Testimony of Charles H. Fay
Pay-for-Performance in the Federal Government
US Senate
Homeland Security and Governmental Affairs Committee
Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia
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Witness Background

I am Charles Fay. I am professor of human resource management at the Rutgers University School of Management and Labor Relations, where I have specialized in the fields of compensation and performance management. These areas draw on the pure disciplines of economics, psychology, business strategy and human resource management, and courses covering both topics are offered in most business schools and all schools focusing on management and labor relations.

I have taught undergraduate, masters' level and doctoral classes in compensation and performance management since 1979. Most of my research since 1979 has focused on compensation (particularly performance driven pay) and the results have been published in a variety of scholarly and professional journals. One area of compensation that is my specialty is incentive pay, which is the intersection of performance management and compensation. I co-authored a leading text in compensation, titled *Compensation: Theory and Practice*, which has been widely used by colleges and universities as well as human resource managers in business and government. I have co-edited, and written major chapters for *The Executive Handbook on Compensation* and *New Strategies for Public Pay*. I have chaired the Research Committee of the American Compensation Association (now WorldatWork), and served as a member of that organization's Certification Program, where I taught several courses on compensation, HRIS and performance management. I was a member of the first Federal Salary Council and chaired the technical working group of the Council. I have also served as a consultant to the Bureau of Labor Statistics on several projects concerning the National Compensation Survey.

I have also served as a consultant to private and public sector organizations on the creation, evaluation and revision of compensation programs and in that capacity have conducted and critiqued job evaluation processes and labor market surveys. I have also consulted on the creation, implementation and evaluation of performance management systems for private and public sector organizations.

Given my background it should be obvious that I have a bias favoring strong performance management systems and pay-for-performance in general. When well designed and well implemented, these systems can and do increase employee understanding of what is required of them, their performance, and organizational outcomes. Flawed programs can and do decrease productivity and employee job satisfaction.

Introduction and Outline of Testimony

I have been asked to testify on the implementation and effectiveness of pay-for-performance systems in the private sector and the federal government. I will first speak to what research has shown us about performance management systems and then what research has told us about pay-for-performance systems. I will conclude with some comments on current Federal pay-for-performance systems.

Pay-For-Performance: What We Know

Pay-for-Performance has two parts: performance and consequent related pay actions. Both performance management systems and incentive systems must be working well if pay-for-performance is to motivate appropriate performance.

Requirements for Performance Management

If performance management is to be successful, the system must meet a number of criteria in the areas of planning, monitoring, developing and rating. These "best practice" criteria are shown below: (These best practices have been taken from a study done by the author and a colleague (Howard Risher) for a study sponsored by the IBM Center for the Business of Government, and published as Managing for Better Performance: Enhancing Federal Performance Management Practices. The entire report is available from the Center online at http://www.businessofgovernment.org/publications/grant_reports/details/index.asp?GID=298.)

Planning

> At the beginning of the year, managers are responsible for determining what they think their direct reports need to accomplish, based on the organization plan and assigned job duties. This is usually a good occasion to update job descriptions. Outcomes and deliverables are the preferred performance measures or criteria, but for many jobs, outcome measures that really capture performance are not available. For these, behaviors that are believed to lead to desired outcomes can be used as proxies.
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> Standards of performance for each of these performance criteria must be set. For any given outcome or behavior, what performance level should be the standard? What performance level would be considered as excellent or outstanding? What performance level would be considered unsatisfactory? The basis for measurement or verification should also be

documented. It takes time, but defining three levels of performance tells the employee what he or she needs to accomplish to realize their aspirations and makes it much easier for the manager to defend year-end performance ratings.

Performance expectations are best set in consultation with the direct report, but however set, managers must make sure that their staff understands what they are expected to accomplish. Anytime an incumbent does not fully understand the criteria that will be used to assess his or her performance, it should be seen as a management failure. That undermines a primary purpose of performance management.

