Can Pay for Performance Succeed in Government?

by
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Pay-for-performance programs have become increasingly popular in recent years. The federal government introduced a merit pay system for managers under the Civil Service Reform Act of 1978. The failure of the system led to its reform in 1984. The current program, the Performance Management and Recognition System (PMRS), is described and assessed. The paper offers a prognosis for PMRS’s future. Other public sector experience is reviewed to identify the probable success of managerial merit pay.

Pay-for-performance policies have enjoyed increasing acceptance in the public sector, primarily as tools for promoting better productivity (Perry and Porter, 1982). One of the most prominent recent pay-for-performance programs was initiated by the federal government under the Civil Service Reform Act of 1978 (CSRA). The merit pay provisions of the 1978 reforms were hailed as means for bringing responsiveness and efficiency back to the federal sector. Merit pay proved instead to be ineffective and demoralizing. Among its shortcomings were inadequate funding for merit pay pools, pay inequities between managers and non-managers, and low validity of performance appraisal ratings (Pearce and Perry, 1983; Perry, Hanzlik and Pearce, 1982; Perry, 1986; United States General Accounting Office, 1984).

Congress sought to remedy these problems in 1984 by creating a second generation merit pay system, the Performance Management and Recognition System (PMRS), which covers managerial employees at grades 13–15. In January 1987, the General Accounting Office (GAO) issued a report entitled Pay for Performance, which reviewed the first year of implementation of PMRS. Although GAO declined to judge whether PMRS would ultimately succeed, the report indicated that PMRS was not without problems. Has the new system been able to overcome the limitations of its predecessor? This paper reviews the history, design and experience with PMRS in an

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effort to answer this question. We discuss problems that have arisen in PMRS implementation and what they suggest about problems with managerial pay-for-performance systems in the public sector generally.

**HISTORY OF PMRS**

Although the CSRA merit pay system did not take effect for most federal managers until 1981, it very quickly became the source of large-scale dissatisfaction (Perry and Pearce, 1983). Managers who performed satisfactorily but were exposed to the greater financial risks and opportunities of merit pay often found themselves achieving lesser rewards than their non-managerial counterparts. An OPM-GAO dispute about the statutorily permissible size of payouts led, in September 1981, one month before payouts, to a comptroller general determination that the OPM formula for calculation of merit pay did not conform with CSRA. The ruling resulted in modified payouts which provided only small differentials between managers, again undercutting the pay-for-performance principle. Congresswoman Mary Rose Oakar summed up the ground swell of congressional and employee opinion in early 1984: “What was designed as an incentive pay system has in fact become a disincentive millstone on the back of the Federal Government” (U.S. Congress, House of Representatives, 1984, p. 2).

Relief from the CSRA merit pay program grew from bills introduced in 1984 by Senators Tribble and Warner and Representative Wolf, which proposed a Performance Management and Recognition System (PMRS). PMRS was enacted on November 8, 1984. The congressional mood was so overwhelmingly in favor of reform that it was made retroactive to October 1, 1984. Although passage of PMRS brought immediate relief from many of the merit pay system’s shortcomings, retroactive implementation created new administrative problems.

GAO’s recent (1987) review of the first year of PMRS in five agencies (Federal Aviation Administration, Internal Revenue Service, Bureau of Land Management, Bureau of Reclamation, and Office of Personnel Management) identified three general problems that arose from retroactive implementation:

- **Lack of preparation contributed to agency administrative difficulties**
  Agencies had no lead time during which they could communicate with employees and train them in the new system. Retroactive implementation also assured that employees received performance awards many months after the end of the performance period.

- **OPM regulations and guidance were not timely**
  Although OPM issued guidance to agencies on October 12, 1984, it did not issue interim regulations until March 25, 1985 and final regulations until August 30, 1985. The GAO report provides many other examples of untimely or unclear guidance.

- **Regulations varied from the law**
  OPM’s original guidance mandated that all employees above the satisfactory level receive a performance award. The statutory language mandated awards only for
outstanding performers. OPM changed the requirement in its interim regulations to conform with the statutory language.

