MAKING POLICY BY TRIAL AND ERROR: 
MERIT PAY IN THE FEDERAL SERVICE

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The merit pay provisions of the U.S. Civil Service Reform Act of 1978 (CSRA) were among the most radical innovations in the history of American government personnel practices. They represented a break from the long tradition of virtually automatic salary increases based on length of service. Borrowing from private sector employment practices, Title V of CSRA sought to motivate better performance and to deter poor performance by increasing grade-level 13-15 managers’ salaries by amounts designated by their rated performance--much as mid-level managers in the private sector are awarded pay increases based on their companies’ profits in the preceding year.

The author's familiarity with merit pay is the outgrowth of a research program that began in 1979. The research has spanned the life of the original Merit Pay System (MPS) and the current Performance Management and Recognition System (PMRS). The initial research was conducted as part of the U.S. Office of Personnel Management's (OPM) organizational assessments of CSRA and it has been continued with support from the National Aeronautics and Space Administration and assistance from the General Services Administration.

This paper looks broadly at the operation and consequences of federal merit pay. It begins with brief descriptions of the two merit pay systems that evolved from the 1978 reforms. They are evaluated within the overall context of reform and its intended objectives. Several merit pay demonstrations are also discussed. The paper concludes by summarizing the learning that has occurred since merit pay's introduction and identifying unresolved issues.

THE REFORM RECORD

The case for merit pay was initially articulated by The President's Reorganization Project (1977). The Project's personnel management report concluded that it was difficult to appropriately recognize performance extremes, both high and low quality performance. They found that periodic step increases had become virtually automatic, quality step increases and cash awards were used sparingly, and supervisory action to withhold increases often met resistance from
affected employees and higher management. They concluded that this situation fostered mediocres performance.

The Merit Pay System (MPS)

In the period preceding passage of CSRA, federal middle managers received a combination of annual comparability increases and within-grade increases. Although within-grade increases, in theory, could be used to reward performance, they seldom were granted or denied on the basis of differential performance. Two other mechanisms that were designed to reward high performance, cash awards and quality step increases, were used sparingly. The Merit Pay System (MPS), which became mandatory for grade 13-15 managers in federal agencies on October 1, 1981, altered how incremental adjustments to salary were distributed. Under MPS, employees received only half of the comparability adjustment automatically. The non-automatic portion of comparability and the within-grade and quality step increase monies that would have been used to adjust pay under the General Schedule were pooled and distributed according to performance (U.S. Office of Personnel Management, 1981a).

How successful was the MPS in accomplishing the objectives established for it? The results of 12 studies of MPS are summarized in Table 1. The Table includes both summative and specialized evaluations of MPS. Research that focused on performance appraisal alone (e.g., McNish, 1986) or that preceded initial payouts (e.g., Nigro, 1982) was excluded from the review. The columns of the Table identify the four primary intended outcomes from MPS as specified in OPM’s evaluation plan (U.S Office of Personnel Management, 1981b): 1) to relate pay to performance; 2) to provide flexibility in recognizing good performance with cash awards; 3) to motivate merit pay employees; and 4) to improve productivity, timeliness and quality of work.

MPS’s clearest shortcoming was its failure to establish a demonstrable relationship between pay and performance. This failure is attributable to a variety of causes. One of the chief causes was lack of adequate funding for merit pay. Agencies were required by law to spend no more on MPS than they had under the previous general schedule system. This problem was exacerbated by implementation difficulties. For example, an OPM-GAO dispute about the statutorily permissible size of payouts led, in September 1981, one month before payouts, to a determination by the Comptroller General of the United States (1981) that the OPM formula for calculating merit pay was not in conformance with the statute. The ruling resulted in modified payouts that provided only small differentials between managers, again undercutting pay-for-performance principles.
MPS also failed to relate pay to performance because it did not satisfy basic standards of fairness. Managers who performed satisfactorily often found themselves receiving lesser rewards than their non-managerial counterparts at grades 13-15 whose pay was set under the General Schedule. The effects of non-performance factors (e.g., the composition of the pay pool) on payouts and arbitrary modification of ratings also diminished the basic fairness of the system.

Employees in most agencies perceived no greater likelihood that their performance would be recognized with a cash award after MPS than they had previously. The use of cash award authorities was highly variable across agencies (U.S. General Accounting Office, 1984). MPS appeared not to have significantly altered agency behavior with respect to cash awards.