Understanding performance criteria and standards is not enough. The direct report needs to have goals for each criterion. Goals represent a commitment by the individual. The idea of "stretch" goals is widely used in industry. Research has repeatedly established that a person selling high, specific goals (or who agrees to high, specific goals suggested by others) reaches a higher level of performance than one who does not set goals. At the time goals are discussed, direct reports should be encouraged to note any anticipated impediments, and managers should commit to providing support within the budget to overcome problems.

One problem that can occur in the use of goals is the confusion between performance and goal achievement. The notion behind a stretch goal is that it is difficult to meet. The "stretch" comes from having a goal that goes beyond the normally expected performance. High performance -- that is, performance that exceeds the standard - should be celebrated and rewarded even if the goal is not achieved.

The performance plan developed by a manager and a direct report becomes a performance "contract." As with all performance plans, changing circumstances may trigger a need to change expectations. Both manager and direct report need to agree on the nature of the changes that might prompt them to modify performance factors and agreed-upon goals.

Different managers may be much tougher than others in defining performance criteria and setting performance standards, especially when a performance management system is first implemented. Senior managers need to see that the managers reporting to them directly and indirectly use appropriate performance criteria and set similar performance standards. Calibration committees of managers who have similar jobs reporting to them can also be used to make sure that performance criteria and performance standards across the organization converge.

Monitoring and Measuring

With the beginning of the performance period, the manager must be in a position to observe performance or, when that is not feasible, obtain feedback from others who have a reason to observe an employee's performance. This can be anyone Impacted by the employer's performance. The individuals who are asked to provide feedback should have direct knowledge.

Whenever verifiable performance information is available, there should be a tracking system to document progress.

"Managing' performance comes about through feedback either to correct poor performance or reinforce good performance. Coaching and mentoring focus on increasing performance levels, overcoming obstacles, and choosing among alternatives Inadequate performance should be handled as a problem to be solved rather than recognition of a personal flaw or inadequacy.

Positive feedback is important in managing performance. The performance contract and goals set should be the basis for the feedback so that it is not merely cheerleading but contains specific content about what was observed and how and why it is good performance. The traditional "atta boy" is frequently just confusing, but effective coaching leads to higher levels of performance.

Observation and feedback as the performance period unfolds makes it possible to provide "real time" coaching. Advice and feedback when a problem or impediment arises makes an incident a learning opportunity

Better managers schedule multiple mini-appraisals at regular times, when problems are encountered, or when projects are completed. Then the feedback *can* be handled as coaching, and more specific to recent events. Regular feedback means there will be no surprises at year-end.

Developing

The transition from over-the-shoulder, close supervision to more of an empowerment style of management changes the role of the supervisor. That makes it important when occasions arise to provide coaching advice and career guidance The performance management process should identify the knowledge, skills, and abilities that an employee needs to develop for continued career success and that provides a good framework tor discussions.

The coaching should include guidance toward job assignments and special projects to help the employee develop or enhance important competencies. Managers should be able to look to their human resources/ human capital (HR/HC) specialists for help with development planning.

Managers and direct reports have to recognize that high performance on the current job does not necessarily translate into high performance on the next level job. Organizations are filled with poor managers who were great individual contributors. In counseling a direct report on career development, a manager should discuss hos, current performance would translate on *the* higher-level lob What may be a minor issue On the current job may become a major flaw on the higher job, and developmental plans should address fixing these flaws now rather than later

Nearly all managers would benefit from training to develop their coaching and mentoring skills. Those skills have become more important as organizations move away from close, over-the-shoulder supervision.

Rating

Shortly before the final ratings are due, managers should solicit input from individuals who have had reasons to observe and interact with the employee. The employee should be asked for a list of the people who should be contacted, the list of relevant others. This feedback should follow a standardized format so that it can be assembled and evaluated easily.

