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Review of Public Personnel Administration 1986; 7; 57
DOI: 10.1177/0734371X8600700105

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MERIT PAY IN THE PUBLIC SECTOR: THE CASE FOR A FAILURE OF THEORY

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ABSTRACT

Contingent pay has become very popular in response to criticisms of traditional pay policies in government. The new systems, however, have generally failed to increase productivity. Although many scholars have attributed failures of merit pay to poor implementation or weak top management commitment, an alternative explanation is that the theory on which merit pay is based is flawed. It is argued here that merit pay is not appropriate for managerial work, imposes excessive information demands on an organization, and diminishes an organization's ability to coordinate interdependencies.

INTRODUCTION

Merit pay has had a long history in the U.S. civil service. Graduated pay systems were introduced in the federal civil service shortly after passage of the Pendleton Act (Van Riper, 1958). Step-in-grade systems enjoyed widespread popularity among all levels of government until the 1970s when they came under increasing attack (see, e.g., Patton, 1974; Savas and Ginsburg, 1973). They were criticized for being automatic and for failing to differentiate employee rewards based upon performance. These shortcomings led to a search for alternatives that resulted in the merit pay provisions of the federal Civil Service Reform Act of 1978 (CSRA) (Hunter and Silverman, 1980; Perry et al., 1982) and similar reforms in a variety of states and localities (Griener et al., 1981).

The CSRA pay reforms were short-lived. In 1984, Congress approved the Performance Management and Recognition Act (also known as the Merit Pay Improvement Act) to correct a litany of problems in the CSRA systems. Among the problems were inadequate funding, pay inequities and ratings manipulation. The 1984 law restored the step-in-grade feature of the old system and instituted a new bonus program to reward performance.

Despite the recent rocky experience with merit pay, there is no indication that it has become less popular with political leaders or the public. The Reagan administration recently has introduced legislation to extend pay-for-performance principles to Grades 1-12 of the General Schedule (Public Administration Times, 1986:1). The reported failures of public-sector systems and the undaunted
response of politicians to merit-pay experience parallels reactions to the failure of such systems in the private sector. Failures of merit pay in private sector organizations have variously been attributed to a lack of commitment to pay for performance (Patton, 1972; Redling, 1981), problems encountered when implementing the theory (Hamner, 1975), or poor judgments which resulted in applying contingent pay to inappropriate situations (Lawler, 1981; Patton, 1972; Ungson and Steers, 1984).

The prospect that merit pay failures are a sign of problems fundamental to the underlying theory has been explored by only a few scholars. Deci (1975) has argued that money is an ineffective motivator because it relies upon extrinsic rewards and, therefore, stifles intrinsic motivation. The ultimate result of diminished intrinsic motivation is to remove the most powerful and enduring motivators. Meyer (1975) has contended that merit pay damages employee self esteem. He concluded that an incentive system that lowers an employee's self esteem is more destructive than constructive.

In addition to these potential threats to merit pay, which are grounded in alternative theories about its psychology, there is another theoretical basis for questioning the viability of merit pay. Pay-for-individual performance is based on the assumption that organizational performance is the simple additive combination of individuals' separate performances. Yet theorists note that organizations are intricate social environments that cannot be understood as simple aggregations of employees. Therefore, a mismatch exists between the simplicity inherent in merit pay programs and the complexities of organizations (Pearce, in press). This mismatch is at the root of many of merit pay's failures.

This article develops a critique of merit pay theory as it has been applied to government. At the outset, it is important to identify the scope of our theoretical critique. The focus is individually-contingent pay for public managers, what will be called pay-for-individual-performance or, simply, merit pay. The critique is not intended to apply to group-contingent pay or to non-managerial employees. The article begins with a brief discussion of the psychological theory that is the rationale for merit pay. An alternative theoretical framework is then presented for understanding the dynamics of pay-for-individual-performance in an organizational context. The predictions of this theoretical framework are discussed in light of research on merit pay in the public sector.

THE THEORY BEHIND PAY-FOR-INDIVIDUAL-PERFORMANCE

Lawler (1971; 1981) developed the first and probably most compelling theoretical argument for the motivating potential of individually-contingent compensation. His psychological model of pay is based on Vroom's (1964) cognitive theory of motivation. Lawler (1971) argued that pay acquires a valence or importance as a function of its perceived instrumentality for obtaining other desired outcomes. Pay is probably one of the most powerful rewards that organizations can offer: "Because it is important to most people, pay has the power to influence their membership behavior and their performance" (Lawler, 1981:5).
Because pay can be an attractive reward, it is assumed to motivate members' actions more effectively if it is made contingent on those actions. Using the expectancy theory argument, Lawler (1971; 1981) noted that individually-contingent pay plans tie a presumably valuable reward (pay) directly to an individual's performance and, therefore, should result in a high subjective probability that performance will result in receipt of the valued outcome. Thus, a powerful motivational effect will result when pay is based on individual job performance.

