Can Merit Pay Work?

By James Perry

Merit pay is more than just a motivational program. It symbolizes the effort to control the bureaucracy and the GAO says it’s not working.

In January, the General Accounting Office (GAO) issued a report titled Pay for Performance, offering data processing professionals insights about past and future federal personnel policies. The GAO report reviewed the first year of implementation of the Performance Management and Recognition System (PMRS), a performance management program for federal workers which covers federal managers at grades 13-15. Although GAO declined to judge whether PMRS would ultimately succeed, both GAO and employees it surveyed were enthusiastic that PMRS suffers from a variety of problems, including inequities in the amounts of performance awards for employees who are at the same grade and receive identical performance ratings.

PMRS is not unique, but part of a growing number of “pay-for-performance” programs in government. These programs, which tie bonuses or permanent salary adjustments to employee performance, are usually justified as tools for promoting better productivity. Indeed, some research in private organizations has reported significant gains in employee productivity, but most documented studies involve non-managerial employees in routine jobs.

Reform '78

The first pay for performance program in the federal sector was created by the Civil Service Reform Act of 1978 (CSRA). The merit pay program was hailed as a means for enhancing responsiveness and efficiency in the federal sector. Merit pay proved instead to be ineffective and demoralizing. Among its shortcomings were inadequate funding, inequities between managers and non-managers, and invalid performance appraisals.

Relief from the CSRA merit pay program came in the form of legislation introduced in 1984 by Senators Ribble and Warner and Representative Wolf, proposing the Performance Management and Recognition System. PMRS was enacted on November 8, 1984. The congressional mood was so overwhelmingly in favor of reform that the law was made retroactive to the start of the performance review cycle which had begun on October 1, 1984. Although passage of PMRS brought immediate relief for many of the merit pay system shortcomings, retroactive implementation created new administrative problems.

GAO’s report about the first year of PMRS in five agencies (Civil Service Administration, Internal Revenue Service, Bureau of Land Management, Bureau of Reclamation, Office of Personnel Management) identified several problems that arose because of retroactive implementation. Among the difficulties were that agencies had no lead time during which they could communicate with employees and train them in the new system and Office of Personnel Management (OPM) regulations and guidance were not timely.

Given the findings of Pay for Performance, we might expect to witness little enthusiasm for extending pay-for-performance principles to non-managerial personnel. But GAO’s report and other disappointing experiences with merit pay in government have not deterred the federal government’s personnel managers. In 1986, OPM introduced legislation to extend pay-for-performance principles to grades one through 12 of the general schedule. Although Congress did not act on the legislation, OPM has again introduced the legislation in the current session of Congress. Thus, it may be just a matter of time before pay-for-performance principles apply to all federal workers.

The idea behind merit pay

Merit pay encompasses a variety of non-monetary reward systems. For instance, sales people who work exclusively on commission are subject to a pure merit pay system. Throughout the public sector, merit pay places only a small portion of an employee’s potential salary “at risk.” For example, under the current PMRS system for federal managers, merit pay is equivalent to the amount of money paid to general schedule employees for within-grade increases. In addition, bonuses of at least two percent are mandatory for managers who receive outstanding performance reviews. Thus, the amount of a manager’s pay which is contingent upon performance, the “merit” portion, is about seven percent in a given year.

Merit pay programs emanate from a widely accepted theory of individual motivation. The theory posits that individuals who expect to receive a valued reward for high performance are more likely to strive for this level of performance than if they received no “pay off.” Merit pay is expected to increase effort and, therefore, performance by changing the probability that performance will lead to the salary increase which is as-
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Merit pay discourages cooperation.

Assumed to be valued by most employees. Thus, for merit pay to be effective, employees must value it as a reward and expect that their effort gives them a high probability of attaining it.

In practice, merit pay has been very difficult to implement successfully, both in government and the private sector. Experience in government reflects four common problems.

Four problems

Invalid performance appraisals. 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.

Many government employees have complained that performance appraisals have become “objective” by quantifying trivial features of jobs, resulting in meaningless appraisals. Data processing professionals are quite susceptible to such artificial appraisals because of the quantifiability of certain features of their jobs—for example, lines of code written, number of systems debugged, or number of database transactions.

Destructive competition. 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 the 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, he risks losing ground to others in the scramble for financial rewards.

Budgetary limitations. Unlike private organizations which have some flexibility in the amount of funds allocated, government agencies must live within a fixed budget.
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merit-pay budget. The budget constraint heightens the demoralizing effect of comparative ratings. Simply improving one's own performance is not enough, one must increase one's relative ranking by displacing another. Because one employee's gain is another employee's loss it becomes more difficult to create expectations that rewards will be contingent upon performance. Although PMRS was designed to lessen the zero-sum nature of its predecessor, GAO reports that PMRS still results in win-lose contests among employees.

Perhaps more threatening to the success of merit pay systems are perceptions among employees that there are few chances for big rewards. GAO surveyed about 1,000 PMRS managers and their supervisors and found that almost 60 percent of the respondents 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, a fact that merit pay does not remedy.

Ratings manipulation. Because government organizations must live within budgetary limits, the amount of money paid out is controlled by holding down average employee performance ratings. But there is an inherent contradiction between, on one hand, objective performance appraisals and, on the other, the manipulation of ratings to control the amount of money paid out. In fact, the manipulation of ratings only undercuts the validity of the performance appraisal system, making it even more difficult in future periods to get employees to respond to merit pay incentives. In its recent study, GAO found that 35 percent of surveyed employees were convinced that ratings were forced to conform to a distribution dictated by top management.

No praise, some hope

The GAO report on pay for performance does not declare the federal government's PMRS a failure, but it also offers no praise, only a hope that the system will right itself before Congressional review in two years. Although PMRS is an improvement upon its predecessor, it is not yet effective. Significant efforts still need to be exerted to debug this program and to establish employee trust in it.

Despite the lack of results from systems such as PMRS, the trend toward more flexible government pay systems is likely to continue. Merit pay is more than just a motivational program. It symbolizes the efforts of politicians and the public to assert control over government bureaucracy. No matter how onerous merit pay may be to those immediately affected, it conveys a message from top executives and legislators about who is in control. It is this symbolic role of merit pay that explains its persistence despite lackluster results.

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. Government would get better results by assuring that employees receive a market wage and by avoiding the use of money to motivate short-term performance.

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