While self appraisals are useful, managers should not ask direct reports to fill out their own appraisal form. Instead, a manager should fill out a "draft" appraisal and share it with the direct report, asking the direct report to consider its completeness and accuracy before the formal appraisal feedback. This gives the direct report a chance to consider the appraisal in a low-pressure environment and bring errors or omissions to the attention of the manager. It also removes pressure from the direct report: he or she can think about the ratings, consider which are not (in their view) accurate, and supporting data for changes can be collected and accompany the revisions.

Toward the end of the performance period, a summary appraisal is made. While this is superficially very similar to the traditional appraisal. it is a much lower-key event. Feedback throughout the performance period gives both manager and direct report a good picture of performance levels relative to goals and expectations. There should be no surprises.

If ratings are high or low, the manager should describe the reasons for the ratings. Ratings at both extremes warrant special plans for the employee, and it is quite possible that the manager will be asked to justify and defend the ratings.

When the rating is linked to a salary increase or other human resource decision, it is important for all consequences of the performance level achieved to be discussed at the same time. People are interested first and foremost in "what's in it for me," and until the "what" is discussed, any other performance or development issues will take a backseat.

Since promotions and advancement are important outcomes of performance, it is important to discuss what kind of developmental efforts are needed in that context. For the employee, development alone is irrelevant—the critical issue is development to prepare for what. This is an appropriate time to discuss the employee's career goals and possible advancement opportunities.

Performance ratings should be based on agreed-upon criteria and verifiable information whenever possible. The performance plan should provide the criteria and observation of the manager and relevant others should provide the verifiable information.

Before ratings are communicated with an employee, they should be reviewed and approved by at least one level of management. The best practice would also have at least the high and low ratings reviewed by a "calibration committee" of managers. The committee's role is to review the validity of ratings.

The summary appraisal meeting is the time for an initial discussion for next year's performance planning. To the extent that the organization plan and organizational goals have changed, these changes will need to be factored into a new performance contract.

Requirements for Pay-for-Performance

If pay-for-performance is to be successful, the system must meet a number of criteria in the areas of program type, design and administration. These “best practice” criteria are shown below:

Program Type

For any pay-for-performance to work there must be a performance management system in place with performance measures that are accepted by employees as valid and managers making ratings who are trusted by their direct reports. A valid, reliable, unbiased performance management is a necessary (but not sufficient) condition for an effective pay-for-performance program.

If a general bonus is to be the incentive program, there must be a single performance rating that is equivalent for all employees in the plan. That is, a “Meets Standards secretary must be equivalent (in terms of goodness of performance) to a “Meets Standards” engineer. This calibration is much more difficult than commonly thought.

Market adjustments must be separated from the pay-for-performance program. Employees expect their salary to be held at least constant against market as long as they meet standards. When pay-for-performance is used in lieu of market adjustments employees feel management is trying to put one over on them.

Targeted bonuses (e.g., safety bonuses, productivity increase bonuses, etc. that are driven by specific measures) are much more effective and more favorably viewed by employees than are general performance bonuses.

Bonuses really need to be “at risk” to be effective. Merit pay lost its effectiveness because everyone expected to get it and the differences in amounts received did not map on performance differentials. Every employee felt entitled to merit pay increases every year.

Ideally, bonuses will be self-funded – that is, the money going to the bonus pool will be generated by the increased performance of employees in the pool. (In the case of government this might be an issue of cost savings or increased productivity – handling a greater case load, for example, while not reducing service effectiveness.) This requires excellent planning and organization outcome measures, and accounting systems that capture appropriate costs and revenues.

Bonuses that are driven by individual performance will work against teaming and cooperation when work outcomes are a product of group effort. Since most work today is a group effort, having individual performance bonuses is likely to engender harmful competition and bad feelings. This is particularly the case when performance/bonus outcomes are forced to some predesignated distribution.

The nature of a group incentive program is a function of the kind of group involved. Clearly a permanent functionally-matrixed cross-organizational team will require a different incentive scheme than will a short-term within-department team.

