Merit Pay
Motivating and Rewarding
Individual Performance

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The most prominent difference between pay programs in the public and private sectors is the emphasis on merit pay. The phrase merit pay is widely understood to refer to pay programs that have at least two defining characteristics: rewarding individual performance (rather than group or organizational performance), and rewarding performance differences by granting different increases to base wage or salary (rather than one-time bonuses or other non-base-wage payments). This chapter focuses on merit pay, but alternative forms of pay for performance are also briefly considered.

MONEY AND MOTIVATION
Although some commentators (such as Kohn and Deming) have criticized current merit pay systems as ineffective or counterproductive, it is generally conceded that money motivates human behavior. Early motivational theorists (such as Maslow and Herzberg) who concentrated on needs fulfillment as the primary driver of human behavior and who argued against the impact of monetary rewards on work behavior have been discounted both in theory and practice.
More relevant theory focuses on the process through which people are motivated in the workplace, rather than on any particular set of needs. Four process-related theories have been used to explain how reward systems can motivate work behavior, and each has significant implications for designers of merit (or other performance-based) pay systems.

- **Equity theory.** Equity theory provides the basis for most traditional pay systems. Employees provide labor and other inputs to employers in exchange for a variety of returns including pay. Because it is difficult to determine whether that exchange is equal, employees tend to compare their return to input ratio with what they perceive the ratios of others to be. Compensation professionals have developed reward systems that institutionalize these comparisons in an attempt to provide pay equivalent to that of others in the same job working for other employers. Job evaluation systems are meant to build an internal value hierarchy based on comparisons of jobs; merit pay systems are intended to ensure differential pay increases to employees holding the same job based on their merit (usually defined as performance). To the extent that employees feel equitably rewarded, pay satisfaction is increased and turnover and absenteeism are reduced.

Equity theory does not suggest that employee satisfaction is causally linked to employee performance. It does, however, suggest that employers specify which inputs are valued, make sure the rewards for success are explicit, specify relevant comparisons to other organizations, jobs, or persons, specify the process through which rewards are determined, and communicate all these to employees.

- **Expectancy theory.** A different perspective on motivation is provided by expectancy theory. Briefly, it argues that an individual faced with a behavioral choice of effort at work (for example, stay late to finish a project or leave the office on time) considers the probable outcomes of the effort (a completed project and an angry spouse vs. an incomplete project and a satisfied spouse). The longer-range impacts of these primary outcomes and their probability are also considered (higher performance rating and subsequent merit increase vs. breakup of marriage from overwork?). The employee will choose the option which, on the whole, maximizes preferred returns. The theory does not specify what longer-range outcomes are preferred (some may prefer the increase, others a stable marriage). Thus expectancy theory is based solidly on the argument that individuals continually make choices and balance their work efforts in light of expected outcomes.

Employers who accept the validity of expectancy theory will make sure that the linkage between work effort and work outcomes is understood by employees, that the rewards linked to desired work outcomes are well known, and that the organization actually does reward performance. In a sense, expectancy theory suggests that employers make sure the rules of the pay-for-performance system are well understood by all employees, and that the organization plays by those rules. The rewards offered by the organization might not outweigh other consequences of desired performance for all employees, but only when employees understand the system and its outcomes can they make rational choices about the effort they will put forth.

- **Goal-setting theory.** Goal-setting theory is less relevant to merit pay than either equity or expectancy theory, but it is reviewed here because it forms the theoretical base for management by objective (MBO) systems and because misunderstanding it has resulted in many failed programs. Briefly, goal-setting theory states that individuals with high, specific, and self-accepted goals will perform better than those with no goals or "do your best" goals. It is not necessary that the goals be participatively set as long as they are accepted by the employee as feasible and commitment to achieving them takes place. Goal-setting does not specifically predict goal achievement, only higher performance. MBO programs typically reward employees for goal achievement rather than performance against standards. Employees who set stretch goals and perform well but fail to achieve their goals are motivated to set more readily achievable goals the following year; soon the system becomes a source of conflict between managers, who try to get employees to set ever-higher goals, and the employees themselves, who understand only too well the "rewards" for doing so.

The other value of goal-setting is that it reminds compensation specialists that rewards encompass much more than money. Feedback and recognition, as well as good performance, can motivate. The goal-setting process and the commitment to goals provide motivation for most employees even if rewards are not explicitly linked to performance.

- **Reinforcement theory.** Reinforcement theory notes the importance of consequences on the repetition of behavior. When a behavior is positively reinforced (that is, when the consequence of the behavior is viewed favorably by the employee) it is more likely to be repeated. Money is usually considered to be a general reinforcement, most employees view it favorably, and it may represent other things of value, such as recognition.
Reinforcement theory has a number of implications for merit pay. The immediacy of the consequences makes it a more powerful reinforcer. It is hard to maintain that a merit increase in March gives much reinforcement for performance last July. The schedule for reinforcement is critical. It is impractical to provide a reward every time good performance is exhibited, although it is under these conditions that learning is quickest. Research suggests that a variable ratio reinforcement schedule is the most powerful in maintaining behavior. This is how slot machines pay off: not every twenty places is a win, but about every twenty plays on average. Merit plans pay off on a fixed schedule, which is not very reinforcing. Like goalsetting theory, reinforcement theory reminds compensation specialists that things other than money reinforce behavior, some of which may be more powerful for some employees.