Although research on the effects of pay-for-performance has usually lacked methodological rigor and has concentrated almost exclusively on routine, non-managerial jobs, it generally indicates that contingent pay results in higher performance than non-contingent pay. Reports of improvements in individuals' productivity range from 12.2% (Roethlisberger and Dickson, 1939), to 30% (Locke, et al., 1980), to 39% (Vitellese, 1953). Based on a comprehensive review of prior research, Lawler (1971) concluded that individual incentive plans can potentially increase individuals' productivity between 10 to 20 percent.

Not all scholars contend that pay-for-individual-performance results in improved productivity. Research by Deci (1975) and Meyer (1975) is among the most critical. Deci conducted a series of laboratory studies on the effects of external-mediated rewards, such as pay, on subjects' intrinsic motivation. He concluded that contingent pay is undesirable because it reduces intrinsic motivation and leads individuals to develop strategies to achieve rewards with minimum effort. Meyer (1975) argued that most employees have a highly favorable self image, but that the feedback implicit in merit pay awards undercuts this self image. The effect is to damage employee self esteem, a factor important in individual and organizational productivity.

Lawler also acknowledges that merit pay is subject to negative side effects, including the restriction of output and conflict among employees working on interdependent tasks. Bass, Hurder and Ellis (reported in Bass, 1965) found that individual monetary incentives resulted in increased performance by those engaged in a simple task, but decreased performance on a more complex one. Bass (1965) suggested that these subjects were already motivated and the addition of financial incentives resulted in a motivational level that was so high that it interfered with performance on the complex task. Similar results are reported by Konovsky and Podsakoff (1984) who found that individual incentives had no impact on performance on an interdependent laboratory task, and that contingent pay actually decreased performance on a task in which subjects' performances were interdependent.

Only one field study has been conducted on the performance consequences of individually-contingent managerial pay. Pearce, Stevenson and Perry (1985) tested the performance effects of the introduction of merit pay for federal managers. The performance measure included four indicators of the productivity of the offices for which these managers were responsible. Productivity measures were available two years before the commencement of merit pay and for the first two years that managers' merit increases were based on these per-
formance measures. They found that office productivity gradually improved over the four-year period, but that the merit pay intervention did not result in a significant change in this trend. Thus, merit pay did not result in improved performance.

The generally favorable reactions merit pay has elicited from senior executives and politicians have impeded its critical assessment. The evidence about the limitations of merit pay presented above hints that its failures represent more than faulty implementation and, in fact, may reflect shortcomings of theories of individual motivation in complex organizations. A theoretical framework which helps to explain the frequent failures of pay-for-individual-performance is developed below.

AN ALTERNATIVE THEORETICAL PERSPECTIVE

A series of theoretical statements which explain merit pay failure in government organizations is presented in Figure 1. It is necessary to begin with some initial premises or axioms about organizations, managerial behavior and managerial jobs to explain the reasoning behind this set of theoretical linkages. The first premise is that public organizations are systems of cooperative activity which are chartered to act for some common interests. As a system of cooperative activity (Barnard, 1938), a range of participants (e.g., employees, managers, suppliers and clients) contract with the organization, both implicitly and explicitly, to exchange their contributions (e.g., expertise, time, loyalty) for inducements the organization offers (March and Simon, 1958). The inducements an organization offers for members’ contributions are likely to vary among categories of participants.

Another premise underlying the theoretical statements is that managerial jobs are characterized by complexity and uncertainty, resulting from the nature of the work performed (Doeringer and Piore, 1971; Mintzberg, 1973; Williamson, 1975). Mintzberg (1973) found that managerial activities were characterized by brevity, variety and discontinuity, indicative of the uncertainty and complexity of managerial work. By their very nature, managerial positions are designed to absorb uncertainty. The scope of managerial work requires a wide range of specific skills that enhances the idiosyncratic nature of managerial jobs. Furthermore, the problems created by uncertainty/complexity cannot be completely mitigated because a manager’s rationality is bound by knowledge, skill and time limitations (Simon, 1957).

The premises above are implicit in the theoretical relationships identified in Figure 1. The figure indicates that any one of three conditions — invalid contracts, information failure or diminished capacity to coordinate interdependence — are sufficient to produce merit pay failure. These three conditions and how they come about are discussed below.