The reported successes of MPS in motivating employees emanated primarily from the performance appraisal requirements of CSRA. Gaertner and Gaertner (1984; 1985) reported that developmental appraisals, those that focused on planning for the coming year and clarifying expectations, were more effective than appraisals that focused only on past performance. However, developmental appraisal strategies were seldom used and the pay administration role for appraisals tended to undermine this function. In fact, one study (Pearce and Porter, 1986) reported a significant drop in the organizational commitment of employees who received satisfactory, but not outstanding, ratings.

The ultimate purpose of merit pay was to improve the performance of government agencies. The most rigorous study of merit pay's effect on agency performance (Pearce, Stevenson and Perry, 1985) failed to find any association between the introduction of merit pay and office performance in the Social Security Administration. No published research to date has indicated that MPS had any positive effects on agency effectiveness.

The Performance Management and Recognition System (PMRS)

Although MPS did not take effect for most federal managers until 1981, it very quickly became apparent that it performed poorly when judged by the objectives established for it. Relief from MPS grew out of legislation introduced in 1984 that proposed a Performance Management and Recognition System (PMRS) (U.S. Congress, House of Representatives, 1984). PMRS was enacted on November 8, 1984, but the first payout was made retroactive to the fiscal year 1984 performance cycle. Retroactive application created a number of short-term implementation problems (U.S. General Accounting Office, 1987).
<table>
<thead>
<tr>
<th>Source</th>
<th>To Relate Pay to Performance</th>
<th>To Provide Flexibility in Recognizing Good Performance with Cash Awards</th>
<th>To Motivate Merit Pay Employees</th>
<th>To Improve Productivity, Timeliness &amp; Quality of Work</th>
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<tr>
<td>Daley. 1987. &quot;Merit Pay Enters with a Whimper: The Initial Federal Civil Service Reform Experience&quot;</td>
<td>Merit pay is not perceived as equitable; raises are too small.</td>
<td>Merit pay did not heighten survey measures of motivation.</td>
<td>Merit pay recipients perceived their agency to be no more responsive or effective than non-recipients.</td>
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<tr>
<td>Gaertner &amp; Gaertner. 1984. &quot;Performance Evaluation and Merit Pay: Results in the Environmental Protection Agency and the Mine Safety and Health Administration&quot;</td>
<td>Not perceived to be rewarding people fairly with significant raises.</td>
<td>Improvement in accuracy of performance standards and overall appraisal.</td>
<td>No positive impact on perceived agency effectiveness or employee work behavior.</td>
<td></td>
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<tr>
<td>O'Toole and Churchill. 1982. &quot;Implementing Pay-for-Performance: Initial Experiences&quot;</td>
<td>Small sample of pool managers complained the monetary reward was not worth the amount of paperwork and energy expended.</td>
<td>Enhances communication on goals and job expectations.</td>
<td>Inconclusive.</td>
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No improvement in the pay-for-performance contingency after merit pay.


Performance criteria were clearer, but may not reflect agency effectiveness.


Relatively low (satisfactory) ratings caused a significant drop in organizational commitment.

Perry, Hanzlik and Pearce. 1982. "Effectiveness of Merit-Pay-Pool Management"

No significant effect on organizational performance.


Modification of appraisal ratings to achieve agency merit pay goals reduced credibility of the system.


Non-performance factors influenced size of merit increases more than necessary.


Standards perceived to be fair, job related and consistent with organizational goals.

Half of all employees perceived a moderate to strong effect on performance.

Provision of cash awards highly variable across agencies.

Performance appraisals have limitations, including overly quantitative standards and lack of pre-testing.

OPM method for computing merit pay would exceed former costs by $56 to $74 million.

Employees perceived ratings as fair and accurate, but not very helpful.
Table 2
Assessment of the Performance Management and Recognition System (PMRS)

<table>
<thead>
<tr>
<th>Source</th>
<th>INTENDED OUTCOMES</th>
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<tr>
<td>Perry and Petrakis. 1987. &quot;Can Merit Pay Improve Performance in Government?&quot;</td>
<td>To Relate Pay to Performance</td>
</tr>
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</table>
| | Employees who achieved high monetary rewards in 1985 were more likely to perform at high levels in the next rating period. | About 2/3 of the sample received performance awards. | Rewards were poor discriminators between "stayers" and "leavers."
| U.S. General Accounting Office. 1987. Pay for Performance: Implementation of the Performance Management and Recognition System | Non-performance factors that caused inequities under merit pay continue to exist in PMRS. | Fifty percent of respondents found the amounts of performance awards inadequate. | Performance standards for many employees were issued more than 30 days into the appraisal period. |
| U.S. Merit Systems Protection Board. 1987. Performance Management and Recognition System: Linking Pay to Performance | Slightly less than half of employees perceived better performance leading to more pay. | | Performance standards were perceived to be fair and accurate. |

Same as MSPB (1987).