CURRENT MERIT PAY PRACTICES

In the private sector merit pay policies are widespread. Heneman's reports on a series of surveys showing that more than 80 percent of private sector employees receive merit pay plans (p. 8). The 1995 ACA salary budget survey of 3,667 organizations found that more than 83 percent of the respondents had merit pay programs for their nonexempt employees, and more than 87 percent had them for exempt employees. Because respondents include some hospitals, colleges and universities, government units, and nonprofits, these figures underestimate the prevalence of merit pay in the private sector. The proportion of large employers using merit pay for at least some of their employees is even greater. In the public sector the prevalence of policies providing for merit pay is decidedly less, although adequate survey data are not available. Heneman reports a series of surveys showing that thirty-seven states had merit pay systems in 1989 and that nearly half of all local governments have some form of merit pay (p. 9). Significantly, surveys conducted over the past decade indicate that the emphasis on merit pay policies has increased in corporations.

Realistically, corporate merit pay programs are often no more effective than those in government. Virtually every employee gets an annual pay increase; in the typical corporation less than 5 percent of the staff is denied an increase because of poor performance. However, the philosophy underlying merit policies is almost as important as patriotism or motherhood. The solidly entrenched belief is that workers should earn their salaries and that the best workers should be paid more over time. This belief has been important in the cultural heritage of the United States and permeates many aspects of our lives.

Still, corporations have become increasingly sensitive to the impact of payroll costs as a competitive issue. This has given renewed emphasis to concerns about practices that effectively guarantee pay increases. Companies across the country have acted aggressively to reduce fixed payroll costs. Cost reduction strategies include staff cuts, changes in benefit programs, and the introduction of variable incentive plans. The last of these is one of the most important trends in compensation management.

These trends make any practice that results in entitlement suspect and a focal point for critics. They also increase the pressure for public employers to review their policies and move away from practices that make annual salary increases a right that is difficult for the employer to deny.

THE PRACTICAL SIDE OF MERIT PAY

There is a gap between the philosophy and the reality of merit pay. It is difficult to argue against the ideals of merit principles, but it is also difficult to translate the principles into effective practices. Formal pay policies are only the starting point. The policies are meaningful when supervisors throughout an organization are comfortable making salary increase decisions based on their assessments of individual performance. The supervisors specifically have to know that the organization expects them to recognize that some employees do not deserve a full increase. The denial of increases is always difficult to justify and explain to affected employees; the organization and top management have to make this an important issue or supervisors are likely to grant increases to virtually all employees.

For supervisors, merit pay is a zero-sum game. Salary increase budgets are typically determined as a fixed dollar amount, determined as a percentage of each employee's salary. Over the last few years corporate salary increase budgets have typically been in the range of 4 to 5 percent of covered wages and salaries. Conventional merit practices make it essential to grant increases in each organizational unit so that the total dollars spent during the fiscal year add up to the budgeted amount. Cash flow considerations may complicate the management problem (for example, increases granted at the beginning of the year
require more of the budget than increases granted at the end of the year, but above-average increases for some employees generally have to be offset by below-average increases for others.

A common problem is the reluctance of supervisors to deny increases or to grant below-average increases; they do, after all, have to continue working with the employees who are adversely affected by their decisions. Supervisors need to know that the organization is committed to merit pay and is providing adequate ongoing support to facilitate these decisions. Employees need to understand that their compensation depends on their performance and on the organization's financial success. There are typically pockets in any organization where merit pay is perceived as more effective than in others, but it is important to avoid completely ignoring the policy of granting increases for some groups of workers.

The reality is that there are only two possible alternatives to merit increases. One is that some companies have begun to adopt is to de-emphasize and reduce the funds available for merit increases, making future pay increases dependent on variable pay incentive plans. Under these plans, payments are made in the form of lump-sum awards, with little or no increase in base salaries. There is reason to anticipate the trend to adopt incentive plans will continue to expand into the future.

The other alternative is to grant the same increase to every employee. That can be done with either a general increase or with step increases.

The latter is clearly prevalent in government and in situations where differences in performance either do not exist (such as where performance is dependent on a mechanized process), cannot be measured, or do not matter. Corporations often are willing to stand behind merit policies even in situations where supervisors and employees know the policies are not effective. Given the pressure from stockholders for increased organizational performance, corporations cannot (or will not) admit that they are not doing everything possible to motivate and reward high levels of individual performance. Public employers have been reluctant to provide the same commitment.

