Human Capital Management Series

Pay for Performance:
A Guide for Federal Managers

Howard Risher

IBM Center for
**The Business
of Government**

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On behalf of the IBM Center for The Business of Government, we are pleased to present this report, "Pay for Performance: A Guide for Federal Managers," by Howard Risher.

Recent legislation has given the Departments of Homeland Security and Defense the flexibility to develop their own pay systems, and both have announced plans to shift General Schedule (GS) employees to salary systems based on pay for performance. And it is highly likely that additional agencies will move from the GS system to pay-for-performance systems within the next few years.

Risher's thought-provoking guide provides timely and comprehensive advice to federal managers involved in the planning and implementation of pay-for-performance systems. He examines arguments for and against pay for performance, reviews various approaches to pay for performance, and discusses the challenges of implementing such systems. He concludes with an exhaustive set of recommendations for creating successful pay-for-performance systems and policies.

Risher warns that the transition to a pay-for-performance environment is not going to be easy. Indeed, for the new system to succeed, managers need to be comfortable with their new role in overseeing such systems. That makes it essential for them to play a role in the planning and implementation of new systems. Pay for performance, including the reward system, must be an integral part of an organization's overall strategy to create a performance culture. We trust that this report will be informative and useful to all those involved in the movement toward pay for performance in the federal government.

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EXECUTIVE SUMMARY

The federal government is now moving to a pay-for-performance salary management philosophy. The change has been discussed for over 20 years—the first pay-for-performance demonstration project dates back to 1980—but the transition has been extremely slow. Currently there are less than 40,000 federal employees working under a policy that links their salary increases to their performance.

The change in policy gained new momentum when the Departments of Defense and Homeland Security were authorized to develop their own pay systems. Both have committed to relying on pay for performance. In combination, the two new pay systems will cover nearly 750,000 employees.

Pay for performance is also the central change in the way the members of the Senior Executive Service (SES) will be compensated into the future. The new model for SES pay requires a solid linkage between pay and performance. Those agencies that meet the criteria established by the Office of Personnel Management (OPM) will be allowed to raise the cap on both SES salaries and on the total of salary and bonuses.

In the private sector, pay for performance is a virtually universal policy for white-collar workers at all levels. At the management level, pay packages commonly include cash incentives and stock ownership opportunities that link rewards to the success of the company as well as individual performance. For lower-level employees, the use of group incentives such as gain-sharing plans has expanded over the past decade. And, of course, their salary increases are based on an assessment of their performance.

For federal agencies, this represents a fundamental change in compensation philosophy. The General Schedule, with its virtually automatic step increases, has long been criticized as responsible for contributing to an "entitlement" culture. Moving to pay for performance will require managers and supervisors to develop the skills needed to manage performance and to handle the discussions related to these issues with their people. It will take several years to develop and implement the new systems and gain acceptance for the new philosophy.

Surveys of federal employees confirm that employee reward practices across the federal government are ineffective. OPM's Federal Human Capital Survey shows consistently, agency by agency, that scores on the "performance-based rewards and advancement practices" dimension are lower than any other HR practice. The survey questions tied to this dimension cover different reward practices, and the results are uniformly low—recognition and reward practices are a general problem in federal agencies.

Research over the years confirms that people—and ultimately the organizations themselves—perform better when they are rewarded for their performance. Tying rewards to results enhances the focus of employees on what they are expected to accomplish. They want to be recognized and valued for their contribution. That is consistent with theories related to the way people are managed and the way they view compensation. Pay for performance should be viewed as a management tool.

There are, to be sure, critics who are opposed to the change in policy. Significantly, they generally base their opposition on practical rather than philosophical grounds. They basically contend that federal managers will be unfair and that federal performance management practices are inadequate for the purpose. Another argument is that the focus on individual performance could undermine teamwork, but, of course, that would also be a problem in industry if it were true.

OPM commissioned a study a few years ago by the National Academy of Sciences to assess the question of moving to pay for performance. After an extensive review of the research literature, the study committee concluded the federal government should switch to the new policy.

The study committee's findings highlight one of the central issues in more recent initiatives to improve agency performance. Where pay for performance is most successful, it is firmly "embedded in the context of other management systems" that focus on performance. Pay for performance can be expected to contribute to a performance culture, but the change has to be seen by managers and employees as compatible with other practices affecting the management of people. The committee's findings recognized that there is a need for "a framework of central policy guidelines," presumably similar to those now governing SES compensation, but with the responsibility for designing pay and performance management systems delegated to the agencies.

It is important to understand and appreciate the importance of the changes in the way work is organized and managed. Dr. W. Edwards Deming, the late quality management guru, convinced American industry that frontline workers should be trusted to solve problems and serve customers. The interest in quality management was followed by a recession that prompted companies to focus on performance issues and by the reengineering of production and service delivery systems. These changes in work management practices have been referred to as a new work paradigm. This experience triggered a high level of interest in improved employee and organization performance, and reinforced the role of pay for performance.

The theories and the experience in other sectors provide a solid foundation for planning a pay-for-performance policy. Salary management is always a problem—it involves ongoing decisions by managers in different work areas confronted by different circumstances. And the decisions affect their employees, their careers, and their relationships with co-workers. In the end, the managers and employees have to live with a salary system. Government is, of course, an environment where neither managers nor employees have prior experience with these issues. For that reason, a basic goal should be to make them as comfortable as possible with their new roles and expectations.

The switch in policy has a much higher prospect for success if managers and employees are involved in the planning. They need to discuss and work to gain agreement on current pay problems, the parameters of the pay-for-performance model, the redefined role of managers, and what the agency hopes to accomplish. The focus of the discussion is how to make the new policy successful in the organization. Very few managers and employees have previously considered these issues, so it may take time to reach agreement.

At its core, a pay-for-performance policy has to reflect the philosophy and values governing employee relations, and those considerations are tied up in the work paradigm. A new policy has to be compatible with the shared understanding of what's expected of workers and the way they are managed.

Experience suggests planning should start with the principles that will govern salary management. These principles relate to managers and their roles, to the management of performance, and to the basis for rewards. Agreement on the principles will facilitate consistent salary management across the organization.

The importance of the discussions cannot be overstated. Pay-for-performance policies reflect a basic model but differ in their details from employer to employer. There are no textbook answers. It is important that the policy "fit" the organization and its approach to management. For that reason, the report discusses the parameters of pay-for-performance policies.

The principles, however, provide a framework for developing and evaluating specific policy provisions and management practices. The report concludes with a series of recommendations related to the following subjects:

- Building support and "ownership" for the policy change

- Defining goals in moving to pay for performance

- Preparing and supporting managers in their new role

- Enhancing employee understanding

- Assessing performance management system considerations

- Planning to avoid anticipated problems

- Managing incentive bonus awards

- Managing non-cash rewards

The transition to pay for performance will not be easy, but it will better serve the needs of the federal government than the current General Schedule salary system.

Background

The federal government is at an important cross-road. The General Schedule (GS) with its step increases has been the basis for paying white-collar employees for more than 50 years. There have been repeated proposals over the years to eliminate the steps and move to pay for performance. Yet when the number of employees involved in all of the pay demonstrations and all of the non-Title 5 pay systems are added together, the total is still less than 250,000.[1] Less than 40,000 are working in agencies with pay-for-performance policies.

Now recent legislation has given the Departments of Homeland Security (DHS) and Defense (DoD) the authority to develop their own pay systems, and both have announced plans to shift GS employees to salary systems based on pay for performance.

In combination, that means nearly 750,000 federal employees and their managers will have to learn to live with this radical change in policy.

Both agencies will have to invest heavily in planning new pay and performance systems, and in training managers and employees in the use of those systems. This may well be the most complex organizational change ever undertaken. People will have to develop new skills and new ways of thinking about these issues. The new policy will change the relationships managers have with their people. And it's almost certain that additional agencies will move from the GS system to similar pay-for-performance policies within a few years.

The first attempt to adopt a pay-for-performance policy was for managers and supervisors (in GS 13–15) following enactment of the Civil Service Reform Act of 1978. It was not considered a success, however, and was terminated in 1993. Over 85 percent of the managers were rated in a typical year as either "exceeds fully successful" or "outstanding." As a result of the inflated ratings, the policy had little credibility. Critics of pay for performance now cite that failed experience as proof of the government's inability to develop effective practices.

The most recent experience that agencies under Title 5 have had with pay for performance is their use of Quality Step Increases (QSIs) and the limited use of small cash performance awards. Neither is a priority in most agencies, and usage is extremely limited. Funds have simply not been available.

Pay for Performance

"Links pay (base and/or variable), in whole and or in part, to individual, group, and/or organizational performance."

In common usage, the word *contribution* is an equivalent term. The phrase *pay for competence* is also used.

In the private sector, the phrase *merit pay* is used synonymously to refer to salary increases linked to performance. The phrase is no longer used widely in the public sector.

Source: From the glossary on the WorldatWork website (formerly the American Compensation Association).

Performance-Based Pay in the Federal Government: An Historical Overview

By John M. Kamensky

The federal government has experienced a series of fits and starts over the past quarter century in the use of performance-based pay. The following chronology reflects some of the challenges that have faced government-wide reformers: Should these efforts be government-wide or agency specific? Should all levels of employees be subjected at the same time, or should it be targeted to, or implemented by, segments (Senior Executive Service, managers, line staff)? Can such a system be cost neutral, or should additional funds be appropriated? Following are some of the steps taken along the way.

Demonstration Projects Involving Pay for Performance

Department of Commerce
National Institute of Standards and Technology (made permanent in 1996)
Department of Commerce (implemented 1998)

Department of Defense
DoD Acquisition Workforce (phased implementation completed 1999)

Department of Defense, Department of the Air Force
Air Force Research Laboratory (implemented 1997)

Department of Defense, Department of the Army
Aviation Research, Development and Engineering Center (implemented 1997)
Engineer Research & Development Center (implemented 1998)
Medical Research and Material Command (implemented 1998)
Missile Research, Development and Engineering Center (implemented 1997)
Research Laboratory (implemented 1998)

Department of Defense, Department of the Navy
China Lake Research Laboratories (started 1980, made permanent in 1994)
Naval Research Laboratory (implemented 1999)
Naval Sea Systems Command Warfare Centers (implemented 1998)

1978: The Civil Service Reform Act of 1978 (CSRA) held promises for performance-based pay for both executives and the managerial ranks. But in the succeeding years, Congress did not support the funding needed to support this initiative, which would have been on top of the existing cost-of-living adjustment and within-grade increases.

1980: CSRA authorized a series of "demonstration projects" to pilot new approaches in personnel management. The Naval Air Warfare Center Weapons Division in China Lake, California, conducted a wide-ranging pilot that centered on the use of performance pay. While not adopted government-wide, its success led to its permanent authorization at China Lake (CSRA demonstration projects were to have ended after five years). In addition, several other Department of Defense organizations have since adopted similar approaches. This demonstration showed both an increase in performance and an overall increase in salary spending.

1984–1993: Congress creates the Performance Management and Recognition System, tying pay increases for GS-13 through GS-15 employees to their performance ratings. Regulations were issued in 1986. Congress revised and extended the program twice, but after numerous implementation and funding problems, the program was terminated in 1993.

1993: In this year, several events revived the notion of pay for performance. First, the National Performance Review (NPR) recommended decentralizing the civil service system to each individual agency, within a framework of guiding principles, and allowing each agency to create its own incentive and bonus systems. Second, Congress adopted the Government Performance and Results Act (GPRA), requiring agencies to create strategic and performance plans, and to measure and report on their performance.

1996: While the administration and Congress took no action on NPR's proposed civil service reforms, the Results Act contributed to agencies more clearly defining and measuring their performance. Also in 1996, NPR recommended the creation of performance-based organizations (PBOs), patterned after British "Next Steps" agencies that created a performance contract between the chief executive

of the agency and the home department. A share of the executive's pay was based on meeting performance targets; in exchange, the department delegated administrative flexibilities (in pay, personnel, procurement, etc.) to the executive in the operation of the agency.

1999–2000: By this time period, most agencies had clear missions, goals, and measures. This in turn created some political pressures for agencies to deliver on their goals, resulting in agency leaders creating better links with what their employees did to contribute to these goals. Some agencies had adopted elements of the PBO—the Internal Revenue Service, the Federal Aviation Administration, the Patent and Trademark Office, and the Office of Federal Student Aid—and they pioneered variations of pay-for-performance systems within the limits of existing law. The Internal Revenue Service experience with pay banding and pay for performance is described in Appendix I.

OPM abandoned government-wide civil service reform in favor of streamlined demonstration authority. But this made no progress either. The President's Management Council (PMC), composed of the chief operating officers of the major departments and agencies, commissioned a task force to examine other alternatives for dealing with poor performers and providing incentives for better performance. Based on the task force's findings, the PMC outlined an approach to improving performance that included elements of a pay-for-performance system, beginning with the SES:

- Administratively changed the SES performance management system to define appraisal elements based on performance, not personal behavior characteristics (for example, "fostering an open working environment").

- Administratively changed the award criteria for presidential rank awards (bonuses for top SES members) to include performance management elements.

2001: The President's Management Agenda set forth by the George W. Bush administration included an element that required agencies to link SES performance plans to the goals and performance of their agencies. The director of the Office of Personnel Management (OPM) decried the trend whereby nearly all members of SES were rated at the top of the rating scale, calling for agencies to make "meaningful distinctions in performance" when rating their executives. In addition, the new leadership in OPM supported agency-by-agency personnel reforms within the bounds of broad performance-based criteria rather than holding out for government-wide reforms. As a consequence, various agencies pursued personnel reforms, including NASA and the Securities and Exchange Commission.

2002: The creation of the new Department of Homeland Security included a requirement for a performance-based personnel performance management system. The same legislation also lifted the government-wide cap on total SES compensation, with the proviso that agencies first create executive performance management systems that make "meaningful distinctions in performance."

2003: Congress authorized the Defense Department to overhaul its performance management system to be more performance based. The same legislation also eliminated government-wide pay levels and automatic cost-of-living adjustments within SES ranks. It also lifted the pay ceiling from Executive Schedule 3 to Executive Schedule 2, but with the condition that agencies first create performance management systems that make meaningful distinctions in performance among executives and that are certified by OPM before they can provide performance pay up to the new ceiling. The law also created an OPM Performance Fund. The Government Accountability Office (GAO) cautioned that the federal government was not ready to implement a pay-for-performance system across the board, so Congress did not authorize funding it.

2004: OPM is now putting in place the implementation of regulations for the SES pay-for-performance system. This includes the creation of a new position for agencies, the "senior performance officer," who will be responsible for approving performance goals at the beginning of the year and evaluating the performance of both the agency and its executives at the end of the year, in addition to pay decisions.

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Plans for New Pay Systems

Department of Defense
The Department of Defense (DoD) was authorized as part of the 2004 National Defense Authorization Act to develop a more flexible personnel system. The new system, known as the National Security Personnel System (NSPS), is expected to change the way DoD hires, classifies, pays, promotes, and disciplines civilian employees.

A basic component will be a new salary system, replacing the General Schedule with one based on broad salary bands and pay for performance. The plan is to categorize jobs into broad career groups and develop a set of salary bands appropriate to each.

DoD is conducting a series of town hall meetings and focus group sessions to solicit input on the system design. The department is also consulting with other federal agencies for feedback on their experience. The Office of Personnel Management and the Office of Management and Budget are also closely involved in the planning process.

The current plan to is to convert all DoD employees by November 2008.

Department of Homeland Security
When the Department of Homeland Security (DHS) was created in 2002, Congress authorized the development of a new personnel system. A design team completed the planning over a number of months. The new system will govern pay, performance management, classification, hiring, labor-management relations, and discipline.

The design team conducted a number of town hall meetings over several months to solicit employee views.

On pay and performance, their review culminated with the presentation in late 2003 of a series of alternative program models to the department's top officials.

The alternative selected is a series of banded salary structures developed for broad occupational groups. Pay for performance will be the basis for managing salaries within the bands.

The shift to pay for performance is going to be difficult. It is best managed as culture change. Change is always difficult to accept—the unknown always causes anxiety. Pay is particularly troublesome because many employees in government understand the changes could affect their lifestyle, their status, and their working relationships. There are "winners and losers" with pay-for-performance policies. Managers, in many cases for the first time, will be expected to make difficult decisions that affect their people.

The goal of this guide is twofold: to help managers who are asked to play a role in planning the new policies and to provide advice for managers as they move into this new era. There are no standard answers; every agency will be expected to develop its own answers. It's inevitable that the new policies will need to be fine-tuned over time. For these reasons, the guide does not attempt to provide specific advice.

Pay for Performance: The Basic Issues

Pay for performance is the linkage between pay—base salary and/or lump-sum bonus or incentive payments—and some measure(s) of organizational, work group, and/or individual performance.

The performance measures can be objective and data driven, purely subjective, or any combination.

The goal is to use the prospect of monetary rewards as an incentive for individuals to improve their contribution to improved or sustained agency performance. There is solid research evidence supporting the incentive power of financial rewards.

In government the phrase, "pay for performance" generally refers to the basis for annual salary increases, since the use of cash awards is so limited. In the corporate world, it also encompasses the incentive award payments linked to group

or individual performance. The business world still uses the phrase "merit pay" to refer to salary increases, although that has developed a negative connotation in government.

