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THESIS

MERIT PAY: THE FEDERAL GOVERNMENT'S
PAY-FOR-PERFORMANCE EXPERIENCE

by

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For many years, businesses in private industry have been utilizing and experimenting with various forms of performance-based pay. These innovations have been part of a continuing search by organizations for better approaches to administering pay. With the passing of the Civil Service Reform Act of 1978, the Federal Government began its own form of this concept entitled, "Merit Pay". Although many studies have examined uses in the areas of pay and total compensation, and even in the narrower area of performance-based

BLOCK 20: ABSTRACT (Continued)

pay, these studies have focused primarily on the private sector. This is not surprising since "merit pay" has only been in widespread use in the Federal sector for the past two (2) years. However, even in its infancy, there are indications that the pay for performance concept in the Federal Government has not lived up to its expectations. This thesis examines the Federal Government's experience with pay-for-performance, discusses the probable effectiveness of "merit pay" as it now stands, and recommends specific actions for more effective performance-based pay management in the public sector.

Merit Pay: The Federal Government's Pay-for-Performance Experience

by

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ABSTRACT

For many years, businesses in private industry have been utilizing and experimenting with various forms of performance-based pay. These innovations have been part of a continuing search by organizations for better approaches to administering pay. With the passing of the Civil Service Reform Act of 1978, the Federal Government began its own form of this concept entitled, "Merit Pay". Although many studies have examined uses in the areas of pay and total compensation, and even in the narrower area of performance-based pay, these studies have focused primarily on the private sector. This is not surprising since "merit pay" has only been in widespread use in the Federal sector for the past two (2) years. However, even in its infancy, there are indications that the pay for performance concept in the Federal Government has not lived up to its expectations. This thesis examines the Federal Government's experience with pay-for-performance, discusses the probable effectiveness of "merit pay" as it now stands, and recommends specific actions for more effective performance-based pay management in the public sector.

TABLE OF CONTENTS

LIST OF FIGURES

I. INTRODUCTION

A. GENERAL

"Pay-for-performance" is quite simply the attempt, within available funds, to recognize and reward quality performance by granting pay increases in varying amounts based upon job performance. This concept embodies two major beliefs:

1. That pay decisions should be based upon demonstrated performance, and

2. That pay is, or has the potential of being, an effective motivator of performance.

At one time it was safe to say that most companies in the private sector were under a pay for performance system and that the Federal Government was under a job rate system which based salary progressions primarily on time in the job. However, in recent years, the civil service is moving towards performance-based pay while many companies are moving away from it.

The Government began its venture into performance-based pay as a result of the Civil Service Reform Act (Public Law 95-454) which was approved October 13, 1978. The Act established a Merit Pay System for high-level supervisers and management officials (grades GS-13 through GS-15) in which annual performance appraisals would be the basis for merit pay increases (Appendix A). Eliminated were within-grade

salary increases which provided progressive pay raises based on time spent in a specific grade.

The literature on organizations is full of beliefs, myths, and opinions concerning how much employees should be paid and what procedures should be used to pay them. It is probable that no other topic concerning the management of organizations is a subject of more debate, controversy, and misunderstanding. A major point in the controversy concerns the concept of pay as a motivator--some researchers contend that internal job satisfaction, among other things, is the motivator rather than externally mediated rewards and that, therefore, merit pay should be discounted as a motivator. Another group contends that the merit pay concept is valid, being based on the "law of effect" (i.e., behavior that appears to lead to a positive consequence tends to be repeated), and that any failure of this concept is due to mismanagement of merit pay programs or to the lack of understanding about them.

There are literally hundreds of mechanical approaches to merit pay and numerous process choices that accompany these approaches. This thesis will focus on the approach that the Federal Government has taken and examine it in light of motivation/performance theory, past research, and private sector experience.

B. ORGANIZATION

This thesis is designed to provide the reader with an introduction to the Federal Merit Pay system, an overview of relevant research, an explanation of motivation and performance theories, a review of both private and public sector experience with performance-based pay, and conclusions and recommendations for improvement or change.