IMPRACTICALITY OF FIXED CONTRACTS

Simon (1957) has argued that open-ended employment contracts allow
FIGURE 1
A Model of the Sources of Merit Pay Failure in Government Organizations

Uncertainty of Managerial Work

Difficulty of Specifying Performance Criteria

Complex Performance Contracts

Information Failure

Excessive Paperwork

Demand for Accountability

Rationalization of Self-Interested Behavior

Requirement of the Merit Pay System for Operational Criteria

Focus on Subgoals

Selective Perception

Failure to Adapt to Changed Environmental Circumstances

Arbitrary Definition of Performance

Invalid Contract

Merit Pay Failure

Diminished Capacity to Coordinate Interdependence

Perceived Violation of Equity Norms

Change in Employee Attachments from Normative (Values) to Remunerative (Money)

Payouts

Norms Among Members of the Organizational Coalition

Complexity of Managerial Work

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organizations the flexibility to respond to future uncertainty. Open-ended contracts permit employers to call upon the undifferentiated time of employees. Given this flexibility, organizations are ideally situated to respond to uncertainty.

Merit pay involves a significant restriction of an organization's flexibility. The fixed-performance contracts characteristic of merit pay, such as those developed under the Civil Service Reform Act of 1978 (CSRA), are difficult to adapt to changing internal and external circumstances. Williamson (1975) contends that fixed contracts are rigid and completely unsuited for circumstances characterized by uncertainty, a condition that is typical for managerial work, particularly in the public sector. If managerial performance requirements are indeed uncertain, fixed contracts restrict the ability of managers to respond to changes. These contracts can, at best, cover only a portion of desired actions, and, therefore, are artificial representations of the kind of performance that would be most effective for an organization. A related and equally serious liability of fixed contracts is that they discourage deviations from performance agreements even when such deviations may be necessary or appropriate (O'Toole and Churchill, 1982).

Experience in the federal government illustrates the artificiality of fixed contracts. For example, Social Security Administration field offices experienced significant disruptions because of efforts to develop objective performance indicators such as processing time (Pearce and Perry, 1983). Although this is a very specific illustration of the artificiality of fixed-performance contracts, it was not an isolated instance of the difficulty of writing performance contracts under CSRA. The General Accounting Office (United States General Accounting Office, 1984b) found in a two-year study of three agencies that despite the legal requirement that performance appraisals rely on objective criteria, less than half the performance standards contained objective measures.

Despite the very real limitations of fixed contracts, many organizations behave as if these shortcomings can be overcome by establishing elaborate control systems which are used to write comprehensive contracts for their managers. Reports about the consequences of such contracts have largely been anecdotal, but they do not appear to remedy, and perhaps exacerbate, performance management problems. For example, one of the side effects of CSRA-mandated merit pay was an estimated billion dollars for operating costs in the first year (Harron, 1981), partly attributable to supervisory effort in developing elaborate performance agreements. Federal agencies consistently reported excessive paperwork as a result of merit-pay performance appraisals (Perry and Porter, 1980).

Although it may be impossible to predict future states of affairs given uncertainty/complexity and, therefore, to write adequate fixed contracts, it is conceivable that such contracts could be re-written periodically to reflect new circumstances. This strategy also imposes significant costs on managers. The costs of re-writing the contract and re-formulating the pay-for-performance linkage are likely to be prohibitive, particularly if change is rapid. GAO reports (United States General Accounting Office, 1984a) that in 1982 the responsibilities of 20% of federal senior executives changed during the rating period, but a ma-
majority (55%) did not have their plans revised. Thus, the contracts of more than 10% of senior executives, and probably a much larger proportion of subordinates reporting to them who were covered by merit pay, were invalid simply because they were not updated.

As an alternative to re-writing the contract, individually-contingent pay programs are frequently adapted to uncertainty by combining subjective and objective measures (Lawler, 1981). This adaptation helps to preserve flexibility, but it has other consequences for pay-for-performance. For example, Carroll and Schneier (1982) note that the more subjective the rating criterion, the more rater judgment is required not only regarding the degree to which the ratee meets the criterion, but also regarding what the measure actually means. The combination of objective and subjective measures is probably an unreliable solution to the performance measurement problem in government. Public sector performance environments are likely to impose severe strain on a manager's ability to make successful subjective determinations because of real or perceived concerns about politicization (Pagano, 1985).