The ongoing problems with merit pay are not new. The period of rapid inflation in the late 1970s and early 1980s helped create a climate in which it was virtually impossible to deny increases. It was during this period that cost-of-living adjustment (COLA) clauses were adopted in many labor agreements. The concern with living cost increases prompted many companies to adopt informal “keep them whole” policies. Although that thinking is now essentially dead in the

private sector, it continued for several years after inflation rates declined to the recent 3 or 4 percent level. The experience during this period was largely responsible for the creation of the entitlement mentality that has recently become a focus of concern for those seeking to increase organizational performance through the use of rewards systems.

Unfortunately, no one has conclusively shown that merit-based salary management is important to corporate success. It would be difficult to demonstrate, as very few corporations claim not to rely on the concept. It also would be difficult to isolate the impact of merit pay from other factors affecting performance.

**MERIT PAY AND ORGANIZATIONAL CULTURE**

Successful merit pay policies can only be understood in the context of the organization, its management style, and its culture. It is also important to appreciate that merit pay is the organizational norm in the United States. Moreover, U.S. culture makes it important to recognize and reward instances of outstanding individual performance. Rewards range from frivolous ceremonial awards with no monetary value to letters of commendation to cash awards. In this broader context, groups that fail to reward good performance stand out to outsiders as unusual and suspect.

The cultural history of the United States includes numerous tales of outstanding individual accomplishments. That history seems to focus on the individual even when it is obvious that the accomplishment involved the efforts of many. Our cultural heroes have been individuals, not teams or groups.

In a corporate setting, the only acceptable reason for ignoring individual performance is the recognition that individuals do not make a difference. This may be the case in work settings where performance is dependent on machines or the availability of materials; thus individual performance can be ignored for some blue-collar and pink-collar jobs. But in almost every other work situation, management will make an effort, effective or otherwise, to assess individual performance.

Merit pay also has a powerful symbolic impact on the culture of the organization. It is a very visible way for managers to control their subordinates. At its best, merit pay provides a manager with a means
of emphasizing the importance of performance. In organizations with powerful unions or in government agencies with restrictive civil service rules, merit pay may be the only material consequence a manager can use to influence behavior. At its worst, merit pay becomes a tool to reward friends and punish everyone else.

Merit pay also can be used to signal the outside world that the organization is serious about performance. Both public and private sector organizations have used the implementation of merit pay and other incentive programs to assure stakeholders that a performance culture is the order of the day. Elected officials or senior management can reap the acclaim for developing organizational effectiveness. But if there is insufficient financial or managerial support, managers and supervisors have to cope with implementation and take the blame if the program does not work.

Experience with merit pay has certainly not been universally positive. More than a few managers and supervisors have administered merit budgets poorly. One of the most common problems is the awarding of large wage or salary increases to friends or favorites regardless of performance. When merit budgets are small (most have hovered in the 3—5 percent range for the last several years), it is difficult to differentiate raises for high and low performers. Flat budgets make it difficult to use money as an incentive for much of anything, especially when downsizing places a heavier load on surviving employees. The potholes can be numerous and arise unexpectedly. As a process it has to be planned carefully and with full appreciation for the potential problems. When it works best, it becomes a key to a performance-oriented culture that can be a decided benefit to the organization.

SHOULD PUBLIC SECTOR EMPLOYEES RELY ON MERIT PAY?

This is perhaps the most perplexing problem in defining the appropriate compensation philosophy for the public sector. There is clearly a high level of interest in improving the performance of government agencies; it is manifest in much of the criticism of government and in the widespread support for reinventing it. However, a clear consensus on how to accomplish this is not apparent. If experience in the private sector is meaningful, budget slashing and staff reductions are demoralizing to the remaining employees, which in the short term will adversely affect performance.

Improved performance in any service-oriented organization depends in large part on the efforts of individual employees. A prime and widely recognized example is Federal Express. FedEx has pioneered a variety of high-technology initiatives, from information technology to business process reengineering, to enhance the speed and accuracy of its delivery services while reducing costs for itself and its customers. Nevertheless, FedEx's reputation and success is highly dependent on the efforts of the individuals who pick up and deliver packages. In the public sector as well technology will play a role, and there is undoubtedly something to be gained from meaningful reengineering and process improvement initiatives. But here, too, individuals will always be the focus of any attempts to improve performance. This necessitates changes in the way people perform their jobs and in their ability to work harder as well as smarter.

At the same time the track record for merit pay in the public sector does not auger well for this change in policy. Despite the reliance on merit principles, little more than lip service has been given in the way of commitment to a performance linkage in salary management. To be sure many public employers have merit policies in place and working as well as those in corporations. But a number of prominent public employers, including the federal government, have not made merit pay a reality. It would be difficult to prove that merit pay contributes to improved performance; no effective basis for determining the impact of such a policy appears to exist. In the private sector the practice is virtually universal, and in other sectors it would require a complicated research strategy to be able to isolate its impact. The evidence is thus largely anecdotal; at any rate the merit increase policy is only one part of an organization's culture. Where merit pay is considered successful, other factors would still need to be considered to fully understand the "action levers" that drive performance. This makes it difficult, if not impossible, to isolate the impact of merit pay on organizational performance.