The remainder of this chapter is devoted to an explanation of Federal compensation practices--both merit pay and non-merit pay. It will provide the background necessary to understand the impact of merit pay on the Federal Government and its employees.

Chapter II discusses the role of pay in influencing individual and organizational behavior. It examines this issue first from a historical perspective and then in light of performance and motivation theories. The chapter concludes with a review of relevant literature in the area of pay and workforce motivation.

Chapter III examines the experiences of both the private and public sectors with pay-for-performance systems. It explores various systems used by different organizations and discusses their successes and their problems.

Chapter IV presents an evaluation of the Federal merit pay system and delves into the reasons for its failure. It examines the problems in light of specific actions taken by

the Government and attempts to relate them to certain issues discussed in Chapter II.

Chapter V discusses Congressional reaction to the merit pay system. It also contains conclusions about the present system and suggests the best alternative for improvement.

C. OVERVIEW OF FEDERAL COMPENSATION PRACTICES

1. The General Schedule

Generally speaking, white collar workers within the Federal Government are assigned to a General Schedule (GS) rating based upon the job duties that they perform. These ratings range from GS-1 (for relatively unskilled work such as a messenger) to GS-15 (for very complex and responsible work such as an Electrical Engineer or functional manager). (Although higher level positions exist, they are for the most part "ungraded" and are referred to as Senior Executive Service positions.) Prior to the Civil Service Reform Act of 1978, the salaries of all GS positions were adjusted by three methods: comparability adjustments, within-grade step increases, and/or quality-step increases. With the implementation of merit pay, however, supervisors and management officials at grades 13, 14, and 15 were removed from the general schedule and placed under a separte compensation system (merit pay).

a. Comparability Adjustments

The Federal Salary Reform Act of 1962 established the comparability principle which states that Federal Salary rates for white-collar employees under the General Schedule should be comparable with private enterprise rates for the same levels of work.

The Federal Pay Comparability Act of 1970 transferred primary responsibility for adjusting the General Schedule pay scale from Congress to the executive branch. Comparability findings and pay recommendations are submitted to the President, who must either agree to the recommended comparability pay adjustment or submit an alternative plan to Congress which would go into effect unless a majority vote of either House disapproved it. If the alternative plan is disapproved, the President must make a comparability adjustment according to the statute's principle of comparability. In either case, comparability pay adjustments take effect in October.

b. Within-Grade Step Increases

Previous law (5 U.S.C. 5332) established the matrix for General Schedule salaries. Under the fiscal year 1980 matrix (Appendix B), grades GS-1 through GS-14 have a 30% pay range with 10 uniform steps, and GS-15 has a 23% pay range with 8 steps. Each step is worth about 3.3% of the minimum rate for the grade. Progression through step

increases is in addition to the general salary increases (i.e., comparabiity adjustments) which occur each October.

Employees advance to the next step after completing one year in steps one through three, two years in steps four through six, and three years in steps seven through nine--provided performance is of an "acceptable level of competence" as certified by the supervisor. These certifications are virtually routine--step increases are received by 99% of all General Schedule employees on the date of eligibility.

c. Quality-Step Increases

The Federal Salary Reform Act of 1962 also provided for recognition of exceptionally high-quality performance through the granting of step increases which were in addition to those achieved by "seniority". This provision is generally considered a performance award. In the past, quality step increases have been granted to less than 5% of all Federal employees each year (.1% of payroll costs).

2. <u>Merit Pay</u>

The Civil Service Reform Act (CSRA) of 1978 established a new pay system (GM: General Merit) for supervisors and management officials in grades GS-13 through GS-15, in which pay increases are to be based on performance. This new system led to two major changes in agencies' personnel procedures:

1. Performance appraisals for merit pay employees must be based on written, pre-established performance standards and conducted much more rigorously than wasthe case previously.

2. Merit pay employees are no longer guaranteed full comparability (October) adjustments and are no longer eligible for within-grade or quality-step increases.