Higher turnover rates for employees rated "unacceptable" and "minimally successful."


Agencies reported reinforcement of linkage between pay and performance.

Size and amount of funding for performance awards increased.

Quality of performance standards a problem; not stated in measurable terms and did not differentiate between performance levels.


Performance ratings were inflated and average rating levels increased with grade level.

Performance awards were granted to most GM employees.
The drafters of the PMRS legislation sought to retain pay-for-performance principles, but to eliminate the dysfunctions of the original system. Under PMRS, employees must be rated at one of five levels, with two levels above and two levels below fully successful. PMRS consists primarily of three monetary components. Employees who are rated fully successful or better are assured of receiving the full general pay or comparability increase. They are also eligible for merit increases which are equivalent to within-grade increases. The size of the merit increase depends on an employee's position in the pay range and performance rating. In addition to these monies, employees rated fully successful or above also qualify for performance awards or bonuses. Beginning in fiscal 1986, performance awards of no less than 2 percent and no more than 10 percent became mandatory for employees rated two levels above fully successful. An upper limit of 1.5 percent-of-payroll for all performance awards was placed on agency payouts under the system.

PMRS also created Performance Standards Review Boards, modeled after the Performance Review Boards in the Senior Executive Service, to review performance standards within an agency to assure their validity and to perform other oversight functions. At least half of each board is required to be made up of merit pay employees. The number and functioning of these boards was left to agency discretion, but they are required to report annually to the agency head.

A summary of evaluations of PMRS is presented in Table 2. Because PMRS is a relatively new program, only a small number of studies have assessed its performance. However, during its brief existence, PMRS appears to have reduced tensions created by MPS and to have improved the prospects for achieving the outcomes intended for merit pay.

There are some indications that PMRS has altered perceptions about the relationship between pay and performance. The U.S. Merit Systems Protection Board (1987) reported that just under half of sampled PMRS employees perceived that better performance would lead to more pay. The likelihood that good performance will be recognized with performance awards has also increased. In its second report on PMRS, OPM (1988) indicated that most GM employees received performance awards. These findings must be tempered by the findings of other assessments. GAO found that fifty percent of employee's surveyed in PMRS's first-year found the size of performance awards inadequate. Perry, Petrakis and Miller (1989) found significant relationships between lagged measures of monetary rewards and 1986 performance ratings, but the same relationships were insignificant for 1987 performance awards, suggesting a possible decline in the effectiveness of PMRS over time.
In MSPB’s 1986 survey, employees indicated that performance standards were perceived to be fair and accurate. At the same time, GAO and OPM reported shortcomings in the motivational value of the performance appraisal systems because of late issuance and low quality of standards. Although the amount of evidence is too limited to be conclusive, the evaluations of PMRS suggest no improvements, and possibly a decline, in the motivational value of performance appraisals. However, OPM (U.S. Office of Personnel Management, 1988) indicates that the Performance Standards Review Boards have made a significant contribution to improving the quality of performance standards and the fairness of the process.

The evaluations of PMRS to date have been silent with respect to the influence of PMRS on agency effectiveness. MSPB (U.S. Merit Systems Protection Board, 1988) has identified a tentative relationship between turnover and performance ratings which suggests that poor performers are more likely than good performers to leave federal service. However, no relationship was found between turnover and performance ratings in an earlier study in the General Services Administration (Perry and Petrakis, 1987).

**Title VI Demonstrations**

In addition to MPS and PMRS, CSRA has spawned several pay experiments (U.S. General Accounting Office, 1987) under the authority of Title VI. The first of these occurred in the Department of the Navy at two of its laboratories, the Naval Weapons Center in China Lake, California and the Naval Ocean Systems Center in San Diego, California. These experiments introduced broad pay bands, simpler position classification and close linkages between pay and performance. GAO (U.S. General Accounting Office, 1988) concluded in its assessment of the experiments that they were implemented to the general satisfaction of managers and employees, but that data were not sufficient to verify that the experiments improved laboratory effectiveness, increased managerial flexibility to assign work, or improved employee recruitment and retention.