DESIGN OF PMRS

The design of PMRS developed from inequities and problems associated with the 1978 Civil Service Reform Act (CSRA) merit pay system. The drafters of the PMRS legislation sought to retain pay-for-performance principles, but to eliminate the dysfunctions of the original system. Thus, PMRS resembles the merit pay system in some important ways, but differs from it in others, as reflected in the comparisons in Table I.

Under PMRS, employees rated fully successful or better are assured of receiving the full annual comparability adjustment and all or part of the equivalent within-grade increases. In addition to these monies, employees rated above fully successful are also eligible for performance awards or bonuses, which are additions to base pay. Beginning in fiscal year 1986, performance awards of 2 percent are mandatory for employees rated two levels above fully successful. However, agencies may not exceed 1.5% of payroll for all awards.

The creation of Performance Standards Review Boards also represents a departure from the previous system. These boards, modeled after the Executive Review Boards in the Senior Executive Service, are intended to review performance standards within an agency to assure their validity and to perform other oversight functions. At least half of the board is to be made up of merit pay employees.

The re-titling of the system from “merit pay” to “performance management” reflects a dual recognition that: (1) improved performance, a complex outcome affected by a wide array of positive and negative reinforcements, is the ultimate goal of the system; and (2) pay, goal setting and feedback are equally important tools for influencing managerial behavior. Despite the symbolic effort to re-focus managerial attention on the broader concept of performance management rather than pay-setting, a legitimate question can be raised about whether the new system departs sufficiently from its predecessor to achieve this goal. For instance, PMRS still requires that appraisal ratings be used to administer pay systems (Meyer, Kay and French, 1965). Thus, the symbolic effort to re-focus on performance may not overcome the behavioral tendencies inherent in the old system.

PROGNOSIS FOR PMRS

What are the probable results stemming from federal merit pay reforms? GAO’s recent report on PMRS, our own research in the federal sector, and the research of others provides some indication whether the pitfalls of the original system have been avoided the second time around and if pay-for-performance is now working.

It appears, quite predictably, that PMRS is viewed by many federal employees and managers as a welcomed improvement over the merit pay system. There are a variety of reasons for this conclusion. First, PMRS provides a net increase in payouts to
**TABLE I**

Comparison Between CSRA Merit Pay System and PMRS

<table>
<thead>
<tr>
<th>Purpose</th>
<th>To link pay to performance for Grade 13-15 managers</th>
<th>To continue pay-for-performance but eliminate inequities</th>
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</thead>
<tbody>
<tr>
<td>Employee Performance Rating Levels</td>
<td>Five level rating system</td>
<td>Five level rating system: two below fully successful; fully successful; and two above full successful.</td>
</tr>
<tr>
<td>Performance Appraisal System</td>
<td>OPM required to issue regulations requiring agencies to set up a performance appraisal system with: 1) five rating levels; 2) critical elements and performance standards; 3) employee-supervisor communication before each appraisal period; 4) reduction in grade, removal or reassignment of consistently unsuccessful employees.</td>
<td>SAME</td>
</tr>
<tr>
<td>Basis of Appraisal</td>
<td>Individual performance, improvements in productivity, quality of work, reduction in paperwork, timeliness of performance.</td>
<td>SAME</td>
</tr>
<tr>
<td>Merit Pay Formula</td>
<td>Agencies devised their own formulas for computing merit pay increases.</td>
<td>The amount of merit increases are prescribed and are based on the employee’s performance rating and position in the salary range.</td>
</tr>
<tr>
<td>Award for Two Levels Above Fully Successful</td>
<td>Determined by agency formula, but could vary by the distribution and number of employees in pay pools.</td>
<td>Annual adjustment, merit increase and 2% performance award. Agency limited to 1.5% of payroll for all awards.</td>
</tr>
<tr>
<td>Budgetary Support</td>
<td>Merit pay increases were funded by monies from 1/2 comparability increase and monies which would have been used for within-grade and quality step increases.</td>
<td>New monies are prescribed for payment of performance bonuses.</td>
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dected employees. Although employees remain skeptical about the new system, loosening the purse strings lessens the harm of system inequities and is one way to win back employee trust. Second, PMRS returns to some of the predictability and sim-
TABLE I

