldatWork. (2003). Salary survey from the website www.worldatwork.org.

U.S. Merit Systems Protection Board
1615 M Street, N.W.
Washington, DC 20419

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE \$300

PRST STD
U.S. POSTAGE PAID
WASHINGTON DC
PERMIT NO. G-13



Designing an Effective Pay for Performance Compensation System