The importance of an organization's culture and its commitment to performance is agreed upon; some organizations place more emphasis on reaching and maintaining high performance than others. When one has an opportunity to work with a variety of organizations, an easily recognized difference between them is how much emphasis each places on performance and the commitment to succeeding. Some simply want to be the best; this permeates almost
every aspect of their operations and culture and is widely shared by the workforce.

Merit pay as an isolated policy is probably not important in this context. It is safe to assume that high-performance organizations—however they are defined—will have a merit pay policy or other ways to recognize and reward the better performers. They make it a focal management issue; they continually identify high performers and high-potential employees and reward them in ways commensurate with their contributions, including with cash but also with promotions and other rewards. Increasingly, such rewards are being shared among a larger percentage of the workforce. All of this contributes to the creation of a performance-oriented culture.

Workers want their value and contributions to be recognized; the value accorded to hard work is an important cultural ethos in this and many other countries. The better performers expect to be recognized and to benefit from their efforts. If they are not so honored over time, questions arise in their minds and in the minds of others who are aware of it. When no differentiation is made between high performers and barely adequate performers, the consequence is likely to be reduced effort. Sooner or later, workers who do not feel their work is adequately appreciated will see no point in continuing to perform at high levels. When there are no rewards the level of effort will taper off to the minimum needed to avoid adverse consequences.

The impetus for merit pay comes, of course, from the private sector. There is evidence that many government employees did not consider money an important consideration when they started their careers; for many it may have been a relatively low priority. Government has the decided benefit of a workforce that is largely committed to public service. Unfortunately, public employers have a tendency to fall back on management practices that diminish such motivations and the commitment to high performance. Policies affecting the pay program, such as budgets for salary increases that are consistently below prevailing levels, contribute to the problem.

The private sector perspective is important to the public sector because the voting public works primarily in the corporate world. Public employers are under scrutiny to improve performance will feel pressured to adopt policies and practices expected to accomplish it. Proven private sector practices will need to be considered and accepted, modified to fit the public sector, or explicitly rejected. Politicians will need to be able to defend the decisions they make while in office.

The merit pay theme has innumerable variations; the alternatives are not limited to a single corporate model. The only common theme is that some relatively small group—typically 15 to 20 percent of eligible workers—receives a slightly larger increase than the balance of the workforce and that another even smaller group—perhaps 2 percent—will be denied an increase. As long as the model provides for both eventualities, it can be an effective merit pay system.

Merit pay requires ongoing management support. It has to be introduced as an important management priority, and all subsequent communications on the subject must reinforce its importance. At least a basic effort must be made to make it a component in a performance management process, which requires manager and supervisor training to make the process a reality at all levels; it cannot be seen as simply another requirement of the personnel department.

Dealing with the problems and work needed to shift successfully to a merit pay environment must be balanced against the implications of staying with a step-in-grade or other automatic salary increase concept. Public employers have a reputation for backing an entitlement culture that is contrary to that in most, if not all, other sectors of the economy. There is a widely shared belief that we as a society can no longer afford to maintain an entitlement culture.

Automatic increase policies fail to satisfy both organizational and individual needs; none but perhaps poor performers feel good about the way their salary is handled. If employee surveys are to be believed, government workers tend to be highly dissatisfied with their employers' pay program. Public employers that decide to reconsider a pay program should start by defining those needs and evaluating program alternatives relative to the potential for meeting them.

**PERFORMANCE APPRAISAL AND MERIT PAY**

The assumption underlying any merit pay program is the existence of accurate employee performance measures. The difficulty of achieving accurate measures is the key shortcoming in many merit pay plans and underlies much of the criticism of pay for performance. This topic is treated in more detail in Chapter Nine. However, it is worth noting a few key points here.

For merit pay purposes it is necessary to have a single performance rating scheme that is applicable to all covered jobs. That is, a clerk who
rates 5 (greatly exceeds standards) must be equivalent to a highway research engineer or senior budget analyst who rates 5 in terms of performance against standard. Because performance is multidimensional (an employee may have great technical skills but the interpersonal skills of a rock), it is necessary to distill the value of many performance measures into that single number.

In most private sector organizations the emphasis has shifted from performance appraisal to performance management. Rather than simply keeping score, these organizations work to develop performance plans for individuals and groups and then provide support and feedback to ensure that enhanced performance occurs. In an effective performance management system the appraisal itself is a non-event because the employees already know how they are doing. Though there is no evidence that merit pay, with its focus on the single performance score, operates against the performance management system in any way, it is critical that the linkages between performance management and the year-end performance appraisal be clear and unequivocal. Similarly, it is critical that the link between performance and reward be apparent as well as real and that employees see the linkage as consistent and fair.

**MERIT PAY MODELS**

Three merit pay models are in wide use. The simplest is typically found in the public sector: in effect, it is a yes-no decision that provides an increase for everyone whose performance is satisfactory. The amount is normally the step increase provided in the salary schedule; a variation is to provide a two-step increase to a limited number of high performers.