Under the GM system, the basic pay of employees is adjusted annually according to two factors:

(1)		(2)		
At least 50% of the annual October comparability	+	A merit pay increase based on-job performance	=	Total dollar adjustment

The total amount of payroll funds under the GM system comes from the within-grade and quality-step increases that would have been paid if GM employees were under the GS system, plus the remaining portion of the October comparability adjustment that was not automatically given to GM employees. Thus, the same amount of money as was previously allocated is still available to merit pay employees but it is distributed differently, according to performance levels.

Merit increases are effective at the same time as the regular October comparability adjustment, and become a permanent part of basic pay (i.e., they are not one-time "bonuses"). Since pay adjustments will vary according to employee performance, an individual's salary can be set

anywhere within the salary range for that grade, as long as it doesn't fall below the minimum or above the maximum.

Approximately 100 agencies in the Federal Government are included in the merit pay program. About 128,000 Federal employees, or 65% of the total GS-13, GS-14, and GS-15 grade level population in these agencies are paid under the Merit Pay System.

The Office of Personnel Management (OPM) took a decentralized approach to implementation of the new system, allowing agencies to design their own merit pay programs so long as they met general OPM guidelines and the statutory requirements.

The Reform Act required merit pay provisions to be implemented no later than October 1981. However, eight small agencies with bout 2200 merit pay employees opted to implement merit pay a year earlier and made payouts effective October 1980.

Upon implementation of merit pay, OPM said:

> "... employees exceeding their [performance] standards should, under the new system, receive salary increases greater than they could have expected under the General Schedule. Also, an employee's position in the pay range will begin to reflect the quality of performance rather than just time in grade. Merit pay should significantly improve productivity, quality of work, service to the public, and employee satisfaction with the reward system" [Ref. 1].

As will be seen, OPM's optimism was rather overstated.

II. THE CARROT AND STICK

Basic to an understanding of the impact of pay in organizations is an understanding of the relationship between financial rewards and individual behavior. In this chapter, these relationships are examined from a historical perspective and in light of major theories and research studies.

A. HISTORICAL PERSPECTIVE

One of the basic beliefs in a capitalistic society is that economic rewards come to those who engage in hard work. The underlying concept behind this belief is known as the Protestant ethic. In a nutshell, the Protestant ethic is a religious or moral imperative which views man as being isolated, competitive, and individualistic. Hard work is seen as the means of accumulating wealth, which is viewed as a desirable end.

These beliefs emphasizing individualism and profit maximization, did not appear suddenly in the Western world. Rather, they developed as an evolutionary process that had its origins in the changing views of the church vis-a-vis commercial activities in the latter part of the Middle Ages. Changes in the religious ethic, brought about by the Protestant Reformation, created an ethical and economic

climate that was very favorable to the progress of capitalism and development of the Protestant ethics. The Calvinists, who led the Protestant Reformation, viewed frugality, thrift, and industry as virtues. To them, worldly success and prosperity were construed as signs of God's approval for the elect--those chosen by God for salvation. These views provided a religious incentive for the spread of the profit motive in Western society.

In the American colonies, puritanism continued the emphasis on hard work and an accumulation of worldly goods as a sign of God's grace. Weber saw in Benjamin Franklin's homilies and writings the essence of the Protestant ethic, and noted:

> "If we thus ask, _why_ should 'money be made out of men,' Benjamin Franklin himself, although he was a colourless desist, answers in his autobiography with a quotation from the Bible, which his strict Calvinistic father drummed into him again and again in his youth: 'Seest thou a man diligent in his business? He shall stand before Kings.' (Prov. xxii 29)" [Ref. 2].

In 1776, Adam Smith's _An Inquiry into the Nature and Causes of the Wealth of Nations_, was published, giving the capitalistic ethic its major ideology. Smith argued for economic freedoms on the premise that by maximizing self-interest, each individual would benefit the total society.