INFORMATION FAILURE

Fixed contracts are not only likely to be invalid when applied to managerial work, but the information that is the rationale for fixed-contracts is likely to be a focus for manipulation. The manipulability of information could occur under several circumstances which are inherent in the situation. A supervisor's lack of expertise in a subordinate's job content or difficulty obtaining feedback about a subordinate's performance could permit a subordinate to withhold negative information or pass along positive information, thereby enhancing the subordinate's evaluation. For instance, a subordinate's attempt to beat the appraisal system by seeking an easy contract, reportedly a problem encountered in both federal (O'Toole and Churchill, 1982) and local (Griener, et al., 1981) merit pay systems, is possible when there is unequal information between superior and subordinate. Performance measurement and occupational characteristics of the public sector context (Perry and Porter, 1982) tend to increase the probability of such information asymmetries occurring.

Merit pay exacerbates the tendency of individuals to adhere to subgoals which, in turn, reinforces the problems of information acquisition discussed above. Merit pay tacitly legitimizes self-interested behavior by defining performance in terms of organization subgoals. According to March and Simon (1958), individuals tend to adhere to these subgoals, even when the goals conflict with those of the larger organization, because of selective perception and rationalization. These processes could produce situations in which a subordinate shirks non-contractual obligations or challenges a superior's interpretation of the contract.

When a manager perceives that it is necessary to deviate from the contract and act in accordance with a broader conception of organizational good, he or she incurs the risk of going unrewarded even when the manager perceives that the spirit of the contract has been satisfied. This appears to be precisely
how many public managers have responded. A widespread result of CSRA performance appraisals (Gaertner and Gaertner, 1985; Pearce and Perry, 1983; United States Merit Systems Protection Board, 1981) were systems that employees simultaneously rated "accurate" and "fair," but not "helpful" or conducive to "improved agency effectiveness." Managers acquired a clearer understanding of the criteria on which they were judged, but were not convinced that the criteria were the best ones to promote improved performance or agency effectiveness. One can only infer that one reason the original CSRA merit pay system failed was the decision of many managers to maximize their personal development or agency effectiveness rather than their appraised performance.

Another result of information problems is that supervisors may not closely tie pay to individually-measured performance because they are unable to judge definitively the relative contributions of employees given the limitations of performance appraisals. The difficulty of making definitive judgments about performance is particularly true for managerial jobs. The small numbers of managerial positions (Williamson, 1975) and the uniqueness of managerial jobs increase the power of managers to control the assessments levied by significant others (Thompson, 1967). This phenomenon helps to explain why raters tend to minimize differentials in rated performance and to inflate ratings (see, e.g., Gaertner and Gaertner, 1984), thus limiting the strength of pay-for-performance relationships. The propensity to minimize appraisal differentials is likely to be reinforced because supervisors bear a large part of the cost, in terms of information acquisition and interpersonal conflict, of justifying performance appraisal decisions to their subordinates.

REDUCTION OF COORDINATION

Individual performance contracts will diminish coordination by altering patterns of interdependence among organizational members. Coordination problems originate with individual performance contracts and their attention to organizational subgoals. The subgoal focus is a necessary pre-condition for linking pay to performance because of the need to hold managers responsible for results within their control (March and Simon, 1958). The focus on subgoals, however, tends to undermine the organization as a unit of cooperative activity by undermining interdependencies among organizational members.

Thompson (1967) identified three types of interdependence, pooled, sequential, and reciprocal, which, he asserted, represented ascending complexity and coordination requirements. Pooled interdependence is the dependence of each segment of the organization on the others for the well-being of the organization. Sequential interdependence involves situations in which a part of the organization depends upon another for supply of inputs, for disposal of outputs or both. Finally, reciprocal interdependence involves situations in which each unit poses a contingency for the other.

Field and laboratory research have documented the detrimental effects of merit pay upon sequential (Babchuk and Goode, 1951; Whyte, 1955) and reciprocal
interdependence (Miller and Hamblin, 1963), the two most complex forms. The detrimental effects of merit pay in the public sector involve pooled interdependence as well. Merit pay undermines pooled interdependence in public organizations in at least two ways: (1) by altering an individual's attachment to the organization and (2) by creating conflicts or inequities among segments of the organization coalition.

Merit pay systems undermine involvement because they treat the manager as a labor contractor and undermine the flexibility of traditional authority relations (Barnard, 1938; Simon, 1957). Such contracts communicate that the organization is only concerned with the employee's performance as it is reflected in the contract measures. In effect, organizations signal indifference to past contributions and to any extenuating circumstances that may have influenced the recent performance measures. Employees come to focus on the pay delivery and performance measurement system rather than the organization's tasks or mission.

