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Compensation and Benefits

Pay for Performance: A Public Sector Puzzle

By Dick Grote

True or false: Good workers should get paid better than bad workers.

Sounds simple, doesn't it? But the apparently obvious concept that those who do better work should receive better pay underlies one of the most puzzling public sector performance management issues: the notion of pay for performance.

In the private sector, the pay for performance issue has been settled for years. With few exceptions, companies accept as a given the idea that along with measuring and evaluating the quality of the widgets you produce, you also need to measure the quality of the widget-maker. Only a few private sector organizations would take the position that longevity correlates precisely with performance, as many municipalities and state agencies seem to do as judged by their compensation programs.

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Our Pay System is *Out of Whack*: How to Get it Back *Into Whack*

By James Fox and Bruce Lawson

With all of the public sector organizations that we talk to each year, the most popular reason for hiring a compensation consultant seems to be because their compensation system is "out of whack." While we never really understood what that meant, being such literary geniuses that we are, we figured it was not good. And the reason they hired us was to get their system back "into whack."

As silly sounding as the problem of an "out of whack" system is, it was even sillier to think of what a system would be like if the system was "in whack," since we had never heard anyone describe their system that way. In fact, we wondered if there were degrees of "whackiness" that could be measured. Could a system be slightly whacked, seriously whacked or totally whacked? Would the opposite be perfectly whacked? Or wonderfully whacked? And would a system that is really whacked be a good or bad thing?

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Inside this Issue

This month's issue focuses on compensation and benefits. Inside, you'll find articles on pay for performance, and about benefits and how they can help in the recruitment process while at the same time helping to retain employees. You'll also read about how one agency is benefiting from the revisions to its sick leave program.

Also this month, read about the 18th Annual Major City/County Human Resource Managers' Meeting, about the keynote speakers for the 2007 IPMA-HR International Training Conference, and about the call for applications for the IPMA-HR Graduate Study Fellowship and Scholarship. Nominations are also now being accepted for the Stockberger Achievement Award Honorary Life Membership and Agency Awards for Excellence.

Pay for Performance

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Trading Effort for Dollars

The relationship between employer and employee can be viewed in its most simple form as an exchange relationship: Employees trade their time and talent for organizational rewards.

Most organizations, public or private, primarily subscribe to the *reward equity* norm. According to this theory, rewards should be allocated in proportion to contributions: those who contribute the most should get paid the most. Basic principles of fairness and justice drive the equity norm. An IPMA-HR study several years ago indicated that more than half of all of the 646 organizations they surveyed—mostly cities—based all or most of their compensation decisions on performance. And the trend is certainly in that direction.

But not everybody agrees. The argument in favor of basing pay on seniority rather than performance is often couched in terms of fairness. If time-in-grade is the only allowable factor, then biased supervisory judgments and nebulous assessments of perceived quality will be eliminated from the compensation decision. But the conventional across-the-board increase is manifestly unfair to the best—the small number of employees who make a disproportional contribution. Worse, it inappropriately rewards goof-offs and goldbricks. Larry Kerr, personnel director for the city of Greensboro, N.C., put it bluntly: "The typical system where everybody gets the same raises has a 100 percent chance of being unfair."

If an organization identifies good performance and then awards bigger paychecks to the good performers than to their weaker brethren, so the theory goes, the organization will increase the amount of good performance. The idea is certainly not new. In 1913, educational researcher Edward L. Thorndike dropped a cat in a small box with a secret door-opening trip lever. The cat behaved wildly and randomly until it accidentally tripped the lever and escaped. From then on every time Thorndike put the cat back in the box it would instantly return to the lever. From that observation came Thorndike's Law of Effect: behavior with favorable consequences tends to be repeated, while behavior with unfavorable consequences tends to disappear.

Thus developed the key concept of contemporary salary administration: pay for performance, or merit pay. Reward what you want and you'll get more of it. Simplicity itself.

What Pay Can Do

Before exploring how pay and performance should be tied together (and whether that tying is in itself a good idea) let's back up and ask an ancient question: does money motivate?

Money talks, we say, and indeed it does. What it says is, "Without me, nothing else matters." While our employees may reflect a diversity of talent, color, background, and satisfaction with their jobs, they share this common denominator: with few exceptions, none can afford to be unemployed long. In a cash society, each of us must have a source of cash.

So money is a priority—a Maslovian basic need. But once that need has been met and our basic needs satisfied, money's leverage becomes a bit trickier.

There are certain areas in which money has a significant impact:

Hiring People: Assuming two different employers are offering similar work, the amount of money paid in salary or wages is probably the single biggest determinant of an individual's choice of which offer to accept. If it is high enough, pay will bring in good job applicants.

Retaining People: Money, in sufficient amounts, will keep people on your payroll. It may not motivate them but it will make them reluctant to leave.

Motivating People: Now the research starts getting interesting. Money can be a powerful motivator of performance, depending on how it's used. If money is used as an expression of recognition, it has the power to generate more and better effort. That's the whole idea behind the "merit increase." Particularly when money comes in the form of a significant increase that reinforces specific and observable exceptional performance, pay will be a powerful motivator—doubly powerful, in fact. The money will be both reinforcement to the lucky recipient and an incentive to everyone else who discovers that this employer reinforces good performance with generous wads of moolah.

Avoiding Dissatisfaction: Here's the flip side of motivation. If managers can't get genuine motivation, they would at least like to have people who are not discontent. And avoiding dissatisfaction is a worthy and meritorious goal: employees who are dissatisfied waste time, money and both physical and emotional energy. They don't work as hard as they might and they quit when the organization would prefer that they stay. And if they become gravely dissatisfied with their paychecks, they can usually find a union organizer with a shoulder to cry on. Pay, when perceived as unfair, is a frequent source of organizational malaise. Keeping pay fair inside the organization *(internal equity)* reduces dissatisfaction. Keeping pay competitive with what other employers are paying *(external equity)* helps avoid resignations and dissatisfaction among those who stay.