Up to the late 1800's, there seemed to be little interest in management thought or philosophy; management style depended more on the unique personality of the supervisor

than on any well-defined body of knowledge. It is fair to say, however, that most management styles emphasized rigorous work and stringency of discipline.

In the late 1800's and early 1900's, the scientific management movement came into vogue under the driving force of Frederick W. Taylor, whose views were strongly influenced by the Protestant ethic. His emphasis was on task management; the ascertaining scientifically of the most efficient way of doing each task, standardizing that method, and requiring workers to use it. By this means, productivity could be increased and higher earnings would be achieved. Taylor viewed the worker as an adjunct to the machine, and assumed that workers would be motivated by greater economic rewards:

> "The management must ... recognize the broad fact that workmen will not submit to this more rigid standardization and will not work extra hard, unless they receive extra pay for doing it" [Ref. 3].

This view was consistent with the concept of "economic man" which was popularly accepted in the early 1900's. Economic man was defined as:

> "a rational creature who uses his reason primarily to calculate how much satisfaction he may obtain from the smallest amount of effort, or when necessary, how much discomfort he can avoid. 'Satisfaction' does not mean pride in one's job ...; it refers only to money. Similarly, 'discomfort' refers, to failing in one's task ..., but solely to the fear of starvation" [Ref. 4].

Pay first became a prominent research subject during the scientific management era. Most of the first studies were

concerned with measuring the effectiveness of the various piece rate incentive plans that were introduced. From 1900 to the early 1930's, time study and incentive plans became a way of life in most companies. Pragmatically, scientific management was successful in the effort to increase efficiency and productivity; however, growing criticism was leveled at Taylor's approach for treating workers like cogs in a well-oiled machine and for eliminating any humanistic practices in industry.

Up to this time, money was viewed as an effective motivator. However, doubt was first cast on this belief with the research of Elton Mayo in a series of studies conducted at the Hawthorne Plant of the Western Electric Company between 1927 and 1932. Mayo had been called in by the company to determine the effects on productivity of working conditions, length of working day, frequency and length of rest periods, and other variables relating to the physical environment. He found that production increased regardless of variations in these conditions. Even more surprising, production continued to increase after the employees were returned to the original conditions with longer working hours, without rest periods, and with poor surroundings.

Another phase of Mayo's research examined the group behavior of workers. He found that the informal work group established production norms that were often in conflict with

those set by management. Even though the workers were paid on a group piecework incentive plan, the workers restricted output and thereby reduced possible earnings.

Mayo's experiments weakened the prevailing belief that work place illumination, work conditions, fatigue, and other physical and physiological variables, along with strong monetary incentives, were the primary factors influencing productivity. Social and psychological factors also began to be seen as important in employee satisfaction and output. In fact, results of the Hawthorne experiments were interpreted as conclusive proof that other factors were <u>more</u> important in motivating performance than pay.

The Hawthorne experiments ushered in the human relations movement in industry which, in effect, put the human element back into the organization. This era paved the way for the more modern behavioral scientists with their theories of motivation, performance and rewards, and their emphasis on human values.

B. THE MOTIVATION TO WORK

One of the most difficult and controversial tasks for behavioral scientists is to explain the urge behind behavior; to identify the motive that prompts a person to act in a certain way. A number of theories have been developed and researched to explain motivation, and evidence has been gathered to support each of the major theories.

The need-hierarchy concept was developed by Abraham Maslow in the 1940's. He identified five levels of needs which served a motivators: (1) physiological, (2) safety and security, (3) social, (4) esteem, and (5) self-actualization (Figure 1). These needs are arranged in hierarchical levels, showing that lower level needs must be met before higher level needs can motivate. According to Maslow, a satisfied need ceases to motivate behavior. In Maslow's theory, pay is viewed as a benefit which satisfies a lower level need such as physiological (i.e., purchase of food to satisfy hunger) or security (i.e., exchange of money for a place to live). However, opponents of his theory argue that pay is also an indication of esteem and a recognition of accomplishments which lead to self-actualization.