Pay-For-Performance Design Issues

When multiple performance criteria are used, weighting becomes an issue. Different human resource decisions may require different weightings. An individual contributor might be a great producer although not very good interpersonally (think computer technician) and deserve the highest bonus possible; if performance were to be used to select a computer technician supervisor this employee might be the last choice. It is important to remember "Performance for what?"

Bonus differentials between "Meets Standards" and "Greatly Exceeds Standards" need to be meaningful and noticeable to employees. A problem in many pay-for-performance systems is that the great employee sees the mediocre employee make nearly as much and begins to ask whether the extra effort spent is worth it.

The bonus structure itself is critical. Is there a floor? Are there caps? If so, these had better be explained and justified to employees from the beginning.

Bonus pools need to be carefully thought out. If each bonus pool is assigned a dollar level based on the prorated salaries of the pool members no allowance has been made for differences in performance across pools. In job class breakout pools (all clericals, for example) this may not present a problem. When the pool is based on geographic or organizational boundaries it is almost certain to present a problem. Employees generally know which parts of an organization are contributing and which are not; if two units with very different performance levels both get pools prorated against aggregated salaries there will not be the difference needed between highly successful and mediocre employees.

Pay-for-performance based on too many criteria becomes confusing.

When goal setting is used in the performance management process (and it should be) it is critical to remember that performance should be measured against standards and that bonuses should be paid out on performance against standards rather than goal achievement. Goals setting theory states that people with high specific accepted goals will perform better, not that they will make their goals. If high performance that does not achieve a difficult goal goes unrewarded while average performance that surpasses an easy goal is rewarded, no one will set difficult goals.

Many incentive systems seem to work best with groups of 500 or less. In larger groups many employees don't see that their effort will be recognized or rewarded, and don't really understand how what they do contributes to the organization.

Even in smaller units it is difficult for some employees to achieve line of sight, that is, to see how what they do is connected to organizational success.

The simpler and more consistent the program is the more likely it is to be a success.

The rating of "Meets Standards" should be the norm. Given the grade inflation in many organizations this may be nearly impossible to achieve.

Administration

The performance management and pay-for-performance system must be owned by management rather than by HR.

Two key criteria in managers' appraisals should be how well they do performance management and how well they do pay-for-performance. These two criteria should be weighted about as heavily as any other criterion. Alternatively, these criteria can be hurdles. A manager should at least meet standards in these two areas to be bonus-eligible.

Communication to eligible employees is critical – they need to understand the upside potential for outstanding performance.

Employees have to trust managers to be fair and impartial when rating performance and when recommending performance based increases.

Calibration committees are useful to look at a larger set of ratings and pay bonus decisions and check for consistency. However, if these become negotiating sessions then bonuses will depend on negotiating skills of managers rather than performance of employees. If employees see gaming and favoritism they will be demotivated.

Unions are generally opposed to performance management and incentive pay. One way to help resolve the opposition is to have union representation on design committees and on calibration committees.

The system must have some basis for dealing with externalities that boost organizational outcomes but had nothing to do with actual employee performance. It must also have some way of dealing with externalities that depress organizational performance but were unrelated to employee performance. This is generally known as the windfall/typhoon problem.

When introducing any new incentive system, managers must treat it (and publicize it to affected employees) as an experiment. If it works it will be extended but if it is problematic it can be changed.

Pay-for-performance systems need to be rigorously evaluated, using input from all employee categories impacted by the system.

Federal Government and Pay-For-Performance

I think it is appropriate for the government to institute pay-for-performance systems. It is clear that agencies have done their homework in studying the large literature on private sector performance management and pay-for-performance systems. That said, I see many of the same problems in the various systems implemented by government agencies that plague similar systems in the private sector.

- The programs seem overly ambitious, trying to do too much too fast for too many. The programs I have seen that seem to work best introduce performance management first, work the problems out of it, and then (and only then) introduce performance bonuses based on performance management system results. Doing both at once entails an organizational change that is too much for many to handle, either in terms of managers running the system as designed or employees accepting the results as fair and equitable.