What Pay Can't Do

An old management training film illustrating the basic concepts of reinforcement theory provides a classic example of what pay can't do: generate happiness. In a seven-second vignette we see a manager beaming with pride, wrapping up his annual appraisal of an employee's performance. "And that's why," he says to her, smiling as he slides the form across his desk, "I'm able to award you this six percent raise."

The subordinate reacts as if stricken. She slams her hand on the desk, starts to stomp out, then whirls around and howls, "You call *that* a raise!"

We may be able to eliminate dissatisfaction with pay. We may even be able to influence motivation. But we cannot make people happy. No matter how big the increase, it's never enough. And even if somebody is thrilled at the moment, within a day he'll probably decide that in truth he was underpaid all along and that the organization's apparent munificent increase actually served merely to make him whole.

Satisfaction and Dissatisfaction

It's been 40 years since Fred Herzberg observed that the opposite of "job satisfaction" is not "job dissatisfaction." It's "no job satisfaction."

There's no semantic sleight-of-hand involved. In simple terms, the *absence of dissatisfaction* is not the same as the *presence of satisfaction*. The factors that control one are significantly different from the factors that affect the other. Job satisfaction is mainly a function of the work itself, the opportunities for achievement and accomplishment, the amount of discretion the individual exercises, recognition for achievement, real responsibility, and the opportunity for learning and growth. Job dissatisfaction results from entirely different factors—primarily deficiencies in working conditions, benefits, salary, supervision, interpersonal relations and status.

Awarding a person a salary increase will generally not escalate the individual's satisfaction with his job, unless the pay raise is clearly a true merit increase awarded as a means of providing tangible recognition for genuine achievement. As long as the increase is not so meager as to be perceived as insulting—the organizational equivalent of nickel-tipping an arrogant waiter—what the pay raise will successfully do is remove a significant amount of any unhappiness a person may be feeling. The *content* of the job is unaltered; only the job context has been changed. The conditions of work have been ameliorated; the work itself remains the same.

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Why Pay for Performance Fails

Merit pay systems encounter their greatest difficulties in administration. The cause isn't in the concept but in its implementation. Line managers and compensation specialists together screw up a good idea.

Despite the soundness of the reward-equity theory, experience shows that the actual operating procedures don't work with the elegant simplicity that the theory suggests. Managers make trivial discriminations in salary in spite of major differences in performance. When managers do make significant salary adjustment discriminations, they're often based on factors other than the individual's performance: future potential, length of service, recompense for lack of promotional opportunities, perceived need to catch up.

Many individuals don't see much connection between how hard they work and how much they earn. People often feel that the goals against which their performance is being evaluated are unclear or unrealistic. And everybody believes they're above average. Leniency and rating inflation are the two most common appraisal errors. Given the natural desire on the part of most managers to avoid conflict and avoid salary dissatisfaction, it is tempting for them to call everyone superior, award the resulting increases, and get on with things.

While most individuals in the organization may agree with the pay-for-performance theory, many are dissatisfied with the actual evaluation of their performance made by their boss. Here the problem isn't with the system itself but with the lack of trust between rater and ratee. Even when rater and ratee agree on the performance rating, the individual may still feel that the proffered reward is inadequate: what the manager considers lavish, the employee may see as insulting. And even an employee who is totally happy with his pay increase will become miserable when she discovers that the sluggards in the organization got the same increase that she did.

Making Pay for Performance Work

What's the most effective way to encourage honesty in appraisals, to guard against rating inflation and protect against pockets of severe strictness or leniency? Providing guideline percentages may work well. Based either on what the senior management of the organization feels is an appropriate distribution of performance appraisal ratings should be, or simply based on previous years' actual distributions, the organization communicates to raters the expected distribution of ratings.

Right on the appraisal form used at the Minnesota Department of Transportation (Mn/DOT), raters and ratees alike discover that Mn/DOT has indicated the percentage of people who typically fall into each of their five rating categories. Less than five percent are typically "Truly Distinguished or Unsuccessful"; about 30 percent are projected to be "Clearly Superior." Only 15 percent typically get a rating of "Somewhat Successful" while "50 percent or more" are expected to earn a rating of "Fully Successful"—Mn/DOT's middle position. There's no forced distribution required, but flatly stating that half or more of all department employees can anticipate a midpoint rating makes it easier for appraisers and appraisees both—and using a term like "Fully Successful" for the middle rating avoids the connotation of average or mediocre.

First Things First

Before a pay for performance system can work, the tool to measure performance must be solidly in place. That's why it's a good idea to develop a good performance appraisal system before you tinker with the compensation system.

In spite of chronic pronouncements of the death of performance appraisal, the process is alive and well. Everybody wants the information that an effective performance appraisal system can provide.

But the conventional appraisal system used in most cities and state agencies doesn't have the horsepower to drive an effective pay for performance effort. The system has to be scrapped and recreated so that the city's mission statement and vision and values are clearly linked to individual performance. It has to identify the small number of cultural core competencies that the agency's senior executive corps has determined to be critical. It needs to permit appraisers and appraisees alike the ability to identify the individual's key job responsibilities and come to agreement on how performance in each area will be measured. It must provide for the setting of meaningful and ambitious goals and development plans.

Once the first step—the development of an effective performance evaluation process— is taken, then pay for performance can become a workable reality.

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