A similar model links each employee's increase to a supervisor's rating of the employee's performance. Typically, permissible salary increases (most often expressed as a percentage of salary) are established for each level of assessed performance. For an organization that recognizes five levels of performance, for example, the ratings and salary increases shown in Table 10.1 might be used.

However, if 80 percent of the employees are typically rated 4 or 5 each year and there is only a 4 percent merit increase budget, giving the increases listed in Table 10.1 would break the bank. By taking into account the expected distribution of performance ratings (there is generally a high degree of consistency from year to year), we can specify ratings that will result in a weighted average increase that is roughly equal to the budgeted amount. A key to successful merit pay policies is to design the increase schedule so that increases are in line with labor market trends and with the organization's financial resources.

The third model combines performance rating with position in the salary range to form a merit matrix. This model is based on the assumption that the salary ranges are aligned with prevailing market pay levels according to a specific policy. The most common policy is to align the salary range midpoints so that they are approximately equal to average market pay levels for the jobs assigned to each range. Thus a job incumbent paid exactly at the midpoint is paid at the market level. If we further assume that the market average pay level is for an average performer, then the company's average performers need to be paid at the midpoint salary level when they are able to perform at an average level.

This policy provides higher-than-average increases for employees paid below the midpoint and lower-than-average increases for those above the midpoint. The position in the range is defined and tracked with a compa-ratio, which is the employee's salary divided by the range midpoint. For example, a salary of $44,000 and a midpoint of $40,000 produce a compa-ratio of 1.10. A salary of $32,000 in the same range means the compa-ratio is .80. In a range with a 50 percent spread from minimum to maximum the compa-ratios run from .80 to 1.20.

People with little or no experience usually earn close to the range minimum, and they gradually progress through the range as they gain

<table>
<thead>
<tr>
<th>Performance Rating</th>
<th>Salary Increase (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Outstanding</td>
<td>8</td>
</tr>
<tr>
<td>4 Above expected</td>
<td>6</td>
</tr>
<tr>
<td>3 Meets expectations</td>
<td>4</td>
</tr>
<tr>
<td>2 Marginal</td>
<td>2</td>
</tr>
<tr>
<td>1 Unacceptable</td>
<td>0</td>
</tr>
</tbody>
</table>

Table 10.1. Merit Pay Model: Increase Linked to Rating by Supervisor.
experience; the compa-ratio is a simple concept to help track their movement through the range. One can argue that employees low in the range who earn an outstanding performance rating deserve a larger increase than employees with the same rating who are above the midpoint and already well paid relative to market levels. Increases begin to resemble a learning curve pattern as an individual progresses to and then above the midpoint. Table 10.2 illustrates the merit matrix concept.

A variation on the matrix concept is to cap increases within the range based on performance ratings. For example, employees rated 3 (meets expectations) may be made ineligible to be paid more than the midpoint. The logic to this is that competent but average employees should not be paid more than the market average, which is the basis for establishing the range midpoint. Similarly, employees who are rated 4 might be capped at the 1.10 compa-ratio level. On this basis only outstanding 5-rated employees can expect to reach the range maximum. This effectively strengthens the pay-performance linkage.

The merit matrix is probably the most prevalent policy in larger companies. The actual matrix will depend on the company's pay-performance philosophy, the width of the range, and the performance rating scale. The format depends on the number of levels in the performance rating scale and the width of the ranges. (The concept is not feasible with a broad-band structure, because organizations that use it tend to manage against actual salaries rather than against compa-ratio or place in range.) The actual percentage difference in increases for high performers low in their range to marginal workers who are in the upper end of their range reflects the organization's philosophy; with some matrices high performers can expect increases four or five times greater.

When salary increase budgets were larger, some companies added a third dimension to the matrix concept: timing of the increase. The better performers who were low in their range were eligible for increases more frequently (sometimes as often as every six months), and the poor performers had to wait eighteen to twenty-four months. The combination allows better performers to make out significantly better than poor performers over time. As budgets have been cut back over the past few years, use of this variation has diminished.

Limits on salary increases reflect a different philosophy than what is common in the public sector, stressing the viewpoint that good performers need to make out better over time than poor performers. As salary increase budgets are always constrained, the intent of limits is to force the allocation to benefit the better performers. In most corporations the salary structures are reviewed and adjusted annually (or biennially), which means that the range minimums, midpoints, and maximums are increased to keep pace with labor market trends. These adjustments reduce the relative position of individual salaries in the ranges and the associated compa-ratios, meaning that employees are eligible for at least a modest increase. That pay increases should depend on individual performance is still a well-established belief.

<table>
<thead>
<tr>
<th>Performance Rating</th>
<th>Compa-Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Outstanding</td>
<td>1.01–1.20</td>
</tr>
<tr>
<td>4 Above expected</td>
<td>1.11–1.20</td>
</tr>
<tr>
<td>3 Meets expectations</td>
<td>1.05–1.10</td>
</tr>
<tr>
<td>2 Marginal</td>
<td>1.00–1.05</td>
</tr>
<tr>
<td>1 Unacceptable</td>
<td>0.90–1.00</td>
</tr>
</tbody>
</table>

Table 10.2. Merit Matrix Model.