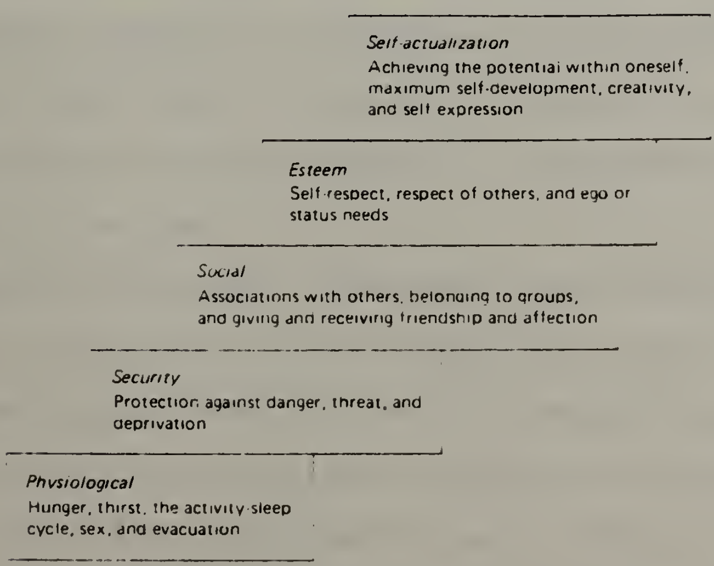


Figure 1. Maslow's Hierarchy of Needs

In the late 1950's, Frederick Herzberg developed his two-factor theory of motivation which states that there are two basic sets of factors which explain employee behavior--motivation factors and hygiene factors. Motivation factors are those whose fulfillment leads to job satisfaction and hence have the power to motivate good job performance. They include recognition, responsibility, advancement, and achievement. Hygiene factors, on the other hand, are important in preventing job dissatisfaction but do not play an important role in motivating employees. Pay is not viewed as a motivator; it is rather seen as a hygiene factor along with company policy, working conditions, and interpersonal relations.

Another researcher, David McClelland, suggests that motivation comes from the need to achieve, which is fostered by Western culture. According to McClelland, much of our society has come to think in terms of getting ahead, achieving, or "being somebody." The need to succeed is the motivator, not pay.

Douglas McGregor developed two alternative views of employee behavior called "Theory X" and "Theory Y". The assumptions of Theory Y are that people are not lazy, that they find work as necessary as play, and that by their very nature they are motivated to make positive contributions. Theory X, on the other hand, says that people dislike work,

have little ambition, and must be coerced or threatened with punishment in order to be motivated to put forth effort.

Practicing managers are perhaps most familiar with what Professor W. R. Bishop of the Naval Postgraduate School calls the "Thom McAn" method of motivation, also referred to as the "kick in the pants" theory. Literal application of the term is rarely used since it is inelegant and might result in negative feedback (i.e., the employee might kick back). However, the figurative application is often utilized in today's environment, either in a pull (carrot) or push (stick) mode. According to this theory, salary is seen as a frontal kick--force is exerted as a "pull" rather than a "push". Herzberg has suggested that while this leads to movement, it does not create motivation. "When I want him to move again, what must I do? I must kick [pull] him again .... It is only when he has his own generator that we can talk about motivation [Ref. 5].

In summary, the majority of theories that focus on specific needs or conditions suggest that money will not be a motivating factor. People want to contribute because of an innate or learned drive, and thus there is no need to use pay increases as a means to improve performance.

However, it is obvious to anyone in the working environment that employees often leave one job for another that pays more money. Process theories of motivation attempt

to shed some insight into this behavior by examining the interrelationship of variables such as drive, reinforcement, and expectancy. The most predominant process theories are equity theory, goal-setting theory, and expectancy theory.

The essence of equity theory is that employees will make comparisons of their efforts and rewards with those of others in similar work conditions. J. S. Adams, who developed the theory, defines inequity as follows:

> Inequity exists for Person whenever he perceives that the ratio of his outcomes to inputs and the ratio of Other's outcomes to Other's inputs are unequal. This may happen either (a) when he and Other are in a direct exchange relationship or (b) when both are in an exchange relationship with a third party and Person compares himself to Other [Ref. 6].