- The culture that makes "Meets Standards" performance failure needs to be changed. Most employees should be at the "Meets Standards" level. Managers rating employees above or below that should have to justify it in two ways. First, it should be justified in terms of the performance criteria and standards set for the job. Second, it should be justified in terms of unit performance. It does not make sense that a unit that is floundering would have a large percentage of high performance employees.

- Managers need to be held accountable for performance management and pay-for-performance. This is not an issue of submitting forms on time (although some organizations hold up paying out any increases or bonuses until everyone has submitted all recommendations; managers who were "too busy" to comply suddenly find the time when their peers complain). More importantly, it is a key managerial function to manage performance of direct reports and reward them accordingly. Managers who don't do this well (including giving everyone high ratings when the unit is not performing, or giving low ratings when the unit is performing well) have earned poor ratings and no performance increase or bonus.

- The programs confuse market adjustments and performance bonuses. Employees expect to be kept whole against market, and it is clear from union and employee complaints that they know the difference between market adjustments and performance bonuses. Some organizations separate market adjustments and performance payments into two different systems that impact employees at different times of the year (e.g., market adjustment to salary January 1, performance adjustments and bonuses in March) to emphasize the difference.

- The market adjustment issue is particularly important to government workers because they generally make less than equivalent private sector workers, especially from about GS 8 or 9 upwards. While FEPCA was supposed to reduce this private/public pay differential it has not. In spite of the views of many cynics, I believe most US Government workers are competent and hard-working, and could compete successfully in the private sector if they chose to. Many of those I have worked with do in fact have a commitment to public service, and are willing to accept lower pay in order to do something they think is important.

- For a variety of reasons government employees are much more heavily unionized than private sector employees. You can't simply port private sector programs into government and expect them to work well. Unions in general are opposed to performance management and pay-for-performance systems because employees and employee representatives lose partial control of terms and conditions. Managers can (and do) show favoritism and bias in measuring performance and rewarding employees. This situation requires two things to occur if performance management and pay-for-performance systems are to be accepted: system design teams and calibration/bonus pool committees have to include employees and/or employee representatives (and pay attention to what they have to say) and there has to be a legitimate appeal system in place so that employees who feel they have been treated arbitrarily or in a biased fashion feel they have adequate voice.

- Having bonus pools where ratings and bonuses are calibrated is one of the better design approaches in these systems. However, calculating the size of a bonus pool solely as a function of the salaries of the members of the pool is inappropriate. It rests on the assumptions that the aggregate performance of employees making up each pool is equal across pools and that the employees of each pool are equally strategic to the agency or department. Neither of these assumptions is likely to be accurate. If pools are based on organizational units, it would be appropriate to rate unit performance and strategic value and adjust the bonus pool to reflect these.

- Calibration committees should not be negotiating ratings or awards. When bonuses appear to employees to be a function of the negotiating skill of their manager, or when there is a drive for some specific distribution of ratings, the whole system loses any value in motivating those employees.

- At the same time, there should be an effort to standardize rewarded share numbers across pools. A "Meets Standard" employee should receive the same number of shares regardless of the pool to which he or she is assigned. Similarly, the range of share measures that each performance level can be assigned is problematic. Performance differentials should be developed in the performance management system, not the pay-for-performance system. Employees and employee representatives alike have remarked on the mischief that can be done in the share process. This process will be "black box" to most employees, and dilutes the performance pay linkage that is critical to the success of any pay-for-performance program.

- Performance management systems and pay-for-performance systems for employees who work as parts of groups or teams need to have "team citizenship" into account as part of their performance. Otherwise, they will be motivated to maximize individual performance even at the expense of suboptimizing group performance.

- It is not clear what evaluation systems have been built into the various pay-for-performance systems. The 2007 Annual Employee Survey Results of the Department of the Treasury notes that only 27% of employees "believe pay raises are determined on how well employees perform their jobs." Only 32% of employees note "they typically receive formal or informal feedback from their supervisor." Those are signs of a broken system, or one that never worked in the first place.

I will be happy to answer any questions.