This contention is supported by an assessment of merit pay for federal managers. CSRA required that managerial performance contracts be drawn up before the performance period, and that half of the money made available for raises be tied directly to rated individual managerial performance. Pearce and Porter (1986) reported the effects of this new pay and performance measurement system for federal managers and employees at two agencies. They divided their sample into those who received "outstanding" and "above average" ratings (55%) and those who received "fully successful" (45%) ratings. They found that whereas the organizational commitment of the relatively highly rated managers was stable over the 30-month period, the commitment of the "average" managers dropped significantly after their first merit rating and remained at this reduced level when retested a year later in both of these agencies. Their findings indicate that merit pay significantly reduced the psychological attachments of a large subgroup of satisfactory performers.

Additional evidence of the potential for merit pay to alter pooled dependence is provided by Perry and Pearce (1985) who traced how CSRA has led to a proliferation of new interest groups. The primary purpose of these new groups is the protection of members (e.g., merit pay managers, senior executives) whose employment status was modified by CSRA. The most prominent of these groups, the Senior Executive Association (SEA), sued for restoration of bonuses to original statutory levels after Congress reduced eligibility for bonuses in the summer of 1980 from a maximum of 50 percent of Senior Executive Service (SES) positions to a maximum of 20 percent. The development of SEA and the subsequent suit vividly illustrate how pay-for-performance can alter the focus of employee attachments from the organization's mission to the pay delivery system.

Merit pay also affects pooled interdependence through its influence upon organizational climate (James and Jones, 1974) or atmosphere (Williamson, 1975). Climate and atmosphere are concepts that explain linkages between a specific transaction and attitudes that have broader organizational consequences.
The relevance of these concepts to the relationship between merit pay and pooled interdependence arises from the fact that inducements for some members of an organization are primarily remunerative and for others are primarily social or moral. Within government such variations are quite common. Nevertheless, expectations among participants about appropriate rewards for other participants are likely to have significant attitudinal implications. For example, taxpayers may have a great deal of difficulty accepting large contingent financial rewards for government managers because they perceive such rewards as "squandering their taxes."

Attitudes of other groups within the organizational coalition may operate in a pre-emptive fashion by influencing the design of merit pay systems. The result is often a design compromise that radically diminishes the probability for merit pay success. A dramatic illustration of this process occurred during the implementation of CSRA merit pay systems. Congress imposed a cap on merit pay funding because of the political sensitivity of federal pay levels. OPM developed a merit-pay-funding formula which liberally interpreted congressional intent. Simulations of the system indicated that few employees would be worse off and most would be better off (Hunter and Silverman, 1980). Agency and employee reaction to these simulations was favorable, primarily because of OPM's liberal assumptions about the payout formula. However, GAO forced OPM to rescind its formula in favor of one awarding less money shortly before the first payout because the OPM formula did not adhere to the "no-new-money" limitation in the statute. It is important to remember that, although this particular episode has been labeled an "implementation problem" by many (see, e.g., Pearce and Perry, 1983; Silverman, 1983), the OPM-GAO controversy originated because of statutory language which represented prevailing norms about appropriate reward levels for federal managers.

CONCLUSION

This article has presented a theoretical view of why merit pay has failed in many public organizations. It was argued that three conditions, i.e., invalid contracts, information failure, and diminished coordination, prevent contingent pay from contributing to improved organizational performance. The theoretical framework is useful for understanding implementation problems that accompany pay-for-performance. Such problems are, in fact, inherent in this form of motivational program in government programs.

An issue related to this analysis is whether pay-for-group-performance would fare better in light of the theory we have presented. It is quite obvious that some of the limitations of pay-for-performance are common to both individual and group programs, particularly the problem of specifying a performance contract. However, group incentives may affect individual behavior and allocate the costs of information acquisition differently than do individual incentives, thereby producing different outcomes. The relative effectiveness of individual versus group incentives clearly deserves further research.
The present analysis does not refute the instrumental value of pay as a motivator. Pay is undoubtedly a primary consideration in an individual’s decision to join an organization and perform on its behalf (Nash and Carroll, 1975; Ellig, 1982; Wallace and Fay, 1983). Although there is evidence that individuals entering public organizations are relatively less motivated by money than their private sector counterparts (Rawls et al., 1975), pay remains a significant factor in employee motivation. An organization’s compensation system conveys a variety of signals to current and potential employees, including information about its fairness, the rewards for long-term loyalty and performance, and its labor market competitiveness. All of these factors are relevant to performance in organizations. The arguments in this paper suggest that also requiring a public organization’s compensation system to harness pay for motivating short-term managerial performance is not realistic.

NOTES

1 This paper grows out of my collaboration with Jone Pearce. My thanks to her for permitting me to borrow liberally from her ideas. See Pearce, in press.

2 The use of the term premises follows Hage (1972). Premises are very general assumptions that help to explain why a particular theoretical relationship occurs.

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