Outcomes in the work environment include pay, fringe benefits, and status. Inputs include effort, educational level, skills, and general qualifications for the job. Equity theory says that the perception of inequity will create tension in an individual thereby motivating him to either increase his efforts to get benefits that will restore equity, or to reduce efforts and outputs.

The comparison process leads to one of three outcomes--satisfaction, dissatisfaction and guilt or discomfort (Figure 2).

Feelings of overreward are reduced by either (1) working harder or (2) increasing the perceptions of one's own efforts

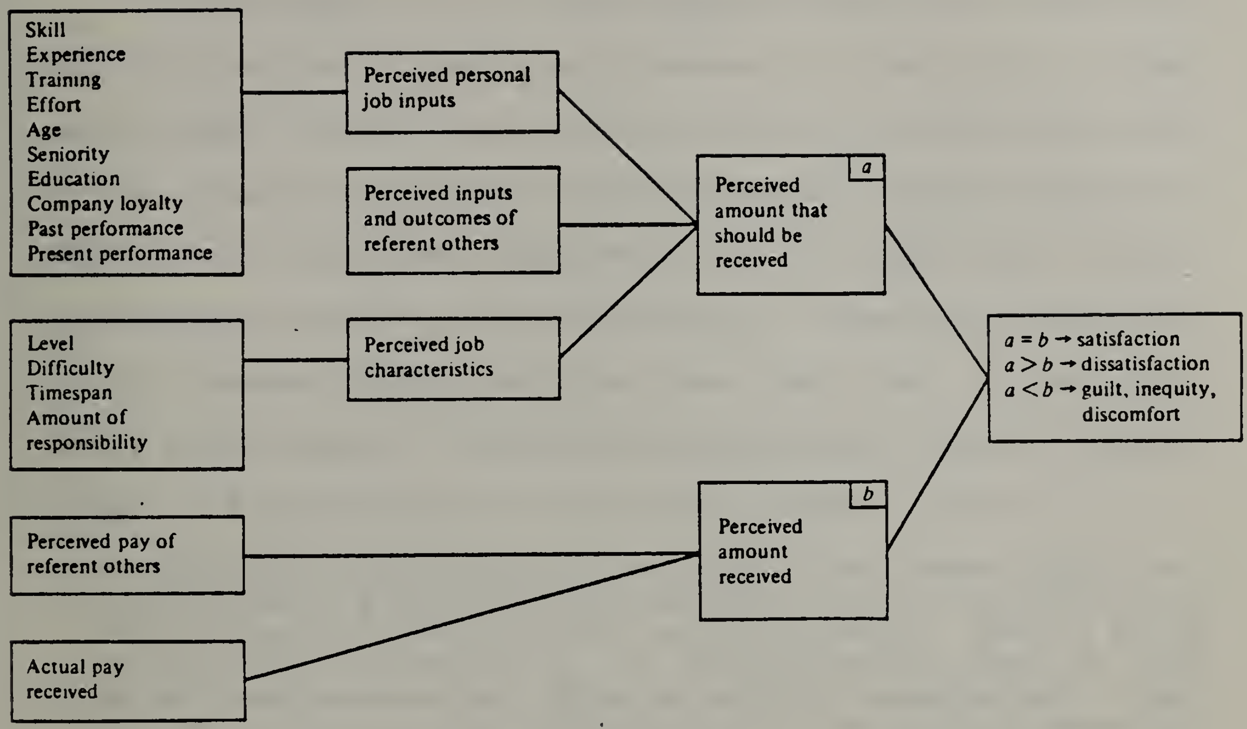


Figure 2. Model of the Determinants of Pay Satisfaction (E. E. Lawler)