ALTERNATIVES TO TRADITIONAL MERIT PAY POLICIES

Several new merit pay concepts have been introduced in the past few years. The intent of most is to strengthen the linkage between performance and pay increases. One idea that fits the government environment is to establish a separate budget line to be used only for increases for outstanding employees. The amount may be only 1 percent or less of aggregate salaries; the balance of the normal merit budget is available for general increases or for more evenly distributed merit awards for other employees. The objective is to reduce the zero-sum aspects of the typical merit policy. When structured as a separate budgeted amount, granting large increases to better performers does not mean taking money away from individuals whose performance is more modest.

Perhaps the most widely used alternative is to cap salary increases at the former range midpoint. If the midpoint is close to the market
average, this makes it possible to progress to the going rate but with further increases possible only when the midpoint and the cap are adjusted. Some organizations provide for lump sum increases once an employee reaches the cap.

Lump sum increases can be used with any merit pay policy. An often unexpected benefit to this is that supervisors seem more comfortable making large lump sum payments than in adding the same dollar amount to an individual’s salary. The reason may be that an implied message goes along with lump sum: the employee has to earn the amount again next year because it is not an annuity that will come automatically until retirement or termination. Regardless of how the lump sum payments are structured, they serve to hold down fixed costs and future payrolls.

An idea that may work in lieu of standard merit increases is the use of lump-sum award opportunities for high performers. In an environment where there is inadequate support for merit pay it may make sense to introduce a self-nomination policy under which an employee can announce the intent at the beginning of the year to accomplish something beyond the norm within the work group. Self-nomination makes it difficult for employees to blame anyone but themselves if they are not considered for awards at year’s end. The selection of individuals for awards can be delegated to an employee task force that would need to evaluate the track record of individuals within their department. If each department has its own budget for this purpose (perhaps 0.5 percent of the department’s payroll), department heads can structure the process and the award criteria to meet their own needs. For example, one department head might want to reward all the members of a team or teams at year’s end; another might prefer making quarterly awards to only outstanding employees. This concept makes the award mechanism a tool that can be managed within the department, not just another personnel system.

PROBLEMS WITH MERIT PAY

Undoubtedly the most prominent critic of merit pay was W. Edwards Deming. He focused on the linkage between performance appraisal and merit salary increases, proclaiming it to be among the deadly diseases of management. To Deming’s way of thinking, this linkage creates several problems:

- It destroys teamwork because most appraisal systems and merit increases depend exclusively on individual performance.
- It implicitly encourages mediocrity by rewarding employees for meeting but often not exceeding performance expectations.
- It creates an incentive to improve short-term performance and effectively deemphasizes longer-term issues.
- The zero-sum aspect of the typical merit policy generates counterproductive competition for salary increase funds.

These criticisms have not prompted many corporations to terminate merit pay, but they have created a high level of interest in new ideas and variations on the traditional policies that are more compatible with Deming’s thinking. The shift to skill- or competency-based pay, with its future orientation, is one idea prompted in part as a response to Deming, as was the move to three-level rating scales. The 360-degree appraisal system is also more compatible with his philosophy than the conventional approach. Deming did not have a meaningful alternative for organizations that wanted to follow his teachings, but he has had a significant impact on the way organizations think about merit pay.

Salary programs send important messages to employees about management’s priorities and expectations, and the messages flowing from a time-in-grade policy clearly do not provide an incentive for improved performance. However, merit pay practices can also result in counterproductive messages, as Deming argues. For example, when completing the appraisal form is little more than a fifteen-minute compliance task at the end of the year, it sends clear messages about the importance of performance management. The problem is not, however, inherent in the concept of performance management; rather it is evidence of management’s priorities and lack of concern with performance improvement. An analysis of the messages is often a useful first step in assessing the effectiveness of these practices.

Conventional merit increases compound over time (that is to say, each year’s increases are calculated as a percentage of the prior year’s salary). Although it is not widely understood, the conventional concept effectively rewards employees for last year’s experience for as long as the worker is actively employed and even into retirement. The difference in the increase for an outstanding employee and an average
employee might only be 3 percent, but over a period of years the difference adds up. For an employee whose base salary is initially $20,000, a 3 percent differential received for outstanding performance translates into an extra $9,000 over 15 years, even if no further increases are received. If further increases do come, they are calculated against the larger base; furthermore, because the worker's final pay at retirement usually is used to calculate the pension amount, the impact of that 3 percent differential increase lasts long past retirement. If the worker could see the total difference in earnings over all payments through the final pension check, it would provide a strong incentive to secure the outstanding rating.

This, of course, is also a problem with automatic increase models: long-service employees are paid more than those with short service. With compounding, any criterion that drives pay increases over time will result in significant differentials. When organizations shift to a more performance-oriented philosophy, it raises questions about differentials related to job tenure.