Continued

| ENTITLEMENT TO COMPARABILITY | Fully successful performers were not assured full comparability adjustment. |
| ADJUSTMENT DISTRIBUTION OF RATINGS MERIT PAY POOLS | Forced distributions are prohibited. Employees were placed in pools for control purposes. |
| REVIEW BOARDS | None. Appeals determined by OPM regulation. |
| | Fully successful employees receive the equivalent of comparability adjustment. |
| | SAME |
| | Amount of merit pay increases are specified by law. However agencies can still use pools to grant performance awards. Performance Standards Review Boards established to oversee issues related to performance standards and appeal of reviews. |

plicity inherent in the pre-1978 system by assuring that covered employees will be no worse off than their general schedule counterparts. Third, many employee representatives played a role in shaping the reforms and, therefore, have a greater commitment to them than the original system. Fourth, in theory, the Performance Standards Review Boards build in protection against abuses and promote quality control. It is still too early to determine what influence they have had. Fifth, PMRS was approved for a fixed, five-year span. This assures that if it has flaws, they can be remedied as part of the re-authorization process.

Arguing that PMRS improves upon the merit pay system is not tantamount to an endorsement of PMRS. The merit pay system was so universally despised that any change—even random change—would probably be viewed with favor. Although PMRS is an improvement, it still contains some serious flaws. One of the most significant is the requirement that individuals rated two levels above fully successful receive mandatory 2% bonuses, but the budget for bonuses is limited to 1.5% of payroll. The 2% mandatory bonus removes considerable discretion from agencies about how awards will be distributed. It also creates pressures within agencies to influence ratings distributions (GAO, 1987). In its recent study, GAO found that 35% of surveyed employees were convinced that ratings were forced to conform to a distribution dictated by top management. There is an inherent contradiction between policies that, on one hand, require accurate, objective appraisals and, on the other, manage ratings to control budget outlays. In fact, the manipulation of ratings undercuts the validity of the performance appraisal system, making it more difficult in future review periods to get employees to respond to pay incentives.

Despite this design flaw, PMRS is still too new for any definitive judgment to be made about its likely effectiveness. Unfortunately, most evaluations of pay-for-performance programs, including the recent GAO review of PMRS, have failed to address...
the central issue: Do they improve performance? There are many issues that need to be investigated by GAO and other evaluators to get a better sense of the motivational effects of PMRS and its consequences for employee performance.

BONUSES

PMRS sought to retain pay-for-performance principles. One of the primary vehicles for rewarding high performance is the provision for minimum awards of 2% for managers rated two levels above fully successful. The theoretical rationale underlying PMRS (Lawler, 1981) predicts that the larger the bonuses received by managers, the more likely high performance will be sustained.

PROMOTION

Movement up a career ladder provides many of the same motivational forces as PMRS (March and Simon, 1958). Promotion usually represents recognition of employee achievement and worth to the organization. It also carries with it financial rewards in the form of permanent increases to base pay. Thus, promotions can be viewed as substitutes for the rewards contained in PMRS. The substitutability of these rewards systems raises many important questions: Do PMRS and the norms of the promotional system reinforce one another or do they operate at cross purposes? Which of these methods of performance management is more powerful? Are employees who have plateaued motivated by PMRS?

PUNISHMENT

As part of the broad focus on performance management, PMRS requires the imposition of penalties against employees who consistently perform unsuccessfully. Are such penalties actually levied? What are the implications of such penalties for an employee's future work performance?

LEAVERS VS. STAYERS

Although one argument in favor of pay-for-performance systems is their immediate affect on individual performance, another supporting argument is that they gradually improve organizational performance norms by encouraging good performers to stay and poorer performers to leave. Did PMRS cause any of this turnover? Can leavers and stayers be differentiated according to their performance? If so, do the good performers stay or leave?