Another experiment is underway at the Sacramento Air Logistics Center, McClellan Air Force Base. The key pay innovation involved in this experiment is gainsharing, which permits employees to share in productivity gains through enhanced earnings. The McClellan experiment pays incentive bonuses based on the difference between allocated funds and actual costs. Savings are divided equally between the government and employees involved in the experiment.

The most recently initiated demonstration involving pay is at the National Bureau of Standards (NBS) (U.S. General Accounting Office, 1988). The project seeks to improve recruitment and retention in NBS.
by permitting salaries to be set and adjusted based on comparability with total compensation (basic pay, bonuses, allowances, retirement, health and life insurance, and leave benefits) in the private sector. Adjustments to salary will also be made based on employee performance.

Other demonstrations are in the planning stages. For example, an interagency task force is presently developing a demonstration that would modify PMRS policy with regard to performance plans, ratings, bonuses and other rewards, and unacceptable performance (Brumback, 1988a). This demonstration would reward a small number of outstanding performers but it would also encourage a portion of merit awards to be allocated according to variations in unit performance.

**LEARNING**

Although both MPS and PMRS encountered implementation difficulties, the shortcomings of federal merit pay have appeared to involve design and fit issues, rather than implementation. The evolution of federal merit pay programs from MPS to PMRS to the current demonstrations indicates that federal personnel managers and policy makers have learned some lessons from the experiences of the past ten years.

**Zero-sum Programs Don’t Work**

The original merit pay program was zero-sum in character at both the individual and organizational levels. At the individual level, it was necessary for some employees to do less well for others to gain financially. It permitted employees performing at a satisfactory level to lose ground relative to their non-managerial counterparts. These features of MPS’s design were transparent and employees responded with hostility and disdain. At the organizational level, the norm of budget neutrality eliminated the prospect that demonstrable improvements in agency performance could be recognized with additional financial rewards.

PMRS has reversed the zero-sum character of federal merit pay. Managers are no longer at risk of receiving less than their General Schedule counterparts. The performance award provisions of PMRS, particularly the mandated bonuses for outstanding performers, have stimulated the payout of substantial cash awards. Furthermore, because movement through the pay range is defined in absolute terms rather than dependent on the relative ratings of other pool members, the results of individual effort are more predictable and more likely to be perceived as equitable by employees.
The Reward Structure Must Recognize Group and Unit Performance

The individual, fixed contracts required by individually-contingent pay programs have a variety of limitations. They become the focus of substantial amounts of administrative energy ("paperwork"), are prone to manipulation by opportunistic managers, and divert employees from the interdependent aspects of work in public organizations (Perry, 1996). These limitations of individually-contingent managerial pay are slowly being addressed by designs being used or considered in demonstration programs. The McClellan demonstration is the clearest example of a merit pay system grounded in unit performance.

Bonuses Are Superior to Salary Increments

Organizations must choose whether increments are awarded to employees as permanent adjustments to base pay or as one-time bonuses (Lawler, 1981). The traditional method in most government organizations has been to incorporate pay increments into regular salary. In terms of the goal of linking pay-to-performance, bonuses place larger shares of an employee's compensation at risk and the increments awarded for performance are more clearly identifiable. The design of PMRS places a larger emphasis on one-time bonuses than did MPS, but employees continue to receive substantial adjustments to salary as well. Although there is no clear evidence that PMRS's emphasis on bonuses is the source of improvements in employee acceptance or perceived strengthening of pay-for-performance linkages, some federal managers believe that it has been a factor (McFee and Brumback, 1988). Recent experimental evidence also indicates that pay and performance are more likely to be contingent under bonus systems than salary-increment systems (Schwab and Olson, 1988).

THE UNFINISHED AGENDA

Despite the learning that has occurred since 1978, many important issues remain unresolved and significant questions are still unanswered. In a recent review of ten years of performance management under CSRA (McFee and Brumback, 1988), two high-level federal managers acknowledged the learning that has occurred but called for further improvements in the performance management system. In some respects, federal managers and policy makers have learned how to operate merit pay to minimize the pain, but they have not necessarily achieved their strategic goals: Improved productivity and effectiveness. This section discusses the unfinished agenda.
What Is An Appropriate Ratings Distribution?