The focus of the new policy will be the linkage between individual performance ratings and annual salary increases. The statement of policy should be very succinct. It may take less than a page to explain the intent and the linkage between pay and performance. Needless to say, the change is not that simple. Books have been written about pay for performance. This report is designed as a primer for federal managers to better understand the issues affecting the planning and management of pay when it is used to reward employees for performance.

A New View of Work and Rewards

The origins of the way rewards are handled throughout government go back to the era when the General Schedule was adopted. Organizations then and until recently were managed as "machines." The goal of good management was increased speed and efficiency. Employees were "cogs in the wheel" and interchangeable. They were expected to carry out management's directives. At the extreme, employees were not supposed to think but rather turn to their supervisor when they experienced problems.

In this environment, job descriptions dictated what employees were expected to do. The focus was on activities and compliance. Employees were expected to meet minimal standards and stay out of trouble. Pass-fail appraisal systems fit this environment. There was really no reason to identify "star" performers—the machine ran fine as long as employees performed at standard. The GS system and agency performance management practices reflected this thinking for almost half a century.

There is also no reason in a traditional work setting to think about rewards or plans to improve employee performance. Added pay is a cost and not part of the equation. Close supervisory control and the threat of disciplinary action is the answer to performance concerns.

Employees are seen as a cost that has to be managed. As with other costs, the goal is to pay as

little as possible. Federal salaries are below market levels for many occupations, but the impact of that on recruiting and on workforce capabilities has not been considered for years.

All of that began to change a decade or so ago with Dr. W. Edwards Deming, total quality management (TQM), and the genesis of reengineering. Employers now rely on their frontline workers to tackle problems, show initiative, and handle situations that would previously be reserved for a management decision. Employees are increasingly "empowered" to tackle problems.

In fact, if they are not empowered, there is little justification to move to pay for performance. The return on investment would not justify the cost. It's the new emphasis on performance that makes the change essential.

The phrase "paradigm shift" came into popular use in the early 1990s to refer to a change in thinking. The heightened emphasis on performance measurement and results-based management is part of the new paradigm. Words like *accountability* and *transformation* are frequent topics in management publications.

In the new paradigm, employees are expected to demonstrate their capabilities and their commitment to achieving goals. Job satisfaction is seen as a key to improved performance. Outstanding performance is now valued. The phrase "high-performance work systems" has been added to the management lexicon. Over the last decade, numerous books and articles have appeared that discuss different strategies for achieving higher levels of performance. Research has shown that this new approach to the management of work and people can result in dramatic gains in performance.

The use of rewards—cash as well as non-financial—is now an accepted tool for managers working to improve performance. Companies have had "merit"[2] salary increase policies for decades, but there have been renewed recent efforts to find ways to enhance the impact of those policies. In addition, there has been widespread interest in group and team incentive plans. Until recently, private employers were granting stock options to the lowest-level employees as an incentive for

improved performance (but changes in accounting principles ended that trend). The cost is still important, but now that is balanced against the expected performance gains.

The Arguments For and Against Pay for Performance

Pay for performance is sometimes thought of as a philosophical issue. That's certainly true in the private sector, where there is solid opposition to automatic or general increases. Advocates of pay for performance contend it will contribute to improved organization performance. Evidence from the private sector supports that argument. The opponents argue to the contrary, that it will backfire and adversely affect government agencies. This section looks at both sides of this debate.

The Arguments Against Pay for Performance

There are actually very few people across the United States who are philosophically opposed to pay for performance. The critics contend it cannot be successful in the public sector—or, worse, they believe it could alienate workers. There are also a few who argue that the focus on individual performance will undermine teamwork or motivate other undesirable behaviors. Those who oppose pay for performance appear to have supporters in the federal workforce, although there is no way to determine how many employees actually oppose the change in policy.

An issue that contributes to the opposition is fear of the unknown. People tend to be anxious about any change that is not well understood or could have a negative impact on their career, their job, or their relationships at work. In this context, the track record from the past is viewed in hindsight as a failure. The advocates of this point have not made a well-stated case for the change to the federal workforce nor have they debated their side of the argument. It should not be surprising to find employees who oppose the change in policy.

Unions tend to oppose pay for performance, although roughly a decade ago the late John Sturdivant, when he was president of the American Federation of Government Employees, was quoted as saying, "Our union has to learn to live with merit pay." He realized the change in policy was on the horizon and that his union would not be able to prevent it. His successors and other union leaders have voiced opposition, but in their public statements the new policy has not been the focus of their concerns. They are always able to win political support, but the passion seems to have waned.

One of the frequently voiced concerns in past years is that as long as federal pay is well below market levels, the first priority should be "catch-up"; federal workers should not have to live with the risk of merit pay as long as pay levels are too low. A related argument is that salary-increase budgets are also too low; every federal employee deserves larger increases.

The other prominent critics are in the academic world. Two have gained recent prominence. One is at Harvard, Alfie Kohn, and the other at Stanford, Jeffrey Pfeffer. Kohn argues that the use of rewards in any context, including schools as well as work, distracts and undermines the intrinsic satisfaction and motivation of the job. He spoke at a number of human resources (HR) conferences when his book, *Punished by Rewards*,[3] was released a decade ago, but he failed to change compensation thinking. Pfeffer is more focused on the business world and makes the argument that individual pay arrangements do more harm than good.[4] He is not opposed to pay for performance for groups or teams. Since faculty appointments and salaries at both institutions are based loosely on performance (faculty evaluations are normally not based on formal performance appraisals), it would be interesting to see their reaction to being paid on an institution-wide step system.

Another academic, Frederick Herzberg, became prominent almost a half century ago for his research conclusion that pay is a "de-motivator." The world of work has changed in dramatic ways, along with our society, since he published on this topic, but his name is still mentioned in articles and books. There is an element of truth in his argument, although he no longer is a major influence on management thinking. (See "Frederick Herzberg's Argument Against Pay for Performance.")

There will be "winners and losers" in a switch to pay-for-performance salary policies. Some employ-

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Frederick Herzberg's Argument Against Pay for Performance

For over 40 years, the most prominent name cited in debates on pay for performance has been Frederick Herzberg, the psychologist who authored the classic books *Motivation to Work*, in 1959, and *Work and the Nature of Man*, published in 1966. He relied on research completed when American industry was still dominated by heavy industry and computers relied on punchcards. Work settings and employee/employer relationships then were very different from those of our knowledge organizations.

Herzberg studied job and work context factors and their impact on employee motivation. He concluded that work motivation is driven by factors that contribute to feelings of job satisfaction. Those factors include achievements, recognition, responsibility, opportunities for advancement, and the work itself. These factors are specific to the way employees feel about their jobs and their success on the job. His conclusions are behind the focus on job satisfaction as a criterion for evaluating management's performance.

Despite the focus on his conclusions, his findings do not support the argument that job satisfaction contributes to employee motivation. Herzberg and other researchers who tried to confirm his theory never considered actual performance data; they asked employees what triggered feelings of satisfaction and learned in the discussions and surveys that accomplishments were important. They found that the two were correlated, but that is not the same as cause and effect. Satisfied employees have a more positive work experience and tend to perform better, but that does not explain their behavior.

Significantly, for our understanding of pay, he also argued that different factors contribute to feelings of dissatisfaction. He referred to these as "hygiene" factors. This list includes company policy, supervision, salary, interpersonal relationships, and working conditions. He concluded that these factors are more likely to be problems and to adversely affect the employee's relationship with his employer.

Although it has been somewhat forgotten, Herzberg also concluded that employees fall loosely into two camps. The first group includes individuals who are driven by motivator needs. The other camp includes those individuals who try to avoid unpleasant work attributes. He referred to them as "hygiene seekers." They tend to be more negative and to resist change because they anticipate increased dissatisfaction. Employees in the motivator camp are more likely to respond positively to work paradigm changes.

There is or was some validity to Herzberg's conclusions, but it is important to keep in mind that supervisory practices and work settings then were far different. Today's knowledge workers were then few in number. Merit pay was then limited to managers and professionals, and they were not the focus of the research. In that era, employee satisfaction was not a priority. It is clear that all employers have to pay their people and that no pay system can possibly satisfy everyone. Other researchers have questioned his conclusions, but even if they are valid, they do not offer useful advice for managing compensation.

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ees, in theory the better performers, can expect to make out better. The few poor performers should not make out as well. In the public sector, the poor performers tend to receive much more attention than their numbers would normally warrant. However, this is a problem that can be managed and its impact minimized.

Realistically, corporations have considered and lived with all the problems that can arise with pay-for-performance policies. On balance, their leaders have decided the benefits outweigh the negatives.

Over time they are strengthening their commitment to pay-for-performance policies.

The Arguments For Pay for Performance

One of the practical arguments for merit salary increases is that every employer has to adopt a policy governing annual salary increases. The options are limited: Salary increases can be based on an added year's tenure or on some measure that recognizes that all employees are not equal—some contribute much more than others. To use a phrase from the U.S. Office of Personnel Management (OPM),

the policy should result in "pay differentiation." Few people at this point would defend the step increases in the General Schedule. GS salaries are increased, employees progress through their salary range, but there is little benefit to federal agencies.

A related argument is that salary management is always a "zero sum" game—funds are limited, and it's necessary to make the best use of the available money. Across-the-board or general salary increases do not represent the best use of funds.

Another practical claim is that the so-called X and Y generation workers are not going to be content with a tenure-based system. They grew up with video games, with instant feedback on performance and rewards for good performance. Waiting until the people ahead of them retire is not an attractive career alternative. The point is that pay for performance will enhance recruiting among this generation of workers.

Although not directly a pay issue, there is a compelling argument that employees need feedback on their performance so they can improve. That should be an ongoing dialogue between supervisors and their people as the year unfolds. Linking the performance assessment to the annual salary increase provides a focus and emphasizes the areas where improvement is needed.

On the research side, the most important conclusions were developed in a 1991 report by a National Academy of Sciences committee working under contract to OPM. After a comprehensive review of the literature and research findings, the committee concluded that the federal government should switch to a pay-for-performance policy. The report's assessment is the most in-depth to date.

There has actually been little research on the impact of pay in recent years. The conclusion that pay can be an effective motivator is deeply entrenched in the values of this country. Moreover, pay for performance is virtually universal for white-collar workers outside of the public sector, which makes it almost impossible to conduct comparative studies. At the management level, studies that are now a couple of decades old show consistently that companies with pay-for-performance practices perform better.

The history of the United States is replete with stories of individuals who were able to earn fortunes. Rags-to-riches stories are always popular. Our values reinforce the idea that hard work and achievements should be rewarded. In almost every walk of life, we recognize the MVPs and those who demonstrate special skills. We also believe workers should "earn their pay" and oppose any sense of entitlement.

The values are reinforced regularly with media stories about people like Bill Gates who have generated personal wealth—a tradition begun by people like John D. Rockefeller and Andrew Carnegie. These values are also reinforced by a tradition of books starting with the old Horatio Alger stories. Opportunities to become wealthy have been a source of motivation for many young workers. Those cultural values and career goals create a supportive foundation for pay-for-performance policies.

Interestingly, there are differences of opinion about the use of team or group incentives versus individual pay-for-performance practices. Pfeffer is a critic of individual incentives, but he is supportive of systems that reward people as a group. He clearly recognizes the power of rewards.

Psychologists who study employee motivation have confirmed that reward opportunities are an incentive for many people. The section that follows summarizes the primary theories of employee motivation. There is solid evidence that pay can be an effective tool to influence the way employees handle their jobs. In fact, there is often a cautionary, somewhat facetious statement in many management texts about managing pay wisely because it can trigger unanticipated behaviors and consequences. The old adage "You get what you pay for" becomes "You get what you reward."

Private Sector Trends

Performance-based salary-increase policies are virtually universal for white-collar employees in the private sector. Despite critics like Deming, those policies are growing in use and importance. There is no reason to think corporations will ever revert back to across-the-board or automatic increase practices.

One of the ideas recently adopted by a number of prominent corporations to strengthen their pay-for-

performance policy is a "forced distribution" rating policy. With this policy, managers are required to force their ratings to fit a specified distribution. At General Electric, only 20 percent can be rated at the highest level and 10 percent have to be rated at the lowest level, using a three-level rating scale. The balance, or 70 percent, are rated as "meets expectations." That is similar to the distribution required in other companies adopting this philosophy. Many more companies have a similar but informal expectation that ratings will fit a certain pattern. The 20 percent rated as stars at GE are granted significantly larger salary increases and bonus awards.

This policy would not be acceptable in government, but it is indicative of the emphasis placed by corporations on pay for performance. GE goes so far as to say publicly that they are quite happy to see the 10 percent at the bottom leave to join competitors.

At the executive level, companies have made incentives and stock ownership opportunities integral components of the pay package. The business press has periodic articles looking at how much top executives earn. Middle managers and senior professionals also participate in those plans, although their prospective income is significantly lower. The new Senior Executive Service (SES) regulations are based on a similar philosophy that links rewards to agency, bureau, or program performance as well as individual performance.

A related trend as the new paradigm has emerged is to introduce team and group incentives for lower-level employees. In some smaller companies, it's as simple and traditional as profit sharing. The more important change is the introduction of specialized incentive plans linked to specific performance measures. The phrases "gain sharing" and "goal sharing" are used sometimes interchangeably to refer to these plans.

The trends are important because they highlight the change in thinking. Incentives are now seen as an effective way to influence employee performance. People at all levels are expected to contribute. Team and group performance is important. The reward practices of the public sector are behind this curve.

1001 Ways to Reward Employees

Almost anything can become a valued reward. The heading of this section is the title of a popular book by Bob Nelson that has been in bookstores now for a decade. It's worth reading. Cash is, of course, covered, but the book emphasizes non-financial rewards, with almost endless listings and brief descriptions of reward ideas. The broad categories of non-financial rewards are listed in the box on the next page.

Another popular management book from the past, *In Search of Excellence*, also highlighted the importance of rewards (along with other effective management practices). One company created a highly sought after reward by carving a banana from wood and painting it gold. The book never actually discusses cash incentives, perhaps because they are so common, but it does make the point that people will work very hard to earn recognition and rewards.

Partial Listing of Non-Cash Rewards
from *1001 Ways to Reward Employees*

Informal Rewards
(requiring minimal planning or approval)
Peer recognition activities
Public recognition event
Communication
Paid time off
Gift certificates
Merchandise/Apparel/Food
Recognition items/Trophies/Plaques
Fun celebrations

Formal Awards
Contest
Field trips/Special events/Paid travel
Education/Personal development opportunities
Promotions/Advancement awards
Employee/Organization anniversaries
Charity/Social donations

Awards for Special Achievements and Activities
Technical accomplishment awards
Outstanding employee awards
Productivity/Production/Quality awards
Employee suggestion awards
Customer service awards
Group/Team awards
Attendance/Safety awards

This guide focuses on the use of cash rewards, but the same arguments apply to non-financial rewards. It appears to be true (although there is no empirical evidence) that public employees have lower expectations and do not expect cash awards similar to those offered in industry. That, however, does in no way diminish the importance of recognizing people who make valued contributions. There are many alternatives to cash.

One other issue that is highlighted in the Nelson book is the fun and enjoyment that is part of reward ceremonies. People turn them into special occasions that provide an opportunity to have fun at work.

Evidence of Poor Federal Reward Practices

There is evidence that rewards are not managed well in federal agencies. In the 2002 Federal Human Capital Survey conducted by the U.S. Office of Personnel Management, employee response data are used to rate and compare agencies on 10 sub-dimensions. The composite scores on the dimensions are all expressed on a 100-point scale. One dimension is "performance-based rewards and advancement."

For government as a whole, the best scores are on "employee skills/mission match"—agencies generally do a good job with that, with an aggregate score of 72.2. At the very bottom of the list is the rewards dimension, with a score of 50.8. The next-lowest score is 52.9. The other seven dimensions score in the high 50s or 60s.

Those, of course, are government-wide scores. Some agencies are well above the norm; others are below. However, even at the 80th percentile—the "top tier" performance level—the score on the rewards dimension is still only 55.7. That is below the average score for all but one dimension. That should trigger alarms; government needs to do better.

The rewards dimension scores are actually the composite of the responses to nine questions. The following questions capture important recognition and reward practices, with the government-wide score in parentheses:

- Awards in my work unit depend on how well employees perform their jobs. (52.2)

- High-performing employees in my work unit are recognized or rewarded on a timely basis. (49.4)

- Employees are rewarded for providing high-quality wok products and services to customers. (51.5)

- My performance appraisal is a fair reflection of my performance. (64.0)

- Our organization's awards program provides me with an incentive to do my best. (43.8)

For the majority of the other 57 questions in the survey, the scores are above 60. The highest is 83.2. Only a couple of the remaining scores are below 50.

Federal agencies considering new reward practices should use these scores to assess the need for change as well as to assess the impact of new policies. The scores highlight the problems; they should be higher.