These are the issues and questions that need to be addressed before we will know how PMRS and similar pay-for-performance programs elsewhere in government affect performance. We do, however, have a growing body of empirical evidence about merit pay failures in government (Gabris, 1986; Gaertner and Gaertner, 1985; Pearce and Perry, 1983; Pearce, Stevenson and Perry, 1985).
The senior author (Perry, 1986) has argued previously that these failures are not a result of poor implementation but that merit pay theory may itself be flawed. Pay-for-managerial-performance is based on the assumption that organizational performance is the simple additive combination of individuals' separate performances. Yet theorists note that organizations are intricate social environments that cannot be understood as simple aggregations of employees. Therefore, a mismatch exists between the simplicity inherent in merit pay programs and the complexities of organizations (Pearce, 1987).

The mismatch leads to one or more of three conditions that are sufficient to produce merit pay failure. Invalid performance contracts stem from the uncertainty of managerial work and the difficulty of specifying performance criteria. Talking to supervisors about performance appraisals reveals an interesting dilemma that is central to the success or failure of merit pay. Many supervisors admit that appraising subordinate performance is a time-consuming and sometimes unpleasant task. But they also acknowledge that they can easily distinguish their best from their poorest performers. The primary problem supervisors encounter is not with knowing who are the best performers, but in measuring and documenting performance differentials. Merit pay often fails as a motivational program because of the inability to accurately and completely measure performance. Of course, if employees have no confidence that good performance will result in a good rating, then merit pay is not likely to influence their behavior.

Information failure occurs when there is manipulation or rationalization of information necessary for assessing performance levels. Merit pay tacitly legitimizes self-interested behavior by defining performance in terms of organization subgoals. Individuals tend to adhere to these subgoals, even when the goals conflict with those of the larger organization, because of selective perception and rationalization (March and Simon, 1958). These processes produce situations in which a subordinate may shirk noncontractual obligations or challenge a superior's interpretation of the contract.

Reduction of coordination results from altering patterns of interdependence among organizational members. Although much has been written recently about the need for team work in effective organizations, merit pay discourages cooperation. Most merit pay systems are focused on rewarding individual rather than group performance. Thus, merit pay systems tend to separate employees into two classes, "stars" and "also rans". Unfortunately, far more employees fall into the "also ran" category simply because of the need to limit the number of employees rated outstanding. As a consequence, merit pay may damage the self esteem and loyalty of numbers of employees. The nature of merit pay systems also tends to reduce the willingness of employees to work outside of their performance contract. If an employee spends time on activities that are not in the contract, the employee risks losing ground to others in the scramble for financial rewards.

One final observation about PMRS and the pay-for-performance principles upon which it is based. We have argued above that, as a practical matter, attempting to pay public managers for their performance may be futile, perhaps quixotic. Pay-for-
managerial-performance may, in fact, run contrary to plausible, yet unconfirmed theories of organizational behavior (Perry, 1986). But ruling out merit pay's value as a motivational tool does not eliminate its potential relevance to maintaining the larger political order. Merit pay represents a symbolic gesture, representing the efforts of politicians and the public to assert control over bureaucracy (March and Olsen, 1983). No matter how onerous merit pay may be to those immediately affected, it sends a message that the governed are in control and things are as they should be. It is this symbolic role of pay-for-performance which may explain its persistence, despite its disappointing consequences.

CONCLUSION

The Performance Management and Recognition System eliminates some of the problems created by its predecessor. However, it is not without problems of its own. More importantly, there is no evidence that the pay-for-performance principles of PMRS actually have improved organizational performance. Affirmative evidence that PMRS and merit pay systems adopted by other governments improve performance should be a prerequisite for their retention.

Pay undoubtedly plays an important role in many employee decisions, including choices about joining, staying with and performing for an organization. In fact, because it is so important, we rely on pay to send too many "messages" to employees, to advance too many organizational purposes. The result may be confusion and misunderstanding. There is clearly a wide disparity between "pay-for-performance principles" and current perceptions of federal employees. Almost 60% of the supervisors and managers responding to a GAO (1987) survey felt they were not adequately rewarded for their 1984 performance. These perceptions were no doubt affected by the lag between base salaries of federal managerial and professional personnel and their private sector counterparts. This suggests that we may need a much broader view of pay for performance, one that assures both equitable market and organizational compensation for public employees.

REFERENCES