MPS was initiated with a strong bias for a normally-distributed ratings curve. Recent assessments of PMRS ratings note a significant skew in most agencies' ratings with 68.7 percent of GM employees in 1985 receiving ratings above fully successful (U.S Merit Systems Protection Board, 1987). These ratings have been viewed with alarm in many quarters, but there is no obvious standard by which to assess the overall distribution of ratings. The highly concentrated distribution of performance ratings may, in theory, diminish the potential motivational power of merit pay, but it is important to recognize that performance ratings affect more than just monetary awards. Appraisal ratings affect an employee's understanding of the job by providing feedback about performance, self image, organizational commitment and trust. Although normally-distributed performance ratings may be desirable to meet the objectives of the compensation system, they could undermine other aspects of employees' organizational attachments, producing an overall negative effect on motivation. Evidence from several sources suggests that trade-offs exist between the compensation objectives of performance ratings and employee self image (Meyer, 1975), performance feedback (Meyer, Kay and French, 1965), and organizational commitment (Pearce and Porter, 1986).

What Is Good Performance and How Is It Measured?

The decade began with considerable discussion about how performance in government should be measured (Perry and Porter, 1982). It ends with many federal managers considerably more adept at applying individual performance measurement, but with little conceptual progress on fundamental measurement issues. How individual performance is and should be linked to organizational performance continues to be a concern for most federal agencies. Recent scandals raise questions about how ethical considerations are incorporated into individual performance plans (Brumback, 1988b). More research and development needs to be invested in improving the state-of-the-art of performance measurement before the promise of merit pay can be realized.

What Motivates Government Employees?

Another area that has received scant attention during the last decade are the bases of public employee motivation. We have learned during the last decade that a poorly designed pay-for-performance system does not motivate federal employees. However, little systematic knowledge has been developed about what motivational programs work.

The complexity of motivational problems in most government organizations precludes reliance on a single dominant motivational program. Federal agencies must design reward systems that recognize the
range of contextual factors—the types of individuals attracted to the organization, the job itself, the work environment, and changes in the external environment—that influence motivation (Perry and Porter, 1982). In addition, managers must be prepared to use a variety of informal rewards—those not mandated by the organization—to influence subordinates' actions (Pearce, 1989). One of the liabilities of merit pay during its first ten years is that it has diverted federal agencies from giving the attention they should to a range of programs to attract and retain members who will perform both reliably and innovatively.

Is There A Better Way?

One of the most important questions about merit pay involves its opportunity costs. If the federal government were to invest the time and energy currently expended on merit pay in a different way could it get better results? After ten years, this question is difficult to answer because so little information is available about the costs and benefits of merit pay.

One of the ironies of merit pay is that it is "money intensive" at a time when the federal government is under severe pressure to curb outlays. The logic of merit pay demands that money be expended commensurate with performance. Other motivational programs are less tied to budget outlays and therefore perhaps more appropriate for today's fiscal situation.

CONCLUSION

In order to fully understand both the past and future of federal merit pay, it must be understood from both an instrumental and a symbolic perspective (Elsenhart, 1988). From an instrumental perspective, merit pay is perceived favorably by many managers searching for tools to improve productivity. Conceptually, it offers a concrete reward that is valued by many employees. Furthermore, many employees believe, in the abstract, that performance is an equitable basis for the distribution of rewards. In sum, merit pay is perceived by many organizational participants as a valuable tool for performance management.

From a symbolic perspective, merit pay represents an attempt by politicians, administrators, and the public to assert control over bureaucracy (March and Olsen, 1983). It is a message from politicians and the public that the governed are in control and things are as they should be. At the same time, it is a way for administrators to communicate that they are responsive to important external constituencies and that they are doing something about perceptions of lagging performance (Tolbert and Zucker, 1983). In sum, merit pay is part of the
ritual and myth that helps to retain the legitimacy of the governance system, but it may have little consequence for individual and organizational performance.

The truth about merit pay probably lies between the instrumental and symbolic interpretations for its appeal. Regardless of the reasons for its appeal, merit pay is likely to become a relatively permanent part of federal management. Given its likely permanence, the unresolved issues surrounding merit pay deserve attention from managers and policy makers. If they do not, merit pay will surely represent for future generations of scholars and practitioners alike an example of Wallace Sayre's (1948) old adage—"the triumph of techniques over purpose."

NOTE

1. This is a revised version of a paper presented at the Civil Service Reform Conference, The Maxwell School, Syracuse University, Syracuse, New York, October 13-14, 1988. The author thanks Gary Brumback, Rosslyn Kleeman and Beth Ann Petrakis for their helpful comments on an earlier draft.

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