Criticism of Federal Reward Practices

One of the reasons for the low scores is undoubtedly the experience with virtually automatic career progression in the GS system. For new hires in the two-grade interval job series, promotions are virtually automatic to GS 12 or 13, the top of the typical non-supervisory career ladder. Those employees can expect annual promotions with increases in excess of 20 percent, with minimal regard for performance (for example, step 1 of GS 7 to step 1 of GS 9 is a 22 percent increase, but the GS 9 step 1 will be adjusted by a percentage, which increases the new salary). And for those who stay for more than a year in their salary grade, the reliance on "living and breathing" step increases diminishes any possible incentive. Thus federal employees have very few opportunities for recognition until they are well established in their federal careers.

There is the possibility of granting an employee a Quality Step Increase, but agencies have been reluctant to take advantage of this policy. At some point this policy was discouraged.

Cash bonus opportunities are increasingly common, but those practices have also been criticized. The *Washington Post* recently obtained 2002 data on federal bonus awards from OPM. The data show that two-thirds of the 1.6 million federal employees received some form of cash award or paid time off. The typical award was 1.6 percent of salary—$881 was the median award—with awards ranging from less than $100 to more than $25,000.

The fact is that the data mask the enormous variation in agency practices. One of the most popular policies is the "peer award," which is often as small as $50 to $100. Many employees receive small peer awards from colleagues to recognize special acts. A couple of agencies have also installed group incentives, which by design pay awards to all participants in the group incentive plan.

At the same time, critics have correctly observed that awards in some agencies "are spread like peanut butter"—everybody gets something—and there are only loose controls and little review. In some situations there is a sense of entitlement. In others, the awards are intended to "make up for" low salaries. There is clearly room for improvement, and that is a goal of this guide.

Understanding Pay for Performance

Few policy changes trigger as much anxiety as the possible shift to pay for performance. The possibility has been discussed since at least the Civil Service Reform Act—that's over 25 years—and, of course, is prevalent in every other sector of our economy. However, very few federal managers or employees have ever actually worked in an organization with a true pay-for-performance policy. The lack of direct experience suggests that at least some of the concern is a simple fear of the unknown. The track record of pay for performance in the federal government is not good, so it's not surprising that it has not been widely embraced. The purpose of this section is to provide an overview of the concepts and ideas under the pay-for-performance umbrella.

Basic to the support for pay for performance is the belief that money is a motivator. The belief is obviously deeply entrenched in our history, but that view rides on large sums—the money made by entrepreneurs and investors, not the small percentage differences between one performance level and another. If pay for performance was only about added compensation, this would be a much simpler problem.

Actually, the theory that supports pay for performance is broader and more complex than simply the desire for more money. Pay is the basis for lifestyle and a measure of one's success. One's income is meaningful, however, only when compared with the incomes of other people and with living costs. Unfortunately, many view their compensation as a measure of their value. Pay is relative—Bill Gates is far ahead, but most of us worry about earning more than our peers. That's important to many of us. And we tend to interpret salary increases in the same way—we think we're more valuable and deserve larger increases than our co-workers. It's not easy for supervisors to consider all of the issues.

The theories of motivation that affect our reaction to salary increases involve what we think is fair and equitable, and what we expect based on our work efforts and level of performance. The theory also argues for reinforcing desired performance. In addition, although not limited to pay for performance, we all want to be recognized when we accomplish something. A related theory is the argument that people perform at their best when they work to achieve specific goals. These theories are discussed in more depth in Appendix II.

Theories of Motivation Related to Pay for Performance

Equity Theory—Employee work efforts are affected by their view of how others are compensated. They want to be paid fairly for their contribution.

Expectancy Theory—Employee work efforts depend on how they expect to be compensated. They have choices and will work hard if they expect to be adequately compensated.

Reinforcement Theory—The pay system needs to establish linkages between work efforts and rewards. Behaviors are more likely to be repeated if they are reinforced.

Goal-Setting Theory—Employees perform at higher levels when they have high, specific goals. Working to achieve them triggers intrinsic satisfaction. Rewards should reinforce goal attainment.

The critics are not completely wrong—poorly managed pay-for-performance policies can create problems. But what they fail to mention is that every employer needs a rationale for increasing salaries. Step increases or general increases with no link to performance are simply an added cost. No employer can afford to continue with pay increases if the practice does not benefit the organization. Since employers are competing for talent, it is important to understand what makes an employer of choice. Salaries are not high on the list for job applicants, but once employees start a new job, they want their contribution and value to be recognized. Pay for performance is better than the alternatives.

Pay-for-Performance Models

At one level, the alternatives are simple. When employees are rewarded for their performance, they earn additional cash in the form of a salary increase or a lump-sum bonus. At another level, there are any number of options and variations on the basic models.

There is an added consideration: Employees can be rewarded for their individual accomplishments or for the accomplishments of their organization or work team. Team or organization awards are not common in the public sector, although the new SES pay and performance regulations make this linkage mandatory. (See "New SES Pay and Performance Regulations.")

New SES Pay and Performance Regulations

In July 2004, the Office of Personnel Management issued interim regulations that established a solid linkage between the compensation of senior federal executives and their performance. The changes are the most sweeping since the Senior Executive Service (SES) was established almost 25 years ago.

Now both salary increases and annual performance bonus awards depend on performance. For the first time, agency performance has to be a factor in compensating executives.

Under the new regulations, SES salaries can increase from the old maximum, $145,600, to the new ceiling, $158,100. The combination of salary and bonuses can now go as high as $203,000, the salary of the vice president of the United States.

To be eligible for the higher pay ceilings, an agency's performance management system has to be certified by OPM that it satisfies nine criteria related to the performance expectations defined for executives as follows:

- **Alignment:** performance expectations linked to the agency's mission, strategic goals, and annual performance plan

- **Consultation:** performance expectations based on executive input

- **Results:** performance expectations that are "measurable, demonstrable or observable, and focus on tangible outputs, outcomes, milestones or other deliverables"

- **Balance:** performance expectations that include measures or indicators of "results, customer/stakeholder feedback, quality, quantity, timeliness, and cost effectiveness ... and competencies or behaviors that contribute to and are necessary to distinguish outstanding performance"

- **Assessments and guidelines:** agency head provides an assessment of the agency's performance as well as the performance of each major program and functional area relative to its Government Performance and Results Act goals to be used in rating executives

- **Oversight:** agency head provides rigorous oversight of SES appraisal system

- **Accountability:** performance ratings reflect the individual's performance as well as the agency's performance

- **Performance differentiation:** the appraisal process "results in meaningful distinctions in performance"

- **Pay differentiation:** pay must reflect "meaningful distinction among executives based on their relative contribution ..."

The funds available for performance awards are unchanged: 10 percent of the SES payroll. In all other respects, however, the new regulations require agencies to completely rethink the way they manage executive salaries and bonus awards.

During the planning process, agencies need to consider the organization's mission and strategic goals, organizational structure, employee relations philosophy, planned award or payout levels, importance of group/team performance, and the specific performance goals for covered or affected employees. It is also important to involve managers and employees in the planning process. When all of this comes together, it may well be that an agency's pay-for-performance policy will be unique and only broadly similar to those of other organizations.

Annual Salary Increase Models

The most common form of financial reward in the private and public sectors is the annual performance-based salary increase. These policies have been growing in importance for several decades. For a few years in the 1980s when inflation was a factor, many companies adopted general or across-the-board increases, but those policies are now extremely rare for white-collar workers in any sector other than government.

One of the trends in salary management that started several decades ago was a gradual broadening of salary ranges. The GS ranges are effectively 30 percent from step 1 to step 10, which is typical of traditional government salary systems. Corporate salary systems relied on ranges that were typically 30 percent to 50 percent (from the range minimum to the maximum) into the 1960s, but then started increasing their ranges to as much as 60 percent. The purpose was to give managers greater discretion to recognize individual performance. In the last decade, the trend has moved in a new direction to broad banding, which can be 100 percent or more in width.

Pay for performance is actually a separate policy issue that is not related to the width or salary ranges or bands. Salary ranges or bands effectively define the boundaries or limits for managing salaries. Pay-for-performance policies govern the progression of salaries through the range or band. This is an important distinction for discussions of pay-for-performance policies. The possible adoption of salary bands does not directly affect or influence decisions to move to pay for performance. (See "Pay for Performance vs. Broad Salary Bands.")

Under a pay-for-performance policy, annual salary increases are based on an appraisal of an employee

and, more specifically, on the appraisal rating. This concept is made somewhat confusing by the fact that salary-increase budgets are based on two factors—the increases needed to keep salaries aligned with market pay levels and the organization's ability to absorb the added cost. This means that a good portion of an employee's salary increase is more accurately seen as a market adjustment. Realistically the pay-for-performance portion is limited to the amount above or below the average increase.

A pay-for-performance policy is, then, the guideline or rule (although that overstates the customary degree of control) to be used by managers and supervisors in making salary-increase decisions.

There are two versions of a pay-for-performance policy, in addition to a third combined type.

- **Pay for Performance.** The traditional appraisal focuses on performance over the past year. Employees are rated on how well they meet performance goals and other job expectations, or on a series of performance dimensions such as job knowledge, dependability, and quality of work. The appraisal rating is retrospective, looking back in concept over the employee's performance over the prior year. In effect, the employee is paid for last year's performance until retirement (since the salary increase is part of the employee's annual compensation).

- **Pay for Competence.** The focus on competence is a future-oriented policy, since it is based on the assumption that more-competent employees will perform better going forward. Employees are rated not on performance but on a set of competencies related to successful performance. The goal is to provide a financial incentive for employees to develop their competencies. Experience suggests that employees are more comfortable and willing to accept ratings based on competencies. This is a relatively new concept that is compatible with emerging employee management thinking related to the learning organization and knowledge jobs. It is particularly attractive in the public sector, where it is difficult to rely on results as a basis for evaluating performance. The caveat is that organizations are still testing and refining ways to use competencies to make the practice fully defensible.

Pay for Performance vs. Broad Salary Bands

The critics of pay for performance sometimes focus on and work to oppose the transition from the General Schedule to a broad-band salary system. Bands will facilitate the adoption of a pay-for-performance policy, but they are otherwise independent policy issues.

The traditional model for salary systems in both the public and private sectors was conceived in the post-World War II era as a basis for controlling salaries. In the 1920s and 1930s, managers and supervisors often had complete autonomy to determine wages and salaries and that triggered growing employee discontent. The Classification Act of 1949 and the General Schedule, with its emphasis on classification and step increases, were part of a broader trend to centralize control and solve those problems.

Businesses lived with that salary model until the late 1980s, when global competitive pressures prompted leading companies to look for new practices to reduce costs, increase flexibility, and make their organizations more responsive to market demands. Many pay systems then were every bit as bureaucratic as the GS system.

Banding gained acceptance as a response to those business pressures. The bands are broader or wider than the traditional salary ranges, but the principal difference is that the concept reduces the requests to have jobs reclassified and upgraded. Job classification is a product of a now-ended work management era and is no longer widely used. Salary bands de-emphasize the traditional focus on job value and on internal job-to-job comparisons. The new focus is on individual skills and contribution.

Within a banded salary structure, there is the same need for policies to guide managers in granting salary increases as there is with a traditional salary grade and range structure. The bands are wider, but the problem is essentially the same. If the steps were eliminated from the GS salary ranges, the critics would have the same concern.

The confusion is not surprising since banding gets more attention in media reports and appears to represent a radical change in philosophy. Banding, however, is actually an innocuous change—except to supporters of job classification. Salary bands are simply a framework for managing salaries. They effectively define the boundaries, high and low, and give managers an easily understood picture of the limits of their discretion in making salary decisions.

It seems at this point that the trend to adopt banded salary systems will continue. The recession made it less important for employers to worry about their salary systems, but traditional systems have lost support.

A year or two after an organization switches to a banded salary structure, most managers and employees typically forget it was ever an issue.

The NAPA report, *Recommending Performance-Based Federal Pay* (2004), provides an excellent discussion of broad banding.

- **Pay for Contribution.** This is simply a combined assessment on both results and the requisite competency profile. The newest concept, it tries to capture the best of both the old and the new. This, according to some experts, is the best practice model. Significantly, the new SES performance criteria explicitly require a combined set of measures and competencies.

The performance management system is the foundation of a pay-for-performance system and the basis for pay decisions. Since those decisions are made by supervisors in different functions and with different backgrounds, it's difficult to argue this is a true system or that the decision making is systematic. The success of the switch to pay for performance will ride on supervisors and how well they perform their role.

As the basis for control, employers in the private sector commonly develop two tools for use in managing salary-increase decisions.

- **Annual salary-increase budget.** The budget is customarily established as a percentage of aggregate salaries. Until the past year or two,

salary-increase budgets for white-collar employees in the private sector have been in the 4.0–4.5 percent range for a decade or more. Now many of the budgets are down to the 3.5 percent range. All salary increases (except promotions) are paid from this budget. The funds are allocated pro rata, based on salaries, to managers across the organization.

The budget is customarily set each year to maintain a planned alignment with market salary levels. If, for example, the market raises salaries by 4 percent, that is justification for a 4 percent merit budget.

That is effectively what OPM and the Pay Agent do each year to adjust the GS ranges. It's a long-standing federal practice. The Bureau of Labor Statistics collects market survey data, which is used to compare federal salaries with salaries in the broad non-federal labor market. The gaps at each grade level are the basis for recommending to the president the annual adjustment to the ranges.

With a fixed dollar budget, the obvious fact is that an above-average increase for one employee reduces the money available for increases for others. Salary budget management is sometimes referred to as a "zero sum" game, since each plus has to be offset with a minus. When there are too many high ratings, it forces an employer to reduce the increases to the true high performers.

The zero-sum problem is unavoidable. It's easier to live with in the private sector, where ratings and increases are confidential, but it makes the manager's role more difficult in every organization. (See "Traditional Thinking Behind an Annual Salary Increase Policy.")

- **Annual increase policy or guidelines.** At each performance rating level, the allowable increase or range of increases is specified. For planning, the average planned increase, based on the budget, is tied to the average rating. As an example, an employer using a three-level performance rating scale and with a 4 percent increase budget might permit the following increases: 1 = 0–2 percent; 2 = 3–4.5 percent; 3 = 5–6.5 percent.

All increases would have to be worked out by the supervisor to fit his or her budget.

In addition, it is common to see the ratings combined in a matrix with position-in-range, computed by dividing an employee's salary by the salary-range midpoint. That translates into ratios that are above or below 1.00. Employees low in their range are granted higher salary increases while increases taper off as an employee moves closer to the range maximum. That reflects a learning-curve concept and the argument that the increase in an employee's "value" is less each year.

The new SES pay regulations also reflect a related concept from the private sector. The regulations specifically "reserve the higher rates [between Executive level III and II] of pay for those senior executives who have demonstrated the highest levels of individual performance and/or made the greatest contributions to the agency's performance...." That is a new concept in the federal community. The purpose is to strengthen the tie between pay and performance, and to provide for pay differentiation, to use OPM's phrase.

The comparable private sector concept limits increases to the higher levels in a salary range or band to the few employees with the highest ratings. The basic argument is that an "average" employee should not be paid more than a market average salary. Only the best performers can expect increases to the range or band maximum.

Corporations also provide periodic training for managers as well as employees in the use of the performance management system and the salary-increase policies. Effective performance and salary management depends on managerial skills and commitment.

It is important to keep in mind that corporate managers "grew up" in an organizational environment where performance appraisals and merit pay are well established. These are not new concepts. Their understanding and willingness to assume responsibility for these decisions is very different from what it will be for federal managers. That substantially increases the importance of training and communication.

There is another salary management model that is used infrequently but could have applicability in public agencies: *knowledge- or skill-based pay*. With this model, an employee's pay is increased by

Traditional Thinking Behind an
Annual Salary Increase Policy

Annual salary increases are normally planned to maintain a strategic alignment with prevailing market pay levels. If, for example, market levels are projected to increase by 4 percent, then the salary-increase budget is logically set at 4 percent.

There are two caveats. First, if salaries are known to be below market levels, and the employer decides it can afford to "catch up," the budget might be somewhat higher. The second is the employer's ability to pay, which in tough financial times might mean the budget has to be less than the market increases.

There are numerous sources of market pay information, including several broad-based surveys of salary-increase budget plans conducted in the early fall (for the next calendar year). One of the problems in planning adjustments to the General Schedule is that the decisions are based on Bureau of Labor Statistics data. There is a significant time interval between the time information is collected and when it is used by OPM and the pay agent to make the adjustment decisions. (The 2004 adjustments were planned in 2002.) That means the increases are out of sync with what's happening in the labor market.

The basic premise is that an "average" employee performing at a "meets expectations" level should be granted an average increase. That premise underlies all approaches to salary planning.

In a pay-for-performance environment, all employees are eligible for an increase. The exceptions are: (1) poor performers and (2) individuals at or close to the ceiling of their salary ranges. The amount of an increase (relative to the budgeted amount) depends on an employee's performance rating and, in some companies, his or her position in the salary range.

The "position-in-range" consideration is a nuance that has its origins in learning theory. Employees who are new to their jobs tend to learn job skills quickly. That suggests their value in the job increases rapidly at first, but then begins to taper off over time. They should be paid at or close to the market salary when they are competent in the job. The market salary is the competitive salary for the average competent employee. Logically, only above-average performers should progress to above-market salaries.