Realistically, there is enough question about the use of rating scales to be concerned about equity. Research evidence shows that raters can agree on who deserves to be rated as outstanding—typically 15 to 20 percent of the workers in an organization—and those who are performance problems—less than 5 percent of the typical workforce. The problem is with the people in between. Supervisors do not always agree on who deserves to be rated 3 or 4; some would rate an employee a 3 while others would categorize the same person as a 4. When those differences of opinion are factored into increases and the increases are compounded each year, it can and should be a cause of concern.

None of these problems, however, sufficiently justifies the termination of merit pay. Falling back on traditional tenure-based salary increases is simple to do, but in the current environment it would clearly send the wrong message. Moreover, the consequences to the organization are serious: inevitably employers who continue to rely on step-in-grade or similar policies are going to have problems caused by feelings of entitlement among employees and growing resistance among voters. Certainly it is difficult to maintain an effective performance management and merit pay policy, but the problems can be overcome, and the argument for some form of merit pay is difficult to deny.

THE ROLE OF NONCASH REWARDS

Organizational rewards are surprisingly diverse. They range from a simple pat on the back or smile from a supervisor to special privileges to public recognition that can take almost any form. The new classic book In Search of Excellence includes frequent references to company practices that publicly recognize examples of outstanding performance. One organization cited in the book rewarded outstanding workers with a golden banana carved out of wood.

The ceremonial occasions can become hokey and may become a focus of derisive comments, but if employees are offered the choice between a hokey ceremony or no recognition of commendable performance, they will typically choose the ceremony. People enjoy ceremonial occasions; they like to have fun and socialize with coworkers. They also like to be involved with and take part in events that recognize the successes of their friends.

People want to make a contribution to their work group's success, and they want to have that contribution recognized. They want to feel they will benefit from their efforts. They start their government careers with high aspirations; many have a strong commitment to public service. Employees do not start their careers with the goal of being marginal performers! If motivation is a problem, it is typically related to a failure to reinforce the importance of good performance. This represents both a challenge and an opportunity for the organization.

A key is for supervisors to make a concerted effort to monitor performance and to regularly initiate some form of recognition to reward good performers. The form of the reward is decidedly less important than the act of recognition. Some organizations use dining or merchandise certificates; others use extra time off. Whatever the form or value, it is important to set aside equivalent funds for each department and to make sure the funds are used for this purpose.

Too often supervisors are not comfortable with selecting recipients for special awards. Where this is so, it may make sense to delegate the selection to a group of coworkers; they generally will take the task quite seriously. Another common problem is that supervisors may decide that saving award money will benefit them. They need to appreciate that the intent is to reinforce commendable performance and that short-sightedly saving the few dollars devoted to it kills any
potential for improvement. It may be necessary to require the full allocation of budgeted increase funds.

IBM used to create policies and practices that had an underlying intent to make as many plan participants as possible feel like winners. Rather than having one employee of the month, it recognized or made special awards to quite a few employees. Every employee would like to feel like a winner. If the awards have a nominal dollar value, the benefit to the organization in terms of employee reaction undoubtedly offsets the cost.

A noncash reward alternative from the culture of another not-for-profit sector, health care, is the practice of allowing employees who contribute to the organization to help design further improvements. Just as outsiders who make sizable donations get a plaque on the wall or other forms of recognition, employees or teams who identify ways to reduce expenses or develop improved work systems create value that is worth as much as a donation and thus warrants the same level of recognition. It may make sense to give the employee or team some input into how a portion of the savings might be spent to improve the individual's or the department's equipment or work area. Perhaps half of the savings could be spent for new computer equipment, for example. This may not be as motivating as a true gainsharing payout, but most employees will certainly react very positively to the recognition.

BUILDING ORGANIZATIONAL SUPPORT FOR MERIT PAY

The shift to merit pay represents a significant organizational change and should be planned for as such. It is doomed if rolled out as a simple change in policy. The planning needs to account for all major stakeholders and to anticipate the sources of opposition to the change. The actual implementation will require two or more years to build support, give supervisors the skills needed to make the decisions, manage concerns such as performance management, and possibly pilot test the new program.

One of the earliest steps is to obtain goal agreement at the highest possible level. Gaining consensus or, if that is impossible, getting all objections on the table may well be the most important step in the process. The consensus also needs to cover the problems with current policies or systems that are prompting the change. These discussions may represent a political statement if they start, as they most often do, in an early period of a new administration. Unfortunately, political considerations may turn this into a motherhood-and-apple-pie argument that makes it difficult to define problems and goals in the specific terms necessary to best communicate expectations and plans.

If the impetus for change arises from a political goal to shake up the bureaucracy and thus gain political advantage, the suggested new policy may quickly develop a very negative reputation in the governmental agencies. This will almost certainly cause it to fall lip service may be granted to the new policy at senior civil service levels, but managers and their subordinates are going to resist the real impact of the change, if only subtly. Before they give it the support needed to make it work, they have to see a practical benefit to their agency.

Building support necessarily has to include estimates of the cost and time needed to get the new system up and running, including the full cost of related steps such as supervisory training. These analyses could conclude that there is no direct cost in terms of additional dollar outlays; instead the new policy might result in a reallocation of budgeted funds. It is critically important that these facts be understood.