There are companies that have strict policies limiting progression above the range midpoint to the better performers. Only the best performers can progress to the range maximum. That is intended to reinforce the importance of pay for performance. The new SES pay policy reflects this idea.

All salary increases are granted from budgeted funds. This means an above-average increase reduces the funds for other increases. The phrase "zero sum" is used to refer to problems of this nature. Supervisors have difficult decisions to recognize and reward high performers because it reduces the increases for other people. That is not popular in any sector, but it represents an important change for federal agencies.

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a specified percentage or dollars per week when he or she demonstrates mastery of a new skill or body of knowledge. The concept has been around for more than two decades, but has never been widely used. One of the most important problems is that there is no direct linkage to performance. Pay is increased with no assurance that it will be offset with improved performance. Moreover, it adds a requirement that employees take a test or demonstrate that they have acquired the knowledge or skill. The added time and cost has been an impediment to wide adoption of the concept.

Incentive Bonus Models

When rewards are paid as a bonus, the plan concepts fall into six basic patterns. As listed, the first four are used as incentives for individuals while the final two are for teams or groups.

- **"Spot" bonus awards.** These are the award practices commonly found in government agencies. Relatively small amounts of money—the budget is typically 1–2 percent of payroll—are budgeted for use by supervisors to make small

Glossary of Terms Used in Incentive Pay Plans

At-risk pay: Cash bonus payments that are dependent on performance and therefore "at risk" of not being earned again in the next performance period. The proportion of pay at risk is a strategy question and generally increases at high levels of management.

Bonus: Payments decided, often subjectively, after the performance period. A bonus usually involves someone at a higher level deciding if a payment is warranted.

Contingent pay: Pay that is related to, or dependent on, performance, competence, contribution, or continued service.

Extrinsic rewards: Work-related rewards that are offered or granted to motivate people to behave or act in specific ways or achieve desired results. Extrinsic rewards include cash payments, promotions, awards, and congratulatory messages.

Incentives: Payments linked to the achievement of previously defined performance levels or targets. The goals or targets are usually quantified and formulas are used to link payouts to performance. Incentives are established and communicated at the beginning of the performance period.

Intrinsic rewards: Rewards that are naturally associated with the job itself and generate job satisfaction. Intrinsic rewards include a sense of accomplishment, contribution to an important mission, and opportunities to develop or improve one's capabilities.

Line of sight: The ability of employees to see and understand how their work efforts are related to performance results. The argument is that they will be more motivated if the line of sight is clear.

Reward strategy: A statement of how the organization intends to plan and manage rewards over the next few years. This is a statement of intentions and goals and desired outcomes.

Team rewards: Payments made normally in the form of incentive pay for achieving team performance goals. Rewards for individuals are sometimes influenced by their contribution to the team's success. The team should, to some degree, be self-managed and responsible for its own performance.

Variable pay: At-risk pay in the form of cash bonuses that are free to vary over time with performance.

(Note: This glossary does not include the basic plan types or models that are discussed elsewhere in the report.)

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awards "on the spot," which is to say with little or no approval and few guidelines. In some cases, peers are also able to make awards. The amounts typically range from perhaps $100 to as much as 2 or 3 percent of pay. The idea is to recognize the employee's accomplishment or contribution soon after the event.

- **Year-end incentive awards.** The most prevalent plans in industry tie the achievement of goals—organization, group, and/or individual goals—to incentive awards at year-end. Although not up to this point widely used in government, the SES regulations reflect this model. The payouts are based on planned performance results and measures that can be tracked throughout the year. This plan

concept is described in greater depth in Appendix III.

- **Technical achievement awards.** These plans are generally limited to specific work groups (for example, engineers) and under a fully developed set of rules. The amounts are often specified (for example, $5,000) at one or more levels. The plans are usually found in companies that have reasons to develop new technical ideas, although they could be used to recognize the achievements in any group.

- **Key contributor awards.** The purpose is to use a cash award to enhance retention of employees viewed as valuable to the organization. The amounts are usually paid in a lump sum.

- **Gain-sharing plans.** These plans were first introduced in the 1930s by a union leader, and until a few years ago were based on a specific plan concept. The original plan called for a sharing with workers of gains from increased labor productivity (or labor savings). It's known as a group incentive. The idea is similar to profit sharing but based on measures that are more closely aligned with worker efforts. More recently, the name or phrase has been adopted to refer to almost any group incentive.

- **Goal-sharing plans.** Goal-sharing plans are a recent variation of the gain-sharing concept. This is also a group incentive. Payouts are based on achieving a limited number of organization or group performance goals. At the planned or target performance levels, the payouts might be in the plus-or-minus 5 percent range (although in government the payout might be lower). That amount is budgeted. Payouts are based on a set of calculations using actual performance levels.

Whatever the plan concept, bonus arrangements have a subtle but significant psychological difference when compared with salary-increase policies. With salary increases, every employee expects one. Managers have to make a conscious decision to deny an employee's increase. That, of course, is not a popular decision, and managers are reluctant to do it. In contrast, with bonus awards, the payments are either automatic (as in gain-sharing plans) or the manager has to make a conscious decision to add an employee to the list of recipients. That's a positive step—the manager is recognizing the employee—while the former is negative. That makes bonus awards much less contentious.

As another variation, in some situations, annual salary increases are paid as a lump sum to avoid inflating the payroll in future years. Lump-sum payments are sometimes made when an employee's salary has reached the top of a salary range. The amounts are generally based on salary-increase guidelines.

Three additional plan concepts are more or less unique to the private sector and not widely used. First, profit-sharing plans are common in smaller companies. Where they exist, they are often used to fund retirement benefits. In larger companies, profit-sharing plans are now rare. Second, commission arrangements are used with sales personnel. Typically, the salesperson is paid a commission or percentage of the sale. Finally, in manual work situations, piece-rate systems pay the worker a specified amount for each unit of production. Piece-rate systems were used extensively in manufacturing starting in the 1930s and 1940s.

Bonus vs. Incentive Awards

The basic plan models highlight the distinction between incentives and bonus awards as these terms are commonly used. Bonus awards are generally based on subjective, after-the-fact decisions. The decisions are made after the accomplishment. Incentives, in contrast, are based on goals and performance criteria defined at the start of the performance period. The intent is to motivate people to accomplish something. Corporations rely primarily on incentives, with payouts linked to business plans. Both are rewards, both recognize good performance, and both reinforce management's priorities.

For the most part, federal agencies have relied on year-end bonus awards. That has been true at the SES level, as well as the performance awards at lower levels. The new SES regulations shift the basis for awards toward the incentive concept—there is a need for evidence showing a linkage between agency and program performance and ratings—but the awards will still be based on after-the-fact decisions.

Corporations often provide funds for supervisors to make "spot" bonus awards. However, these payments are decidedly less important in terms of the amount of the awards and the budget than the payments from incentive systems. Spot awards tend to be valued by employees more for the recognition than the increased compensation.

In the private sector, the focus of a company's reward philosophy is the executive incentive system. To understand incentives in industry, the starting point is the way executives are rewarded. Base salary often accounts for less than half of an executive's "direct compensation." (Stock options can account for a larger percentage of compensation than salary or incentives, but that depends on market appreciation.)

Executive incentives started years ago as profit-sharing schemes, with a percentage of profits committed for distribution to designated executives. The formula governing the distribution is the key. That establishes a mathematical relationship between company performance, as measured by after-tax profits, and executive rewards.

The reliance on profit-sharing formulas has essentially ended, although the basic philosophy continues. But the notion of a formula and mathematical linkages between performance and executive awards is still the foundation of executive incentive planning. The linkages between performance and awards are always specified and documented in contractual terms—"if X is achieved, you can expect to earn $Y." At the beginning of the year, the amounts an individual can earn are expressed as a percentage of salary, and performance plans are established in the form of goals or objectives. That now well-established concept is the genesis of executive performance agreements.

Once the goals and potential awards are established early in the year, individuals can keep track of how well they and the organization are performing against the goals, and use that as a basis for estimating their payouts. The idea that they can take corrective action to achieve goals and increase their year-end payout is a central consideration that distinguishes incentives from bonus awards.

The other difference between incentives in industry and the typical government practice is the importance of organization performance. A fundamental concept in the old formula-based profit-sharing schemes is the idea that no one earns a payout unless the company reaches a minimum or threshold level of profitability. Executives share as a group in a percentage of profits above the threshold. That makes the scheme a team incentive—the executive team is rewarded as a group when the company is successful. With the shift to more complex ways of planning and tracking performance, like the balanced scorecard, the philosophy behind incentives continues to reflect the team concept.

This thinking continued as incentives were extended to lower levels of management and to the professional ranks. It also is the basis for gain-sharing and goal-sharing plans—there is a formula or explicit linkage between awards and performance, and that is combined with a team-reward philosophy. Industry would rarely make large awards on a subjective, after-the-fact basis. (Appendix III provides a more complete discussion of incentive pay plans in the private sector.)

Pay for Performance and a Performance Culture

Pay-for-performance policies do not exist in a vacuum. The research shows that pay for performance contributes to higher performance, but in every business there are other practices that also reinforce the importance of successful performance. In combination, these practices are responsible for creating and sustaining a culture that makes successful performance a shared priority.[5] This makes the contextual issues related to pay for performance at least as important as the specific design considerations.

Perhaps the most important contextual issue is the overwhelming importance of the so-called bottom line—the need to maintain adequate levels of profitability. Employees understand that companies have to be profitable and they behave accordingly. It does not have to be explicitly discussed; it's always an issue. The importance of continued financial success is reinforced in internal communications almost daily.

In the drive for profits, companies track any number of measures of performance indicators related to profitability—revenues or sales, expenses, productivity, quality. They have data tracking systems that make the information available often the next day. People at all levels are inundated with performance data. That makes performance a topic of daily discussions. Although government is changing, there is by no means the same emphasis on performance and on the communication of results.

The thrust of those discussions is: How are we doing? There is always a point of comparison—

last year, last month, the business plan—and the goal is to find ways to improve. There is a high level of internal competition as managers try to prove their capabilities. In addition, companies are competing with other businesses—for customers, for investors, for top talent—and that introduces another point of comparison. The competition makes the private sector different. People respond to competition and work hard to win.

The focus on performance is reinforced by the importance of pay for performance at the senior career executive level. As the business press regularly reports, corporate leaders sometimes earn what to most people are outrageous levels of income. However, the pay levels down to the middle management ranks are impressive and directly linked to company and business unit success. Managers at all levels are motivated by the potential income. The new SES regulations move in this direction, but executive pay is still very different in federal agencies.

The career ladder to the senior management ranks is filled with people who are trained in business management, often with undergraduate and graduate business degrees. Many have had a personal goal of becoming a successful executive from the time they started college. Well-managed companies treat their management cadre as an asset, invest in individual development, practice succession planning, and provide the incentives to develop the needed capabilities. The promotional opportunities are very definitely integral to the reward system. The focus on performance starts years before they reach the executive ranks.

Another more subtle factor is the purpose of pay for performance in industry—to recognize and reward the high performers. Pay for performance in the private sector is about opportunities and using the incentive power of financial rewards. Too often the focus in the public sector is to deny salary increases to the few poor performers. Many agencies have not had systems to identify the outstanding contributors, and those that do too often negate the impact by rating virtually everyone as outstanding.

Industry does have a small percentage of people rated as poor performers. They are handled quietly and confidentially, and encouraged to leave. Poor performers are not tolerated for long—and that reinforces the importance of good performance.

Another very important factor is the role of unions across the federal government. The private sector to be sure has unions, but it's unusual to find white-collar work groups that have been organized. Moreover, unions are still a factor in only a few industries—for example, auto manufacturing, telecommunications, hotels, and transportation. Less than 10 percent of the private sector workforce is unionized. Unions would normally not downplay the importance of performance, but they sometimes make it more difficult to single out and reward the high performers and to take quick action to transfer or terminate poor performers.

The success of pay-for-performance policies rides on performance planning, measurement, and management practices. Managers and employees alike need to know performance management is a priority. Managers need to invest the time and they need adequate training. Their success as managers has to ride on the performance of their unit. These practices contribute to a performance culture.

Companies also devote more attention and energy to celebrating their successes. They do that at all levels and throughout the year. A prominent law firm in San Francisco once had a cannon on the roof that was fired when they won a case. Business competition naturally produces "winners and losers" and virtually everyone will work hard to be seen as a winner. That alone is a reason for pride and commitment. The added compensation confirms that success. It's rare in government agencies to see people celebrating their triumphs.

All of these elements—the focus on performance and performance data, the prospective high compensation levels, and the competitive spirit—work together to create a performance culture. When the culture makes performance important, it influences the behavior of people at all levels. They do not have to be reminded. When the goal is culture change, that requires behavioral change, and the reward system can be an effective tool to confirm management's priorities and reinforce the desired behaviors.

There is an often repeated mantra: Government should be run more like a business. Public agencies have begun to adopt the management systems proven in business. The Government Performance and Results Act and the investment in measurement systems are evidence of that. However, those systems alone will not create a performance culture. Pay for performance—or, more broadly, the reward system—should be an integral element of an integrated strategy to create a performance culture.

Implementing a Pay-for-Performance Policy

It is important to understand the broad discretion to plan a pay-for-performance policy in a salary system based on the broad-band concept. For years, corporate salary systems looked very similar across organizations. The system parameters reflected an off-the-shelf or cookie cutter approach. The similarities carried over to most of the components, including the formula linking salary increases to performance. While those traditional systems continue to be the prevalent practice, when a company now adopts a new salary system, it's likely to be based on broad banding. That is clearly the case with the federal government.

The shift to banding is simple on the surface, but the old rules no longer work as well. With a traditional salary range, employee salaries progressed to the range midpoint and above on a reasonably predictable schedule. Those practices do not fit a banded system. The goals of banding are to simplify salary management, reduce administrative costs, and make the system more responsive to change. The discretion to manage salaries within a broad band is simply incompatible with rigid, restrictive rules.

Salary management is always a problem—it involves ongoing decisions by managers in different work areas confronted by different circumstances. It is also a problem because those decisions impact employees, their careers, and their relationships with co-workers. In the end, it's the managers and employees who have to live with a new salary system. In an environment where the concept of salary management is new and managers have no prior experience, it will not be easy to achieve this level of comfort, but that has to be the goal in planning and implementing a new system. For a new system to succeed, managers need to be comfortable with their role and with the support they can anticipate. That makes it essential for them to play a role in the planning and implementation.

The Starting Point: Developing Agreement on a New Direction

The switch to a pay-for-performance policy is much more likely to be accepted and successful if managers and employees understand why the change is necessary, what they can expect, and what steps are planned to ensure it is fair and equitable. They also need to understand the problems with the current policy. Most employees will go along with changes that are intended to benefit the organization.

The goal of the initial discussions is gaining agreement on the problems, the basic approach, and what the agency expects to accomplish. This is a new arena for federal agencies, so it may be too soon at this stage to develop specific program goals or to announce plans to employees.

The discussions should cover at least these basic issues:

- Will the pay-for-performance policy be limited to salary increases, cash awards, or both?

- Is the purpose to motivate employees to reach higher levels of performance? Should awards be limited to employees who exceed expectations? All "fully successful" employees?

- Is there a reason to develop a specific plan to reward team or group performance? Who should participate?

- Are we ready to link pay to the agency or program goals? Do employees understand our goals? Do we need to do a better job of communicating results?

- Is the purpose to provide a focus on organizational goals or individual performance goals, or both? Do employees have an adequate "line of sight" to our goals?

- Do employees understand current reward practices? How do they view those practices?

- Are we investing enough in cash awards? Are the awards going to the right people?

- Do we adequately understand the impact of current reward practices? What practices should we continue? Are the practices complementary?

- Is the current performance management system ready for the new policy? Do managers have the skills to be effective in performance management? Is the process credible to employees?

- Does the agency use non-financial rewards effectively? Should we broaden our use of non-financial rewards?

- How should we evaluate the effectiveness of the new policy?

The answers will serve as the foundation for planning the work necessary to support the change in policy. It is essential that top management agree on the answers so they can communicate their solid support.

Principles of Effective Reward Management

Despite all the research and the experience of the past half-century, employers are still learning how to manage employee reward systems. Realistically, pay policies need to reflect the philosophy and values governing employee relations, and those considerations are tied up in the emerging work paradigm. As the paradigm has changed over the past decade or so, our view of rewards and their role in the management of people has also changed.

There are several principles that emerge from this experience. Reaching agreement on the principles makes it much easier to reach agreement on the specific system design parameters. Since the experience was primarily in the private sector, the principles need to be translated into practices adapted to fit the federal environment. The "fishbowl" nature of government and the rights of employees make it even more important to be consistent with the principles.

Principles Related to Managers and Their Role
The performance of employees at all levels and the management of rewards needs top management support. Someone at the highest levels should be the champion for the new policy.
Top executives should be vocal in their support for the change in policy. Managers need to know the leaders want the policy to succeed and are solidly behind the change.

In a well-managed organization, the long-term viability and success of the company is a much higher priority than individual performance. The performance measures that drive executive rewards should reflect that reality. Managers in businesses are rewarded for the company's continued success. That is a purpose of the balanced scorecard. It is also a reason for granting executives both long-term and short-term (annual) financial rewards. Government should consider this idea.

Rewards for managers should in part be based on how well they manage employee performance and handle reward decisions.
Organization performance depends on employee performance, and that makes it a priority for managers. That should be true at all levels of management. Linking rewards to their efforts will reinforce the importance.

Employee rewards should be planned and managed as a management tool.
The purpose is to influence employee performance, and that is best understood and handled by the responsible managers. There is a need for oversight review and for guidelines, but only frontline managers are in a position where they can determine how to manage their people.

Award levels or amounts should reflect the level of effort or accomplishment. This necessarily involves the judgment of responsible managers, governed by guidelines and budgetary controls.
Managers need a degree of discretion and sound judgment to determine appropriate awards. They also need training and guidelines to maintain consistency and equity. The rules should be clear and not overly explicit. Managers are inevitably going to reach somewhat different conclusions, and that prompts the need to develop guidelines governing the amounts that can be awarded. Rigid rules, however, would undermine the manager's role.

Principles Related to the Management of Performance

Managers and employees who are involved in an operation are in the best position to develop performance plans and measures. When they are involved in the process, they are much more likely to buy into and support performance plans and standards.
Employees normally want to see their organization succeed, they want to feel like they work for a successful organization, and they are interested in playing a role in making it a success. They can be trusted to assume a conscientious and serious role in developing performance plans.

The management of rewards should have a clear and explicit linkage to the management of performance.
It is not practical to separate rewards and performance management. Performance planning and measurement is integral to both. The rewards should be used to recognize accomplishments that go beyond expectations or work situations that were unexpected.

In the federal context, base salaries are intended as the reward for meeting work expectations. That suggests that added rewards should be limited to employees who exceed expectations.
Performance expectations are based on an employee's position description and the duties that are understood to be part of the job. Supervisors should be accountable for discussing job duties and reaching agreement with subordinates on expected performance levels.

Employees are more motivated when they have a good "line of sight" understanding of how their
work efforts contribute to an organization's success. The phrase "line of sight" was coined to refer to an employee's ability to understand how their contribution is related to organization or group goals. Generally that is best accomplished with cascading, interlocking performance goals and frequent communication of results.

The standard practice with corporate incentive systems is to tie payouts to specific performance goals and measures and to what are often mathematical links between performance levels and payouts.
This makes it possible for plan participants to estimate their year-end awards as the year progresses. When payouts are directly related to the attainment of performance goals, people like to track progress toward the goals. That provides a focus and certainty for employees participating in the plan. The best incentives provide a reason to focus on goals.

Some performance results flow from team or group efforts and some from individual work efforts. Rewards can and should be used to reinforce both.
Cash awards need to be made consistently to the employees responsible for results. People tend to behave based on the way they are rewarded. If teamwork is desired, then rewards should be based on team performance. Team awards have proven to be powerful incentives in certain situations. The balance of the two is a key design issue.

Principles Related to Reward Management

When rewards are linked to specific results, it sends a powerful message related to management's priorities.
Employees perform at higher levels when they know what needs to be accomplished. That is consistent with goal-setting theory. The impact of the linkage is well established.

The "rules" for earning awards need to be transparent and managed consistently. That applies to the reasons for the awards, the amount of the awards or the basis for determining the amounts, and the timing of the awards. That is consistent with expectancy theory as well as equity theory.
Employees need to know what they can expect if the awards are to be viewed as "fair." Managers need to be able to explain and defend all awards. If there is a perception of inequity, and rumors can be as powerful as facts, it can undermine the view of awards.

The receipt of an award should follow the accomplishment in a timely manner. That is consistent with reinforcement theory. However, businesses have learned that employees are realistic and do not expect to be rewarded immediately or on every occasion.

Cash awards in the corporate world tend to be made at the end of the fiscal year or at scheduled, regular intervals. In that context, of course, awards depend largely on year-end financial results. The smaller peer or thank-you awards should follow the event, or employees may forget the reasons. However, if employees know their work efforts will be recognized and rewarded at some date, the timing is normally not an issue.

When special projects and crises require unexpected attention, and an employee has to put in extra time or defer normal work duties, it may be that the unexpected work effort justifies special recognition, time off, or a tangible award.

These situations should be outside of the scope of the normal duties in an employee's position description. They cannot always be reflected in individual performance plans. However, the choice between simple recognition and a cash award is important.

Employees are naturally looking for fairness and equity and are therefore interested in information related to award recipients and the amount of awards.

When information is not made public, it triggers concerns about the reasons. When awards are justified, there is little reason to keep the decisions confidential. Public recognition will, for most people, enhance the impact of an award. Employees need to be confident the decision process gives everyone similar opportunities.

These principles are intended for use in evaluating current award practices and considering future changes. Proposed reward practices should be evaluated in light of the principles.

Planning a Pay-for-Performance Salary-Increase Policy

The planning starts with the budgeted funds available for salary increases. Presumably those decisions will be made above the agency level. Salary management, then, is the process for allocating the funds set aside for increases across an organization and to its employees.

With a dynamic workforce, people retire or terminate, new people are hired, and others promoted or transferred to new positions. The movement of people in and out and across the organization affects salary planning and management since people who are new to a job are generally paid less than those with more tenure. Moreover, when someone starts a new job it is a common policy to defer salary increases until the completion of the first year in the position. All of that can and should be considered in salary planning.

In addition, if the salary system is aligned with market pay rates, someone annually needs to analyze salary survey data to determine salary increases in the labor market over the past year. Market increases depend on the balance of supply and demand for specialized occupational skills, which explains the focus in surveys on selected "benchmark" positions, defined with common occupational duties. The Bureau of Labor Statistics has historically collected the market data used to adjust federal salaries, although there are many other salary surveys. Whatever the source of the data, it is used to determine the percentage increase needed to maintain the planned alignment.

The pay-for-performance policy, then, governs how the budgeted funds are allocated among those employees who are eligible for an annual increase. The policies are based on a simple idea: The policy specifies the increases allowed at each performance level. The increases are normally determined as a percentage of salary, so the funds are allocated pro rata to managers based on aggregate staff salaries.

Through most of the 1990s, budgets for salary increases in the private sector averaged 4.0 to 4.5 percent annually. Recently with the recession, they have fallen to the 3.5 percent range annually.

The surveys of salary budget plans compare with the total of the salary-increase funds under the GS system for: (1) the general increase, (2) the locality adjustments, (3) the step increases, and (4) any Quality Step Increases. The GS system adjustments are based on surveys of salaries and salary-increase

rates in the non-federal sectors, but there is a delay of over a year, so the increases are not on the same timetable.

For planning, the average increase should be linked to the average rating. For example, if the average rating is 3.2 (on a 5-level rating scale) and the budget is for 4 percent, it would be reasonable to allow a 3.8 percent increase for a 3 rating and a 4.4 percent increase for a 4 rating. That is a well-established planning idea.

The other planning step governs the allowable increases at each rating level. It's based on an assumption—that the distribution of ratings for the coming year will be essentially the same as the previous year. That information is available in personnel files. If, for example, 20 percent were rated as a 5 last year, it is assumed for planning that a similar percentage will be rated at that level in the coming year.

The two planning steps in combination make it possible to specify tentative salary increases at each rating level and, using the expected distribution of ratings data, to estimate the weighted average increase. If the estimate is higher than the budgeted percent, one or more of the increase percentages will have to be lowered. If it's too low, they can be increased. It's trial-and-error to make the weighted average equal to the budgeted increase. There is no completely defensible approach to plan increases.

The salary-increase policy specifies the allowable increase at each rating level. It is common to give managers and supervisors some flexibility by specifying a range of increases at each level. For example, the increases for a 3 performer might be 3.5 to 4.0 percent, and for a 4 the increases might be 4.1 to 4.6 percent. At the highest rating level, the range of increases might be the widest to provide greater latitude.

A key question is the increase permitted for the lowest-rated employees. The common answer in the private sector would be no increase. It is important to keep in mind that any funds allocated for increases to poor performers come out of the budget for high performers.

Managing Annual Salary Increases

This new responsibility managing salary increases will change every manager's role and his or her relationship with direct reports.

For many, this will not be an easy transition, but there are a growing number of managers in federal demonstrations who have learned to handle the changes. Many at China Lake are second generation. There are of course millions of supervisors outside of government who have also learned to manage this responsibility.

For reasons that are buried in history, federal employees assume they will be worse off under a pay-for-performance policy than they are under the General Schedule and its step increases. This perception should be addressed in all discussions about pay for performance. Very few employees are performing so poorly that they will be denied increases. For the high performers—and every agency will define that differently—their salary will go up more rapidly than under the GS system. For most employees, their annual pay increases will effectively be the same as in the past. Employees need to understand that.

This is also not about making employees work harder. That's a misconception. The prospect of rewards should provide a focus to work efforts. It's the old "You get what you pay for [or reward]" argument. Supervisors need to keep in mind that employees will want to understand what they need to accomplish to earn increases.

It's sometimes argued, "All my people are good employees and deserve a pay increase." That should not be an issue. Pay-for-performance policies are commonly planned so virtually every employee gets an increase. But in every group a few people stand out who accomplish more than others. A basic problem with the GS system is that everyone is paid on the same basis, regardless of contribution. The goal in pay for performance is to recognize the stars and grant them increases higher than the norm.

There is also a concern that it will undermine teamwork. If that were a real problem, industry would share that concern. Teamwork can be one

of the criteria for evaluating employees. If true teamwork is important, it can be reinforced with team bonus awards. Our sports teams are proof that stars can be rewarded without undermining the performance of the team.

It's essential that all employees understand what they can expect. That communication is basic to the new policy. The organization has to take the lead, but supervisors should discuss the new policy with their staff. Developing a shared understanding of how the change in policy will be handled is a key step.

The new policy will make it much more important to develop effective performance management practices. Pay for performance will quickly become a problem if supervisors do not approach their responsibility for defining and communicating performance expectations as a priority. Ideally those expectations and year-to-date progress should be the subject of several discussions throughout the year.

Regardless of how an agency decides to assess performance, it will be up to each supervisor to work with his or her people to discuss and reach agreement on what's expected. That's performance planning. The more specific the planned performance levels, the easier it will be to avoid problems. Solid plans make it easy for employees to track their progress throughout the year. There should be no surprises in the year-end ratings. When ratings are based on verifiable performance criteria, they are more defensible.

Ratings have been inflated in many agencies for years. Part of the problem is that under the GS system, the ratings have carried no consequences. That history is now baggage that will affect the new policy. Research shows that in the typical work group, only 15 to 20 percent of the people are truly star performers. There is no "right" distribution of ratings, but a goal is to make them more realistic.

Most employees are doing their jobs and meeting expectations. Of course, planned performance levels may be high. Of course, employees are working hard. But their performance does not stand out from their peers—that's the key. Employees need to be told that they are solidly doing their jobs. They deserve and should expect an average increase (based on the salary-increase budget for the year).

Under the GS system, the step increases were sometimes referred to as "living and breathing," so any linkage to performance is a change. A goal is to end the entitlement thinking. The typical employee should still expect increases, but the old way of thinking very definitely needs to change.

Inflated ratings really do not benefit anyone in the long run. The dollars available for increases are not going to increase. Inflated ratings cannot raise the average; it simply means the increases for the true star performers have to be held down.

An idea that has recently gained acceptance to address some of the problems is the so-called "calibration committee." Supervisors recommend ratings to a committee of fellow supervisors. It's the job of the committee to consider the ratings across the organization and decide which employees truly are stars and which are the few whose performance is below acceptable levels. This idea, which has worked very well in several of the demonstrations, makes it easier for everyone.

The initial round or two of ratings and increases will trigger a few problems. Employees are accustomed to the GS system and will be anxious about the change. That would be true in every organization. Investing the time to define expectations and to discuss performance concerns will reduce the problems. Each supervisor has to assume responsibility for helping his or her people understand the new direction.

This new role will require the development of new supervisory skills. Agencies will need to provide training, but it's more than skills. The policy requires agencies to focus on the communication of performance issues. This will change the organization culture, and that needs to be managed. Supervisors should look to their leaders to develop an integrated set of tactics to support this change. The stage needs to be set.

Setting the Stage for a Successful Pay-for-Performance Policy

The transition to a pay-for-performance environment is not going to be easy. That is no doubt an understatement. Defining the allowable increases is the easy part. The steps taken to facilitate and support the change in policy are much more difficult and critical—and will require extensive discussion and ongoing communication with managers and employees.

The focus is naturally on the money, but the real key is the process for making decisions regarding the design and operations of the system. Employees at all levels will need to feel the issues have been adequately considered and that new policies are credible and fair. They also have to believe the decisions are governed by a process they trust and that decision makers have the knowledge and understanding needed to deal with the issues. Since this represents a significant change in the role of supervisors and their authority, it will change the relationship between supervisors and their staff. It has to be handled with sensitivity to the concerns that this will trigger.

The management of rewards at all levels is intended to influence the way people do their job—in a positive way of course. Their perception is going to govern their reactions. There is an often used analogy about a train leaving the station—employees need to get on board. That should be the goal.

Building Support and "Ownership" for the Policy Change

Experience in the public sector shows very clearly that the best strategy for gaining broad support is to involve managers and employees in the planning process. The experience in the pay demonstrations confirms that the nuances that differentiate one policy from another are decidedly less important than the shared commitment to making the change successful. The game plan should provide for broad involvement in focus groups, surveys, and problem-solving committees to create a sense of ownership.

- **Recommendation 1.** One of the earliest steps should be to document, evaluate, and understand current reward practices. The review should carefully consider the existing performance management system as well as cash awards. It will be useful to ask managers and employees how they view these practices. People want confirmation that their views are valued. It is unlikely that the existing performance system is viewed as solid enough to support a new pay-for-performance policy. The assessment should look back at ratings and awards over at least the past year or two. Confirming the problems reinforces the need for change.

- **Recommendation 2.** Agency leaders should play a prominent role in planning the changes. Their role may be limited to attending key meetings or adding statements to communications, but they should be visible.

The changes in the way rewards are handled should be seen as a management responsibility. This is in keeping with treating rewards as a management tool. The HR staff will presumably play a role in administering rewards once the changes are

finalized, but they are not accountable for managing any aspect of the rewards. Managers will take the lead in deciding who deserves to be recognized and rewarded, and they need to be accountable for making the policy change a success.

There is a need for someone to champion the changes. There is also a need for someone who is accountable for shepherding the changes through to implementation and for administering the new policies.

- **Recommendation 3.** Ideally the individual who champions the change in policy will be in a senior leadership position, but the tradition in the private sector is to make someone in HR responsible for managing pay and performance. The change will take months, if not a year or more, and it will be important to have someone who is respected communicate periodically the importance of the change.

There are stakeholders that have to be involved. One of the early steps is to identify the groups, their constituencies, and their issues. They need to be involved in the planning process, but they cannot be an impediment to change. There is an art to gaining their support.

- **Recommendation 4.** The typical corporation has a director of compensation who is responsible for the staff work needed to maintain a pay-for-performance system. The individual—in addition to the people on his or her staff—is the internal expert and serves in a similar capacity to, for example, a budget director. Federal agencies will need to create a similar position with appropriate support staff. Managers as well as employees will need an individual or office to contact when they have problems.

Defining Goals in Moving to Pay for Performance

The goals should be clearly articulated and should be a communications priority. In most cases, the primary goal will be improved organizational performance. A secondary goal might be to recognize and reward the employees whose performance and/or contribution exceeds expectations.

- **Recommendation 5.** A statement should be prepared that clearly and succinctly articulates the goals in changing the policy. Employees should be involved in the discussions, but the goals are properly a management responsibility. They will be accountable for making the new policy a success. The goals need to be positive and clearly intended to benefit the organization.

However structured, the high performers have to make out better over time. That is basic to pay for performance. OPM recognized this in the new SES regulations, where "performance differentiation" and "pay differentiation" are key issues. It would be surprising to see OPM back away from this requirement for lower-level salary programs.

- **Recommendation 6.** Agencies should plan reward opportunities so there is comparability across the organization. That does not mean "equal" or "the same." Ideally, the same level of performance—however that is defined— should have comparable reward opportunities, regardless of function. That's possible, but it takes planning. The most straightforward approach is to budget amounts pro rata based on payroll. The increase policy should make this clear to employees.

The distribution of ratings and related salary increases are critical issues. In most agencies, the current distribution will have to change. That is clearly OPM's intent with the new SES regulations. It is safe to assume that employees know ratings now are not completely valid or honest. However, any changes have to be perceived as equitable across the organization. The intent in working to change the distribution will have to be communicated adequately. It will not be a surprise, but there will be deeply seated concerns about equity. Gaining broad acceptance should be a goal.

Preparing and Supporting Managers in Their New Role

The track record is not good. It is undoubtedly true that many managers and supervisors did not anticipate being responsible for salary management decisions when they moved into management posi-

tions. Many have not had or possibly been offered opportunities to develop adequate performance management skills.

- **Recommendation 7.** Agencies should commit to adequate training for managers. They are likely to need training—more than their counterparts in the private sector, who are accustomed to a performance culture. The training should involve opportunities to practice new skills. This subject is not suited to lectures or videos. Managers will also need the assurance that their leaders see the policy change as a priority.