The change cannot realistically be planned behind closed doors; that could doom it even before initial approval. The level of trust of both senior administrators and supervisors has to remain high at all times, which means a communication strategy should be one of the first considerations. It may be important to hold open meetings so that there is a forum for debate. And as the conclusions reached in these sessions will get to the workforce anyway—the grapevine will make sure of that—it makes sense to manage the communications to ensure that the information is accurate.

Still, there is a definite need for certain high-level closed-door planning sessions. When federal pay reform was being planned in 1988 and 1989, Connie Newman, director of the Office of Personnel Management in the Bush administration, held open task force meetings with presentations by numerous stakeholders and experts. At the same time she conducted closed-door strategy discussions that, when the planned changes were ready to be submitted for congressional approval, shifted to senator-by-senator and representative-by-representative discussions of what was needed to gain these individuals' votes.

The adage about getting everyone on the bandwagon as early as possible applies here. It will undoubtedly prove to be impossible to
co-opt all stakeholders, but the planning process should at least try to
minimize their ability to shoot down the change. One way is to involve
them in the planning. There is no inherent reason to exclude anyone
at the planning stage; all stakeholders and interest groups should have
an opportunity to state their arguments. At the very least this makes
it easier to understand the strength of the opposition. If they have an
opportunity for input, it may provide valuable insight to the nuances
that may determine the policy's success or failure. Merit pay in par-
ticular can generate strong emotions, and people need the chance to
express them.

Other strategies to get people on board are to conduct an initial
test or demonstration study involving selected work groups or to
manage the new process for the first year or so without linkage to the
pay program (that is to say, salary increases would still be granted
under the old policy). The purpose of both is the same: to iron out
any problems and to provide a showcase where stakeholders can see
how the policy will affect subgroups of employees. This should help
alleviate anxiety.

When the combination of step increases and range adjustment
increases is compared with the typical merit budget in the private sec-
tor, it will probably show that the increases received from public pro-
grams are reasonably competitive. (This is not to suggest that actual
salary levels for public employees are fully competitive.) Thus only a
couple of poor performers can expect to lose under a merit pay policy. Once
employees understand and believe this, they may be more willing to
acquiesce to the new policy.

**MERIT PAY EVALUATION**

When an organization establishes a merit pay program, it is impor-
tant to evaluate its outcomes to determine how effective the program
has been and how it can be strengthened. Ideally, the evaluation
approach should be established during the program design phase and
be tied to the program goals.

Two aspects should be evaluated. The first part of the evaluation
should cover the workings of the program. At the least, this part of the
evaluation should answer the following questions:

- Are the performance measures linked to organizational and unit
goals?
- Do employees who perform at higher levels get larger increases
  (it may be necessary to take into account place in range or
  compa-ratio here.)
- Are program schedules followed?

The second part of the evaluation should cover other important issues,
including the following:

- Does the system signal to employees important organizational,
  unit, and individual behaviors and outcomes?
- Do employees understand the system and accept it as fair?
- Have employee behaviors changed along the lines intended?
  (That is, have individual performance improved?)
- Has organization and unit performance improved?
- Does the value of the increased performance exceed the costs of
  the program?

**SUMMARY**

The most likely private sector incentive practice is to gain wide ac-
ceptance in public sector organizations is merit pay, and in fact many
public organizations already have some form of it in place for at least
some employees. In spite of insufficient merit budgets, inadequate per-
formance measures, lack of a good performance management system,
and the tendency of many managers to use merit pay to reward things
other than performance, most corporations rely primarily on merit
pay systems to align the behaviors of employees with organizational
goals and to reward performance.

There is risk in moving to merit pay; it can be disruptive and
adversely affect employer-employee relations for several years. But
there is no inherent reason to expect that, nor to avoid the change
because of the possibility. When the transition is planned and man-
aged successfully, agencies stand to benefit, and high performers—the
ones who should be recognized under any circumstances—will begin
to believe that their efforts are appreciated. Other employees may decide that the potential payoff for extra effort is warranted.

Notes

CHAPTER ELEVEN

Gainsharing in Government
Group-Based Performance
Pay for Public Employees

Ronald P. Sanders

Think about the ideal compensation strategy, one that energizes and engages employees, focuses them on bettering the bottom-line performance of the organization, and links at least part of their pay directly to that performance. Such a strategy brings a work group together as a team, mobilizes its members to increase productivity and improve quality, and encourages them to motivate and manage themselves toward that end—without the destructive competition that often accompanies other forms of merit-based pay. Does this ideal exist? It may, in the form of something called productivity gainsharing (PGS), a compensation strategy that rewards employees on the basis of the productivity of their work group.

Gainsharing quite literally shares the tangible monetary results of productivity increases with the employees who achieve them, a classic example of the kind of strategic pay that focuses and aligns individual efforts in furtherance of the organization's bottom line. Though gainsharing has been around for decades in the private sector (where it goes by other names as well: Scanlon, Improware, and others), it has not been widely embraced by public employers, its