- **Recommendation 8.** In addition to the training, it would be highly advantageous to make coaching and advice available to managers. Coaches are relatively new to federal agencies, but have proven their value in industry. Each agency should have people with this expertise on staff.

Regardless of their previous experience with performance management, the new ties to pay change the ballgame. Everyone will pay more attention to what has been in some offices a meaningless exercise. Managers will be forced to spend more time on these issues. They need to be prepared to accept the changes in their roles. Training is essential to make them comfortable with their new responsibility.

One of the basic changes is the shift of day-to-day salary management responsibility to managers. To this point, federal managers have not had any real involvement in the management of compensation. That will now change. It makes sense to give local managers discretion in how they manage salaries, but they will need an agency-wide framework of policies and resources to guide their decision making.

- **Recommendation 9.** Each manager should be accountable for managing the salaries and rewards of his or her people. This will be a new responsibility, and many will not be comfortable in the role. HR specialists will need to develop consulting skills and be ready to work with managers.

A few years ago decentralization was a priority, but the pendulum is swinging back. Realistically, some managers take their responsibility more seriously than others. When managers and supervisors have too much discretion, it's almost impossible to maintain consistency and a sense of equity across a large organization. For pay for performance to be successful, employees need to have confidence they will be treated fairly.

- **Recommendation 10**. The ratings process should have a second level and approval along with organization-wide monitoring. It will be particularly important to review the justification when an employee is rated as outstanding and for those few that are rated as unsatisfactory. Managers should be responsible for documenting an employee's accomplishments as well as any performance problems. Senior managers and executives need to know who is making the greatest contributions so they can acknowledge the individuals.

  It may also make sense to establish a "calibration committee" to review individuals rated at the highest and lowest performance levels. The idea has been used successfully in the DoD lab demonstrations and has also been cited as a best practice in human resource journals. It provides for a highly visible quality check and increases the importance of high ratings. The idea will be most readily accepted in a collegial management climate. Both the second-level review and the committee actually serve to reduce the burden on managers.

The recently announced changes in SES compensation will move rewards at that level to a pay-for-performance philosophy. Similar changes could be adopted for the next levels of management. That is the general practice in industry.

- **Recommendation 11.** The management of performance and rewards should be reflected in the evaluation of each manager's performance. Their effectiveness in managing the performance of their people should affect their compensation. That sends the message that it's now a priority.

Enhancing Employee Understanding

Performance expectations and the rules governing pay-for-performance policies should be explicit and understandable. People need to know what they can expect and what's expected of them. Communication has to be an ongoing priority.

With the typical pay-for-performance policy, the average increase is based on market surveys and the increases needed to remain aligned with market salary levels. There is no reason to look for a different approach. In theory, this is the policy used to adjust the General Schedule. However, since that approach was not consistently followed under the Federal Employees Pay Comparability Act (FEPCA) and the locality pay policy, it's only reasonable to expect skepticism. Nevertheless, the intent should be communicated.

Every federal employee is accustomed to and expects an annual salary increase. Under the General Schedule, employees have been granted at least the general increase. While a new policy has not been developed, it is unlikely the automatic adjustments will be continued.

- **Recommendation 12.** Employees will need to understand that the funds for increases will be distributed differently, but the total budget for salaries will not be reduced. That communication is critical.

People working at a "meets expectations" level—the typical employee—should expect average increases. That's the classic policy. Under that scenario, the average employee should be granted an increase that is essentially the same as he or she would have expected under the General Schedule.

- **Recommendation 13.** Only a small number of employees—the poor performers—will be adversely affected by the new policy. That is an important message that should be repeated to alleviate some of the anxiety. Critics have argued that a large percentage of employees will be denied increases. If that surfaces in discussions, it needs to be refuted.

In the private sector, pay for performance is viewed as a positive policy. That's because the goal is to recognize and encourage star performance. The stars, of course, are granted above-average increases (as well as bonuses and stock options in many companies). Companies also have a list of poor performers, but they receive very little attention—they are handled discretely and quietly. Government tends to spend too much energy and gives too much attention to the poor performers. That gives the policy a negative connotation.

- **Recommendation 14.** Federal agencies should work to shift the attention to the high performers in internal communications. It should be an explicit policy to recognize employee contributions and celebrate accomplishments.

A key to implementation is the series of discussions between supervisors and employees regarding performance expectations. Both need to understand operating plans and expectations and the basis for future ratings. Most employees are solid performers, but do not warrant high ratings. In the past the ratings triggered few, if any, consequences, and there was no pressure to hold down ratings. All of that changes with a pay-for-performance policy. It will take time for everyone to understand the implications of the change. The discussions should start as early as possible.

- **Recommendation 15.** The discussions of expectations and results should continue periodically throughout the year. That strikes a lot of supervisors as an unwarranted time commitment, but it reduces the prospect that year-end ratings will be a surprise. That's important. At a minimum, there should be a mid-year performance discussion. Then employees have an opportunity to change the way they approach their jobs if that's to their advantage.

This is an area where best practices are useful, not because identical policies will always be effective, but because it creates an environment where the focus is on finding or developing effective answers. Employees accept change more readily if they know the goal is developing effective practices. Moreover, they can play a role in identifying and evaluating the best practices.

Assessing Performance Management System Considerations

The SES performance regulations provide useful guidance on what OPM expects. The regulations summarize what is usually seen as the best-practice thinking for performance systems. The new SES systems base executive appraisals on some combination of "appropriate measures or indicators of results, customer/stakeholder feedback, quality, quantity, timeliness, and cost effectiveness, as applicable, and competencies or behaviors that contribute to and are necessary to

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Best Practices in Performance Management

A recent study by one of the recognized experts in pay and performance management, Dr. Edward Lawler, focuses on those practices that contribute to the effectiveness of systems used to manage employee performance. The study was triggered by recognition that it is difficult to manage human capital without a system that measures performance and the capabilities needed to achieve organizational goals.

Study respondents were HR managers working in medium to large corporations. The practices identified as most effective were those that enabled the organization to reward top talent and identify poor performers. The sequence of practices is based on impact.

- **"Ownership" of performance management by line managers.** How managers handle performance management is a key to system effectiveness. They need to take control.

- **Training for both managers and individuals being appraised.** Both managers and employees need to understand the process, their roles, and the skills and behaviors important to the process. The training also contributes to the accuracy of the ratings.

- **Leadership by top management.** Executives need to demonstrate their strong commitment to the performance system and to the importance of high performance.

- **Performance goals that are driven by business strategy.** Most of the companies rely on individual goals with explicit ties to the strategy. The best practice relies on goals jointly set by managers and employees. The linkage helps to justify the ratings.

- **Ongoing feedback from managers.** Employees should receive regular feedback on results and their performance throughout the year.

- **Use of competencies, development planning, and assessments of how individuals achieve their results.** The feedback should also focus on the individual's strengths and weaknesses and involve development planning to improve future performance.

- **Ties between financial rewards and performance ratings.** In order to manage the budget for salary increases, managers need to differentiate among their people.

- **"Calibration" meetings for managers to compare and level ratings.** When managers meet to discuss performance ratings, it strengthens the credibility and validity of the ratings and reinforces the perceived importance of the process.

- **Use of e-HR appraisal systems to integrate performance management.** Web-enabled systems facilitate the integration of performance data with performance plans and ratings. Also, e-HR systems make the process more than a year-end event.

(Source: Study by Dr. Edward Lawler and reported in WorldatWork Journal, Vol. 12, No. 2, 2003.)

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distinguish outstanding performance." They further define results as performance that is "measurable, demonstrable or observable, and focus on tangible outputs, outcomes, milestones, or other deliverables."

The SES regulations have established a high standard for defining performance expectations, which may not be feasible for every job, but striving to satisfy that standard would greatly enhance the prospects for success with a new pay-for-performance policy. In many respects, the criteria now used for the SES are state-of-the-art.

The SES regulations highlight what may be an obvious point: Performance appraisals cannot be completely objective. There are to be sure objective measures of performance for many jobs, but any appraisal based only on objective measures would provide an incomplete view of how an employee is performing. That's one reason why even the toughest corporations require assessments on softer

criteria like competencies. One of the decided advantages of a results- or goal-based appraisal is that it focuses on criteria that can be measured or verified. That is a huge advantage. Whenever possible, performance systems should be based on performance plans specific to a position.

The organization needs to identify and develop special policies to manage its star performers and the few whose performance is a problem. Agencies need to take full advantage of the capabilities of their stars. They also need to make certain that poor performers get the support they need to improve or to move to new positions where they can succeed, or are supported in finding new job opportunities. An organization cannot afford to ignore either category.

- **Recommendation 16.** The pay-for-performance policy needs to reward the stars and deny increases for the poor performers. That means the appraisal rating scale has to have at least three levels. Companies rely on rating scales that have three, four, or five rating levels. Five-level scales are the tradition, but managers generally find three-level scales easier to live with. There is somewhat of a trend to shift to three levels.

There are only a limited number of high performers—those individuals whose accomplishments go beyond job expectations. Federal agencies have too many people rated as high performers—that's a given.

Companies sometimes have a similar problem, although seldom to the same degree. Their answer has been the adoption of "forced distribution" policies. That is not a viable alternative in government, but the number or proportion of people rated as above average is going to be a critical issue. Too many, and it diminishes the impact of pay for performance; too few, and it turns people off. This will require discussion at the highest levels, and managers will need to accept the conclusions. This should be addressed in communications. There are no simple answers. But it is important that ratings show consistency across the organization.

It is important to appreciate that the salary-increase policy and the budget for increases will affect ratings. Under the GS system, appraisal ratings are of little consequence, so it's easy for a supervisor to hand out inflated ratings to employees. With pay for performance, in contrast, assuming increases will come out of a fixed-sum budget, supervisors will have to make difficult decisions and limit high ratings. Federal managers are obviously not accustomed to that, and it will be a radical change to the way they approach the appraisal process. It is, however, virtually universal outside of government.

An alternative policy possibility is reflected in the OPM Human Capital Performance Fund idea. If the funds to be used in rewarding high performers are set aside in a separate budget, with informal guidelines on the number of high performers (OPM would limit the awards to 15 percent of the workforce), it will be much easier for managers to make the decisions. They no longer have to deal with the zero-sum dilemma. (See "OPM's Human Capital Performance Fund.")

- **Recommendation 17.** Agencies should consider setting aside the funds to reward high performers in a separate budget. This can be completely independent of the OPM proposal. It can also be done within the constraints of the GS system, making the payments in the form of a QSI or as a lump-sum bonus. The awards would be limited to those employees rated as high performers.

To illustrate the recommendation, a budget as small as 0.5 percent of payroll translates into an added 2.5 percent when awards are limited to 20 percent of the employees. That is a simple but effective basis for resolving the zero-sum problem.

- **Recommendation 18**. Agencies that want to recognize and reward high performers should plan to redesign their performance management system. The dynamics of pay for performance will place more pressure on the performance rating process. There are too many problems, too many bad habits, and too many inappropriate expectations with existing systems.

The GS system also has too much baggage; it cannot at this point be the basis for a new pay philosophy. It should be replaced. The shift to pay for performance is more likely to succeed if it's based on new salary and performance systems.

OPM's Human Capital Performance Fund

In 2003, Congress approved an OPM "Human Capital Performance Fund" to be used for special salary increases to high performers. Congress authorized up to $500 million to be appropriated for this fund. When funded, agencies will be eligible for a pro-rata share (based on payroll) when OPM "certifies" that their performance management system(s) is well designed and they agree to limit awards to 15 percent of the workforce. To date Congress has not agreed to full funding.

The $500 million is roughly 0.5 percent of the federal payroll. The amount does not appear to be adequate, but when it is limited to 15 percent, the average award can be 3.3 percent of salary. For the typical employee with a $50,000 base salary, that is $1,650 ($50,000 x 3.3%). That would be in addition to the normal increase in a pay-for-performance environment. The idea is to differentiate the rewards for high performers; the special award should accomplish that. It should also carry with it the value of recognition.

Research shows that in the typical work group, 15 to 20 percent of the workers are considered to be the stars. The high performers tend to stand out and their co-workers agree on who is in the group. Significantly, the typical "forced distribution" pay-for-performance policy recognizes a similar group of high performers.

One of the problems identified by agencies is that in the second and succeeding years they would be responsible for the increased payroll since there is no commitment to continued funding.

Actually, however, any agency can use this idea to establish a pay-for-performance policy. If the funds for increases to recognize and reward high performers are in a separate budget, it will make it much easier for supervisors to make those decisions. It's no longer a zero-sum game. The amount set aside does not have to be large—0.5 percent is enough—and they can be carved out of the money budgeted for all increases.

However, the performance system is simply the forms for documenting plans and decisions. It really has little to do with effective performance management. It provides the basis for sensitive pay decisions and is essential to defending those decisions. But the success of a pay-for-performance policy rides on the managers and their ability to manage the performance of their people. Agencies need to provide adequate training and support. It would also be advantageous if they are rewarded for their success in managing under the new policy. They need to understand that this is a priority.

All of this will be new in most agencies. Managers will be looking for assistance with both performance management as well as salary-increase decisions. When a federal agency is authorized to replace the GS system with a new performance-based salary system, the focus will shift from salary administration to compensation management.

Planning to Avoid Anticipated Problems

There will be bumps in the road. This is a complex organizational change, the track record is not good, and there are no universal answers in the public sector. People need to be willing to try new ideas. Managers need to develop new skills. Problems are inevitable. The key is that management has to make a commitment to address problems as they arise.

A basic issue is the need to make pay decisions that are defensible. There is no easy answer to this potential problem. It requires the manager's attention to the problem of performance management. Those managers who are conscientious in defining expectations early in the year and providing periodic feedback are far less likely to have problems.

- **Recommendation 19.** Agencies should require managers to justify high and low ratings with a full explanation of what the employee achieved or failed to achieve. Too often, in an attempt to simplify the ratings process and make it more palatable to managers, the documentation is not required. This simple step should influence performance ratings and make it easier to defend them. This should be required under any circumstances for poor performers. According to this recommendation, middle ratings could still be as simple as checking off a few boxes.

- **Recommendation 20.** The idea of relying on calibration committees would also serve to make the ratings more defensible. When managers know a committee will review their ratings, it prompts them to take the process somewhat more seriously. All high and low ratings have to be reviewed by the committee. Employees are also more likely to view the process as credible and trustworthy. The idea has worked well in the Department of Defense demonstrations. It is also a best practice from industry.

Ratings need to be defensible—that's basic. It can be very difficult when the criteria used to assess an employee's performance are overly vague or abstract. This is a primary reason—but by no means the only reason—why it makes sense to rely as much as possible on job-specific or job-family-specific criteria. The criteria also need to be as objective or verifiable as possible. That again argues for job-specific measures. The idea is consistent with the new regulations governing SES performance and pay. It is also consistent with the planned Department of Homeland Security salary system, which is based on broad job families. Redesigning an appraisal system to conform to this argument will take time, but it should be a goal.

Under equal employment opportunity (EEO) law, the appraisal system and the ratings should be validated, which means there is statistical evidence that the ratings are accurate. There have, however, been few court cases on what this means in practice and few companies that have made this investment. It will no doubt be an issue for federal agencies. Experience tells us that the process used to plan the appraisal systems and review ratings is a key consideration. If it's credible, the system is said to have "face" validity, which means people see it as valid. Their perception of the system will affect their willingness to accept ratings. Validity will have to be a consideration going forward. Agencies should be prepared for this.

- **Recommendation 21.** To enhance the system's face validity (as well as its actual validity), managers and employees should be involved in the design process. They naturally understand the jobs and the work better than anyone. They can be surprisingly tough in setting performance standards. That will enhance the system's validity as well as employee understanding.

- **Recommendation 22.** In addition, the HR staff will need to monitor ratings and salary increases. The EEO issues are of course paramount, but it is also important to identify managers who may not be handling their new role effectively. It is essential that the new policy be successful.

Employees will always have the right to appeal ratings and awards; they need to know this recourse is still available. There are reasons many do not trust their supervisors. Some problems are inevitable, but the process used to plan and implement a new policy is critical to its perception by employees. At an early step, agencies should take the time to assess the recent experience with performance management and initiate steps to address problems. Experience shows that a well-planned implementation strategy and a commitment to review ratings and award decisions before they are final will reduce the number of appeals.

Managing Incentive Bonus Awards

The cash award policy should be discussed at the highest levels, and when there is agreement it should be clearly communicated and also reinforced in supervisory training programs. Guidelines should be developed to help managers implement any new policy. Everyone should understand the intent and know what they can expect in their work area.

The discussions should focus on the difference between bonus awards and incentives. With the new emphasis on performance planning and measurement, federal agencies have the basis for planning effective incentives. Incentives are easier to manage and much more effective.

- **Recommendation 23.** Managers and supervisors should be responsible for making bonus awards—they are closest to the work and the accomplishments—but there is a need for guidelines and monitoring. Consistency across the organization is essential. Recipients need to "earn" the awards, or they lose their impact.

- **Recommendation 24.** Agencies should develop adequate record-keeping systems and require written justification for awards. On the one hand, some managers will not take the time if it involves too much work. On the other hand,

if it is too easy, some will abuse the responsibility. Continued credibility should be an overriding concern. Corporations would rarely give their managers the autonomy to make awards without having them substantiate the reasons.

In addition, there is a need for regular reviews of awards to make certain the funds are used as intended.

- **Recommendation 25.** Budgeted funds should be allocated to lower-level managers—not necessarily, however, first-line supervisors. The award money should be allocated pro rata based on salaries so every employee has an opportunity to earn an award. Employees should know their leaders have funds intended for awards.

There is a compelling reason for creating one or more calibration committees to review proposed awards. The nominations have to come from managers, but the overriding need is for consistency and equity. The committees are for quality control. Their involvement also makes the awards and the accomplishments more important.

The size of the awards and the number of award recipients should be considered in light of the funds available. Current award levels in most agencies are low, by any standard, if the goal is to improve performance. The awards in the typical agency currently represent roughly 1 percent of payroll—not a large amount—although the budget in several agencies is much higher. Ideally, the amount budgeted should reflect the reward strategy.

- **Recommendation 26.** The award funds should be budgeted. Awards should not be paid from "leftover money"—that sends a very unfortunate message. If the goal is improved performance, it is advantageous to define the carrot and set aside the funds. When awards are hit-or-miss, they lose their impact. A well-planned and -managed incentive policy would justify the cost by triggering improved performance.

OPM's Performance Fund concept was announced as a salary increase scheme, but it could also meet the requirements of an incentive system. The fund idea is conceptually sound.

It makes sense to consider two or more levels of awards. That recognizes that some accomplishments are more highly valued. However, it is not practical to try to ascribe a specific "value" to each accomplishment. It all depends on the funding and the underlying philosophy—the peanut butter problem means money is often spread very thinly. Awards of $1,000 to $2,500 are more or less the norm in federal agencies.

Larger awards should be limited to very special accomplishments. There are, to be sure, achievements that warrant awards of perhaps $5,000 or $10,000. However, after-the-fact bonus awards are suspect as motivators. There is no reason to believe the impact of a $10,000 award will be twice that of a $5,000 award. The ceremonial setting for the awards and the recognition may be more important than the money. Senior agency officials should be involved in the decisions and any presentation ceremonies.

Group incentives like goal sharing can be powerful incentives, but they take planning and divert money from individual awards. If team or group performance is important, the concept should be evaluated.

Individual awards should be reserved for employees whose performance, however measured, exceeds expectations. Equally important, poor performers should not receive awards. That sends an unfortunate message.

- **Recommendation 27.** Poor performers should not receive awards under any circumstances; it bothers everyone and undermines the credibility of the awards. It also may make it more difficult to terminate an employee. Any evidence that they are contributors can be a problem.

Peer awards—thank-you awards decided by co-workers—are often very popular and contribute to a culture where cooperation and a willingness to help are valued. The amounts are less important than the recognition. These awards can be made as gift certificates to shops or restaurants. Employees can play a role in the planning. The policy will need controls—for example, no more than two awards by an employee.

But all of this depends on funding. Agencies should decide what they want to accomplish and develop

a supportive game plan. It may take a year or two to develop an adequate budget. Employees should know the plan and what to expect. They are usually understanding and willing to wait.

Managing Non-Cash Rewards

Employees may feel award ceremonies are "hokey," but organizations benefit from reasons to bring employees together to highlight accomplishments and discuss performance issues. Even the skeptics enjoy these occasions. They should be encouraged at all levels.

The military services are very good at ceremonial occasions to celebrate accomplishments. Their model is worth emulating.

People like occasions to celebrate success. Even small gatherings for a few minutes can be valued.

- **Recommendation 28.** This is another area where good ideas can be copied. When another agency or an office or region develops an effective awards practice, it should be evaluated and possibly adopted by others. It would also be advantageous to adopt an internal best-practice approach where the goal is to stay abreast of what other agencies are doing.

- **Recommendation 29.** Since cost is not an issue, it makes sense to involve employees heavily in planning the awards and any ceremonies. They tend to take these opportunities very seriously.

Conclusion

Federal agencies will have to overcome barriers of cynicism and distrust among federal employees. There will be bumps and detours, and agencies should expect to adjust their plans with experience. In the end, however, the new policy can be expected to contribute to improved agency performance. Research over the years confirms that organizations benefit when they recognize and reward employee and group performance.

The research also confirms that people respond to reward opportunities. They want to contribute and to realize success. The money is clearly part of it, but people also want to be recognized and valued. When they understand what they are expected to accomplish, the linkage of pay and performance can be a powerful motivator.

The strongest and most vocal resistance at this point is from the unions. Their public statements support the step-increase concept, which effectively guarantees a salary increase to employees. They argue that a number of high-performance employees will not receive an increase. That, however, would be contrary to the experience in other sectors.

Unions have also expressed concern that the budget deficit will necessitate a cutback in funds available for salary increases. That may prove to be true, but it is commonly argued that available funds should be used to satisfy the better performers. Their contribution is vital, and government can ill afford to see them resign for jobs in other sectors where they may be more appreciated. Companies with tight budgets maintain their commitment to pay for per-

formance. The fact that the outlay is variable and not a fixed cost is normally seen as a positive.

The new SES pay and performance regulations have introduced a meaningful pay-for-performance policy at that level. Canada and the United Kingdom have made similar commitments to pay for performance for their senior civil servants. The United Nations common system is also working to implement a pay-for-performance philosophy. This is consistent with a global trend to adopt the U.S. business model.

Pay for performance will have the best chance of succeeding if it is an element of an integrated change strategy focused on improving performance. In that context, it will contribute to the creation of a performance culture.

It will require a commitment by managers to making it work. They need to understand that the change in policy is an organizational priority that has top management's solid support. It will be advantageous for an agency's leaders to be public in their support for the change in policy. The organization in turn will need to invest in the development of the skills needed by managers and in supporting them in the face of criticism.

There is also a need to establish adequate controls. An analysis of experience in the demonstrations shows that the introduction of pay-for-performance policies can result in payroll increases. That is not necessarily a problem if it contributes to improved performance. However, the purpose of salary plan-

ning and budgeting is to make certain that payroll costs are consistent with human capital goals. Salary-increase guidelines also serve that purpose.

There is no single formula to follow. The experience in the DoD laboratory demonstrations is instructive. Each lab has a slightly different way of managing pay and performance, but the evidence shows that each one has had positive experience. A key to success has been the involvement of managers and employees in developing the policies and practices governing pay. That creates an environment with broad support and ownership for the new policy.

In many respects, the performance management system is more important than the pay policy. There are a number of agencies where ratings appear to be inflated. In the past, the ratings were of little consequence and managers long ago found that their role was more palatable if they rated people higher than their work warranted. That has to change. Managers will need to hear from agency leaders that the change is important.

There are at the same time a number of principles that should be considered in planning. Several address issues of fairness and consistency in the management of salaries. Employees need to be confident they will be treated equitably in relation to other employees.

Pay for performance is best seen as a management responsibility. HR generally has the lead in planning and is responsible for the annual analyses to determine needed adjustments, but the day-to-day decisions have to be made by managers. The success of the policy change is in their hands.

The transition will not be easy. This may well prove to be the most difficult change any organization has ever attempted. It needs to be planned and managed as a change initiative. It can be expected to take a year or more until employees become comfortable with the new policy. But federal agencies should expect to be viewed as better places to work in the end.

Appendix I: The IRS Experience— Heightening Performance and Maintaining Accountability

The following is an excerpt from "Modernizing Human Resource Management in the Federal Government: The IRS Model," by James R. Thompson and Hal G. Rainey (IBM Center for The Business of Government, April 2003, pp. 35–39).

Developing Technical as well as Organizational Leaders: the Senior Leadership Service

In modernizing the structure and identifying and defining the roles and responsibilities of different units, it became apparent to IRS leadership that a number of new high-level positions would be required to accommodate the technical demands of modernization, including the modernization of data systems and the move to electronic forms of service delivery. Such a requirement usually would be addressed by seeking an increase in the allocation of SES slots from OPM. However, many of the new positions are technical and professional rather than executive in nature and, hence, are not technically "executive" level.

Rather than redefining the positions by adding supervisory and executive responsibilities, the IRS employed the "streamlined" demonstration project authority included in RRA '98 to create a separate category of senior executive position to be called "senior professional."[30] Both senior professional and senior executive positions will be combined in a new Senior Leadership Service. Positions with significant line management leadership responsibilities will be designated "senior executive," whereas executive positions with technical and professional leadership responsibilities would be designated as "senior professional." Most of those in senior professional positions will be in mission-support functions, such as IT, HR, research and analysis, and financial management. Pay levels for the two sets of positions will be comparable.

Creating a "dual track" in this way will allow senior professionals to receive the compensation they deserve without creating a management structure around them. This helps hold down costs by avoiding the creation of unnecessary management layers. The Senior Professional Corps also will allow staffing and compensation flexibility and will provide a means of rewarding superior technical and professional expertise without imposing managerial leadership responsibilities. The IRS anticipates that the new structure will facilitate recruitment of senior technical leaders. Pay will be more closely tied to performance to facilitate the retention of high performers and the departure of poor performers.[31] The separate classifications also will serve to reinforce the original intent of Senior Executives as a corps of mobile, executive leaders. Under the demonstration project authority, the project has a life of five years, after which it will be reviewed and a determination made as to its future.

Linking Pay to Performance through Paybanding

The RRA '98 authorized the IRS to implement a paybanding system. Paybanding allows managers much greater flexibility in classification and pay decisions than does the traditional General Schedule (GS)—flexibility that can be utilized to reward and, hence, motivate high levels of performance. The system further creates direct linkages between pay, individual performance, and organizational performance and, hence, keeps employees focused on the agency's strategic objectives.

Figure 7: Senior Manager Compensation Plan (2003)

Senior Manager Payband	SM-1 $72,381	SM-2 $75,879		SM-3 $79,545	SM-4 $83,389		SM-5 $87,419		SM-6 $91,643		
G-15/step						15/1 $85,140	15/2 $87,978	15/3 $90,816		15/4 $93,654	
G-14/step	14/1 $72,381	14/2 $74,794	14/3 $77,207	14/4 $79,620	14/5 $82,033	14/6 $84,446	14/7 $86,859	14/8 $89,272	14/9 $91,685	14/10 $94,098	

Special Assistant for Compensation Strategy Chuck Grimes describes a design process involving a best practices study by the Hay group, gathering ideas about what people wanted in the pay system from monthly meetings of a Performance Management Executive Council, and focus groups of managers. Senior managers described in focus groups what they did not like about the pay system and repeatedly expressed what Grimes describes as "a fairly universal feeling": the managers felt that the excellent performers did not receive better pay increases than those who were "barely breathing." The Performance Management Executive Council also strongly endorsed the principle of rewarding better performance with better pay. At the time, there were provisions for quality step increases and bonuses, but these offered very limited rewards. There also was a strong emphasis on spreading the reward money around evenly. The OSHR team sought to design a system that would remedy this situation.

As shown in Figure 7, the IRS's new senior manager pay band consolidates two general schedule salary grades (GS-14 and GS-15) into one. The principles on which the new system is based include the following:

- Higher levels of performance will result in higher pay. Managers progress from step to step within the band only if their rating under the PMS meets or exceeds certain standards.

- The higher the pay, the higher the performance expectations. The standard for moving up a step within the band increases the higher up a manager is. A manager can move from step 1 to step 2 with two "met" expectations ratings over a two-year salary review period but can move from step 9 to step 10 only with a combination of "exceeded" and "outstanding" performance ratings over two years. Increasing the performance "bar" in this way will ensure that only outstanding managers advance to the top of the pay band.

- Longevity no longer matters in managerial compensation. The rules that govern the senior manager pay band contrast with the traditional approach, in which step increases were based primarily on longevity.

Traditionally, a disproportionate number of managers have been rated in one of the top two ratings categories, making the distinctions and the associated awards less meaningful. To address this problem, the IRS has provided each division with a "point budget" with four points awarded for each senior manager. For an "outstanding" rating, the division must spend six points of its budget. An "exceeded expectations" rating costs four points, and a "met expectations" rating costs two points. This system places restraints on the number of high performance ratings that can be awarded.

Barnett comments:

> It's still a cultural change. The reality in the IRS has been that if a manager got a 'met' appraisal, there was probably something lacking in the performance. The new reality is that a 'met' means a manager is doing everything expected—that is still a big cultural change. We're trying to enforce the new standard in W&I, but there is still some resistance.

SM-7 $97,071		SM-8 $100,713	SM-9 $105,580		SM-10 $110,682
15/5 $96,492	15/6 $99,330	15/7 $102,168	15/8 $105,006	15/9 $107,844	15/10 $110,682

Each division now has a Performance Review Board (PRB) made up of executives and senior managers to actively manage and monitor the pay-banding system. The PRBs review the performance ratings to ensure consistent application across the divisions, evaluate the ratings against the performance of the organizational unit, compare the ratings to the overall point budget, and forward reports to the commissioner of the division. Each commissioner, in turn, reviews and approves the PRB report. As necessary, the commissioner can reallocate points within the division, and request

additional points from the deputy commissioner of the IRS, who can allocate additional points as warranted.

To enhance the effectiveness of the system, the IRS has made pay differentials more meaningful. "In 2002, outstanding managers could receive as much as $4,900 in bonuses, compared with only $2,400 in 2001.

In 2001, the payband structure used for senior managers was extended to managers in IRS service centers and call centers. Salary grades GS-11, GS-12, and GS-13 have been consolidated into a single 16-step department manager payband. The requirements for progressing to a higher step within the band are similar to those for senior managers.

The pay and classification flexibility afforded by the senior and department manager paybands expedited the reduction in management layers that accompanied the organizational restructuring. Approximately 400 mid- and top-level management positions were eliminated in the process of collapsing management layers by half. Managers

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IRS Senior Manager (SM) Payband Performance Awards

- Based on the SM's annual performance rating—payout expressed in terms of "shares"

- Award pool is established at 2% of aggregate SM salaries, divided into performance bonus (90%) and special act (10%) pools

- Share value is determined by dividing the SM performance bonus pool by 4 shares per SM

  – Example: SM bonus pool is $2.7M for 1,500 SM (6,000 shares)

  – $2.7M divided by 6,000 = $450 per share (this share value applies servicewide)

- Performance bonus and special act pools are allocated to business units on a pro-rata salary basis—the pool funds are fungible for a given payband

- Once the business unit has allocated minimum bonus shares for Outstanding ratings, the business unit can allocate remaining funds as it sees fit

- See chart below—using $450 per share, a Level IV SM with an Outstanding rating would receive a minimum bonus of 8 shares at $450 per share or $3,600

Performance Bonus Share Minimums by Rating, SM Level				
Rating	Level I (Steps 1–2)	Level II (Steps 3–6)	Level III (Steps 7–8)	Level IV (Steps 9–10)
Outstanding	6 shares	6 shares	7 shares	8 shares
Exceeded	Optional—must be less than for Outstanding			
Met	No Bonus (Exceptions by Division Commissioner)			

who had previously been segregated into separate GS-14 and GS-15 grades were placed into a single senior manager band, thereby eliminating hierarchical distinctions and permitting the agency greater flexibility in making assignments. Any manager in the senior manager band could be appointed to any senior manager position. A similar dynamic prevailed with regard to the department manager payband. As a result of the reduction in management positions, the IRS was able to fund additional frontline positions and thereby improve service to taxpayers.

In June 2002, the Hay Group completed an evaluation of the senior manager paybanding system.[32] The evaluation concluded that the new system does link compensation to performance, eliminates longevity-based increases in base pay, and supports the concept of equity by recognizing and rewarding high performance with biennial step increases and performance bonuses. The evaluation further concluded that the system provides better rewards than the GS system to those who meet or exceed their performance rating requirements. In addition, the new system assisted the Service's realignment from a geographically based structure to a business-based architecture and was cost neutral.

According to the Hay Group, senior managers have expressed some concerns about the new system, such as the concern that the higher requirements as one moves up the steps actually put the better performers at a disadvantage as they move up, compared with those at lower levels. The Hay Group evaluation also noted that it is too early to conclude that base pay increases and performance bonuses are linked to organizational performance.

It is a lot to ask that a new paybanding system, involving dramatic changes from the previous system, display immediate and striking success. The IRS paybanding system, clearly a very innovative one, has met some of its preliminary objectives and will require further evaluation in the long run.

Distinguishing Levels of Performance through the Performance Management System

The value of the new paybanding system is heavily contingent on the effectiveness of the IRS's new PMS, which provides a means of assessing individual performance. Consistent with the practice of leading private sector firms, the PMS is designed to "create a line of sight between the contributions of individual employees and the organization's performance and results."[33] Under this system, a manager's pay is increased in direct proportion to the contribution he or she makes to the achievement of organizational objectives. To ensure that pay decisions are based on a credible and accepted performance appraisal process, the implementation of paybanding was delayed a year pending development and implementation of the PMS.

Under the PMS, the performance of IRS executives and managers is appraised along two dimensions. "Responsibilities" correspond to the organization's core values and performance measures in the areas of employee satisfaction, customer satisfaction, business results, leadership, and equal employment opportunity. These link to the LCM and serve as the basis for assessing ongoing, day-to-day behaviors. In addition, executives and managers identify personal performance "commitments," which link directly to the business objectives of each unit and acknowledge individual accomplishments that promote those objectives. In essence, responsibilities relate to how the job is done on a day-to-day basis, and commitments pertain to what is done—often expressed in terms of specific projects or objectives. Under the new senior manager and department manager paybands, managers and executives are eligible for rewards exclusively on the basis of performance management outcomes.

Barnett said about the PMS and paybanding:

> What it is doing for us, I believe, is enabling us to drive to real pay for performance. I know in Wage and Investment we are actually looking at our ability to reward the people who perform all of the balanced

measures to the highest degree. This means we're very seriously looking at how they performed in business results and customer satisfaction and employee satisfaction. Because of the payband structure, we look across the functions at our senior managers as a group, and I think that's very healthy.

Managers attempting to implement the PMS have to contend with provisions of RRA '98 that prohibit the use of "tax enforcement results" to evaluate employees.[34] That provision of the law was a direct consequence of findings during the 1997–1998 Senate Finance Committee hearings that revealed that numerical quotas imposed in some IRS offices had contributed to the abuse of taxpayers by revenue officers. The IRS has interpreted the law as prohibiting all use of numerical measures for evaluation purposes. As a result, managers' "commitments" must be expressed in terms of actions rather than results. One manager commented:

We're trying to get away from numbers. And we're all learning how to evaluate people without absolute numbers. Sometimes in the attempt not to use numbers we get a little too general, I think. And I find my managers constantly saying, "What do they want?" "What do they want us to say?" It's been a learning process.

In partnership with the NTEU, the IRS has rewritten the performance standards for all nonmanagement employees. Frontline employees are being appraised according to new "critical job elements" (CJEs), which have been rewritten to reflect the strategic goals set forth in the new Balanced Management System. Previously, the principle focus was on "business results." Now, of the five categories of CJEs, two correspond to the "customer satisfaction" goal, two to the "business results" goal, and one to the "employee satisfaction" goal. The employee satisfaction goal states that "the employee supports the workplace climate where ethical performance is paramount and everyone is treated with honesty, dignity, and respect, free from harassment and discrimination."[35] Any employee not meeting this or the other CJE standards can be dismissed.

Appendix II: Pay and Employee Motivation—An Overview of the Theories

Why do some people work hard and others do not? The answer is neither simple nor completely understood. The most frequently discussed theory of motivation is Abraham Maslow's hierarchy of needs. He argued that people are driven by several needs, starting with basic physiological and safety needs. In today's world the focus is on the top of his scale: the need for esteem (self-respect, achievement, recognition, status) and for self-actualization (the development of individual abilities). Those themes are now dominant, so his theory is still credible after half a century.

Maslow's conclusions about the importance of achievement and recognition are consistent with those of Frederick Herzberg. They are important to job satisfaction.

Significantly, Maslow never mentions pay, although income is related to several of the needs. Among public employees, there is a wealth of anecdotal evidence that pay is not or was not a high priority when people chose their careers. Their views may change over their career as family obligations make income a more important issue. There is also evidence that media reports of income levels in other fields feed concerns about pay levels in government. However, if there was a government-wide survey looking at the reasons people work in government, it would undoubtedly show that pay is not the primary motivation.

In our society, pay—or actually income—is related to one's status. It is also related for some people to feelings of self-respect and personal success. Very few people feel they are paid too much or, for that matter, that they are paid enough. Regardless of philosophy, pay matters and it affects the way we view each other.

There are actually two components to understanding pay and its impact on employee motivation. The distinctions are subtle but important to dealing with pay issues.

- First, there is the relative salary level. Salaries are always relative. We all use other people and other occupations as a point of comparison. Not surprisingly, people tend to think their particular job and they as individuals should be paid higher salaries.

- A second, separate issue is the annual salary increase. Again, increases are relative and best evaluated in relation to the increases granted to other people. In a pay-for-performance environment, the salary increase is both a reward and a recognition of individual contribution. Bonus awards are similar in that they are intended to recognize the individual or work team.

The two components are naturally related—both can trigger feelings of inequity—but people react to them in different ways. People with very high salaries can become very angry if their increase is small. It's also true that individuals with low salaries can be very pleased with large increases.

The goal of a pay-for-performance policy, of course, is to recognize and reward employees and thus to enhance their motivation. There are several theories of motivation that focus on the management

of salary increases. Salary levels are likewise an employee concern, but generally seen as unrelated to motivation.

It may be, as the critics argue, that salary increases are not an effective way to recognize an employee's contribution. But under the General Schedule, with early promotions that are virtually automatic and step increases that are an entitlement, there is often no formal recognition and minimal sense of reward. Supervisors who want to recognize an employee are largely on their own and may not do this effectively.

As government agencies shift to a pay-for-performance philosophy, managers will need to shift their thinking and develop an adequate understanding of how to manage rewards. Fortunately, people use the basic tenets of reward theory every day. We consciously reward our children as well as our pets when they behave in ways that please us, and many use rewards in the broadest sense to influence the behavior of other people. The same thinking is reflected in the "standard textbook" for supervising employees.

It may well be true that every adult has at least a superficial understanding of the role of rewards and the importance of reinforcing desired behaviors. These concepts are covered in basic psychology courses as well as in academic majors as diverse as teaching and law enforcement. Names like Pavlov and B. F. Skinner are ones that many who have studied psychology would associate with these ideas.

But this is not the same as training animals. Skinner's operant conditioning methods would never work in an organization setting, and it is a mistake to think employee behavior can be controlled in that manner.

Four theories are relevant to rewards that affect performance and compensation management. Significantly, they are not completely consistent and can lead to different conclusions about how to manage rewards. The generally used principles of reward management have solid ties to these theories.

Equity theory provides the basis for most traditional pay systems. Employees provide their labor in exchange for a variety of returns, including cash compensation. The argument is that they tend to compare their return-to-input ratio with what they perceive the ratios of others to be. In other words, they want their compensation to reflect their efforts. The theory explains the focus on internal equity in salary management. It also serves to explain employee reactions and behaviors when they think they are underpaid or were not rewarded adequately for their contribution. Under this theory, when employees are convinced the rewards for their work efforts are inadequate, they will reduce their efforts.

Equity theory assumes employees regularly assess the fairness of the rewards and base their work efforts on that assessment.

Expectancy theory recognizes that employees have choices. If they have reason to expect their behavior will be rewarded (with rewards that they value and are seen as adequate), they are likely to put forth the work effort. If the rewards are missing or inadequate—or if they have other uses of their time or energy with greater rewards—they will not put forth the effort.

That explains, for example, an employee's reluctance to work late or on weekends. For an employer, it means that the rules for earning rewards should be explicit and the employer should consistently follow the rules. Employees are assumed to make rational decisions regarding their work efforts and base their decisions on their expectations.

Reinforcement theory emphasizes the importance of reinforcing desired behavior. The theory argues for linking consequences with desired results or behaviors (as well as with the failure to demonstrate those behaviors). The theory argues for granting the reward as close to the results as possible. Actually, the theory would argue that a variable reward schedule is better for maximizing performance— that is to say, not granting a reward every time an employee does something, which is much more practical and realistic under any circumstances.

Reinforcement theory has its origins in experiments with animals and in artificial research settings. For that reason, it is important to keep in mind the differences when the theory is applied to the reality of the employer-employee relationship. Salary increases, for example, are typically granted once a year. It is also important to keep in mind that the rewards in the experiments rarely involved cash payments.

Goal-setting theory is the basis for management-by-objectives (MBO). It relates to performance rather than compensation management, but is involved in virtually all pay-for-performance policies. Experience confirms that employees working with high, specific, and self-accepted goals will perform better than employees with no goals, ones that are not accepted, or simple "do your best" statements. It is not essential for the goals to be set with employee input as long as they are accepted by employees as fair and reasonable. Significantly, the motivation from goal setting is the intrinsic satisfaction that comes from striving to reach and exceed them.

When employees fail to attain their goals, they will be motivated to set more readily achieved goals. The ongoing adoption of goals that prove to be unattainable can adversely affect employee motivation. Goals that prove to be out of reach can have a long-term adverse impact on employees. They have to be within reach to be a source of motivation.

The goal-setting theory helps to explain the high performance of work teams. When true teams are formed and understand the goals, a shared commitment often emerges and team members tacitly agree to work together to achieve the goals. The desire to support the team becomes a powerful motivator.
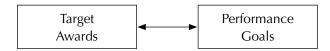
Conclusion

These theories are useful only if they provide an answer for the bottom-line question: Can we use pay to motivate employees? The answer is an unqualified "yes." When pay systems are designed in accord with organizational values, and everyone shares a solid understanding of the goals and principles and has consistent expectations, the evidence from industry confirms that the prospect of financial rewards—salary increases and/or bonus awards—can be an effective incentive. The

expectations created become part of what is often referred by psychologists as the "psychological contract" with employees. Practices that are contrary to employee expectations can undermine the impact and actually create problems. That is the point of the critics. When a reward system is managed conscientiously, it will help to create a culture that supports high performance. This change in policy should benefit government agencies.

Appendix III: Linking Year-End Incentive Awards to Performance— An Overview of Corporate Concepts

Executive incentives in the business world are based on a straightforward model that can be developed for any organization or any work group that has shared performance goals. Over the past 20 years or so, industry has moved from simple profit-sharing schemes to more complex plans based on balanced scorecard concepts. The basic model is reflected in most executive and management incentive plans—that is to say, awards are based on performance relative to goals. The model is reflected in the regulations that now govern Senior Executive Service compensation.

The planning process involves two separate considerations that can be understood as the two sides of an equation. One side is the planned cash payouts. The basis for planning the payouts is the so-called target or guideline award, expressed as a percentage of salary. The target award is the payout a participant can expect for achieving performance goals. Generally, cash awards increase at higher organization levels. To illustrate, at a base salary level of $100,000, the typical target award might be 20–25 percent of pay. At a $50,000 salary, the target might be 10 percent, or $5,000.

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┌─────────────┐           ┌─────────────┐
│   Target    │ ◄───────► │ Performance │
│   Awards    │           │    Goals    │
└─────────────┘           └─────────────┘
```

Actual awards go up and down around the target payouts. If performance exceeds the planned level, the payouts would be above the target levels. When actual performance fails to reach the planned levels, awards are less than the target amounts.

It is important to appreciate that incentives in industry are integrated with base salaries to create a cash compensation program. If competitive or market pay levels suggest an individual should have an opportunity to earn $100,000, the target award level leads to the base salary as follows. If the target is 20 percent, the base salary should be $83,333 ($100,000/1.2). If the target is 25 percent, the base salary should be $80,000. With the latter, the potential awards are larger, but that is balanced with more risk and lower salaries. That reflects the company's risk-reward philosophy.

On the other side of the equation is the set of performance measures. Typically, performance revolves around a set of performance goals, with the balanced scorecard now as a common platform. The scorecard concept, of course, is conceptually related to the management-by-objectives (MBO) idea that has been used in industry for over 40 years.

One of the standard MBO arguments is that the number of objectives or goals should be limited to no more than six. That contrasts with some of the performance measurement initiatives in federal agencies where long lists of measures are often generated. The MBO logic, which also carries over to the scorecard concept, is that the focus needs to be on the most important goals. When there are too many goals or measures, it diminishes an individual's ability to concentrate on the most important issues. To use an old descriptive image, there are "too many balls in the air."

For award calculation purposes, it is a common practice to define a threshold level of performance, which is the minimum level of performance associated with minimum cash awards. The typical threshold is set at 80 or 90 percent of the performance goal. At that performance level, the cash payout might be half of the target award. In other words, if the target award is $5,000, the threshold level award would be $2,500. When performance fails to reach the threshold, no awards are paid.

Awards increase from the threshold as performance improves, usually in a mathematical progression. At 90 percent of goal, the payout might be $3,750. At 95 percent, the payout might be $4,375.

Corporations typically recognize performance that exceeds the goals with increased payouts. Using the same example, when performance reaches 120 percent of the goal, the payout might be $7,500. There is typically a ceiling on payouts at some level of performance. That effectively defines the range of expected performance and the payouts associated with performance.

All goals are not suited to measurement scales, but it is normally possible to define a basis for assessing performance. Some involve yes/no criteria—"We met the schedule." Some may involve a consensus judgment—"The new hires met our standards." Some require a combination of measures. It is important to develop a consensus on how performance will be measured.

With multiple goals, it is common to weight them to reflect their importance. Of course, the total has to equal 100 percent. The weights, then, are the basis for developing a combined performance score as illustrated below:

An important issue is the consistency this introduces both across an organization and over time. It also makes it possible for a plan participant to estimate his or her incentive award at any time during the year. Using the example, the 102 percent results in a payoff of $5,100.

This basic model makes it possible to develop a basis for determining cash awards at any level from executive plans to the group incentives covering factory workers. The target award percentages decrease for lower-level jobs, but the concept is still relevant. Goal setting and performance against goals is also relevant. Goal-sharing incentive plans can be developed for any group of workers using these ideas.

At the executive level, it is common to base awards on a combination of organization and individual goals. For example, a chief financial officer's payout might be based 50 percent on organization performance and 50 percent on the achievement of functional goals. At the next level, the split might be 25 percent/75 percent, with greater weight on individual performance. These are arbitrary decisions, but the logic is generally accepted.

When organization results are linked to awards, it means every plan participant stands to earn at least a portion of their award, which is typical in corporations. That reinforces a team philosophy.

The same logic can also be used to bring together goal achievements and performance ratings. GE is often credited with the phrase "the what and the how," where the "what" is the goal results and the "how" is a rating on competencies. That company decided that it is not a good idea to reward executives strictly for short-term results. The long-term health of the organization depends on how execu-

Performance Goal	Percent of Goal	Goal Weight	Percent Contributing to Weighted Performance
Goal A	80%	15%	12.0%
Goal B	120%	25%	30.0%
Goal C	90%	40%	36.0%
Goal D	110%	10%	11.0%
Goal E	125%	10%	12.5%
Weighted Performance			101.5%

tives handle their jobs, so evaluations combine the two views of performance.

Every corporate incentive plan is not the same, but these concepts are reflected in many plans. It is important in that sector, as it is in government, to gain a consensus on how performance is going to be measured and how results are to impact cash awards. There is room for discretion—CEOs, for example, often want to control final awards—but the basic model provides for certainty over time.

The same basic "equation" model is used with gain- or goal-sharing group incentives, profit-sharing incentives, sales commissions, and indi-vidual "piece rate" incentives. In each case, the linkage between awards and performance is based on what is best understood as a formula.

It would be extremely rare in the private sector at any level to rely wholly on subjective, after-the-fact decisions. The exception is the so-called "spot awards," which tend to be smaller amounts. The argument is that well-designed incentive systems are much more powerful motivators than subjective awards. To borrow the old donkey-and-carrot illus-tration, incentives define the carrot.

Endnotes

1.   The non-Title 5 pay plans include Transportation Security Administration baggage screeners, Federal Aviation Administration air traffic controllers, State Department Foreign Service personnel, Veterans Affairs nurses and doctors, and teachers in Defense and Interior. In total, these systems account for 140,000 employees. The FIRREA (Federal Institutions Reform, Recovery and Enforcement Act) agencies have special authority and account for another 9,000 employees. The total work-force paid under the GS system is roughly five times larger. The intelligence agencies also have special author-ity, but do not report employment to OPM.

2.   The phrase "merit pay" was long used to refer to salary increases based on individual performance rat-ings. In the past few years, it has been replaced in some discussions by other phrases, most frequently "pay for performance."

3.   *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise, and Other Bribes* (Houghton Mifflin, 1993).

4.   Pfeffer discussed his views in two books, *Competitive Advantage Through People* (Harvard Business School Press, 1994) and *The Human Equation: Building Profits by Putting People First* (Harvard Business School Press, 1998).

5.   The Government Accountability Office has published a number of excellent reports that discuss issues related to a performance culture.

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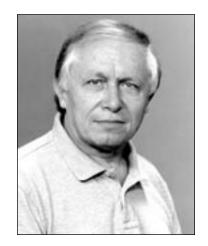National Academy of Public Administration, *Recommending Performance-Based Federal Pay* (2004).

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A B O U T   T H E   A U T H O R

Howard Risher is a consultant to numerous organizations, including the National Academy of Public Administration (NAPA), where he has worked on studies related to employee compensation and performance in the federal government. He was a member of the project team for the recently released report *Recommending Performance-Based Federal Pay*. He previously was a member of the NAPA teams that prepared reports on the Senior Executive Service and on a new personnel system for federal IT specialists.

He has been responsible for consulting studies for several federal and state agencies, including the 1990 study for OPM that led to the Federal Employees Pay Comparability Act and the locality pay system. He has also consulted with the United Nations on pay and performance issues.

Previously in his career, Dr. Risher worked as the compensation practice leader for two national consulting companies. He has also served as a Senior Fellow in the Wharton School's Center for Human Resources. Early in his career he worked as a compensation director for a large diversified corporation. His experience includes years of experience as a consultant to the private sector as well as to higher education.

He has published over 30 articles on pay and performance and has developed three books. His most recent book is *Aligning Pay and Results* (New York, AMACOM Books).

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