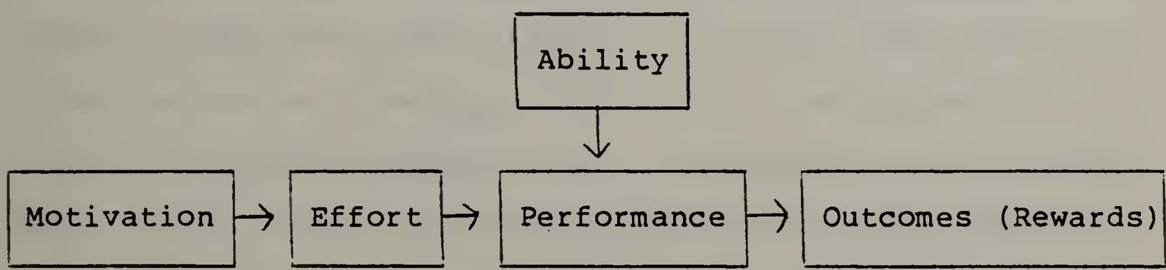
and/or of the pay that others receive. However, there is evidence that people are more inclined to increase their perception of their inputs than to increase their actual inputs [Ref. 7]. Feelings of underreward do not seem to work the same way (i.e., perceptions are not altered). In these cases, feelings of dissatisfaction can usually be reduced only by receiving higher pay or a new job. Failing that, the most obvious alternative is to reduce one's effort.

A good example of real-life equity situations occurred in the professional sports environment of the 1970's. Many established "stars" were playing out their options so they could renegotiate their contracts and/or change teams. In doing so, they were responding to the long-term, no-cut contracts given to some "superstars", especially those who hadn't proven themselves over the long run. In February 1977, Slick Watts of the Seattle Supersonics, who had led the league the year before in steals and assists, said:

> "I know most people think I'm taking good money, and I am. [Reportedly $70,000 plus bonuses, with increases to $80,000 and $90,000 for the next two years] But, I bring people into the Coliseum. ... That helps the Sonics. Sam is getting compensated, Russ is getting compensated, Tommy is getting very well compensated.... Me and Norwood get the same salary and he's been in this league a long time and he's on his last legs. There's a lot of guys in this league making over a hundred grand a year and they don't even get off the bench" [Ref. 8].

The goal-setting theory postulated by Edwin Locke, a behavioral scientist at the University of Maryland, says that the setting of specific goals is more conducive to goal accomplishment than monetary incentives [Ref. 9]. When goals are set and accepted, performance levels are as high as when monetary rewards are provided. According to this theory, the intrinsic motivation to accomplish goals is the driving force. Opponents of Locke's theory argue that he dealt with small incentives that had little potential to motivate, and that in fact, larger monetary incentives do result in better performance when goal levels are constant.

Expectancy theory postulates that motivation is a function of three factors--effort, performance/achievement, and reward. For individuals to be motivated, they must believe or expect that additional effort will result in higher performance as measured by the organization, and that higher performance will result in rewards which the individual values. An additional factor is the belief or expectancy of an individual that he or she is in fact able to succeed in achieving the effort. Figure 3 shows a simplified version of the expectancy-theory model.



An individual's motivation is a function of:

(1) Effort/Performance Expectancy ("Will my Effort Result in Higher Performance?")

(2) Performance/Outcome Expectancy ("Will the Performance Lead to Rewards?")

(3) Attractiveness of Outcomes ("Do I Want the Reward?")

Figure 3. The Expectancy Theory Model (Based on E.E. Lawler's Model)

According to this theory, if an employee wants some reward but believes that in spite of all his efforts there is nothing he can do in the current organization that will

result in geeting it, he will cease to be motivated by the possibility of that reward.

C. RECENT RESEARCH

The heated debate among researchers as to the value of money in motivation has continued into the present time. Some say that money not only motivates, but it motivates best. Others argue that money is only a means of exchanging social utilities in a modern society and, as such, cannot be relied on as a motivator.

In reviewing the research in the area of compensation, it becomes clear that very little is really known about the incentive value of money. Most of the published data are exclusively psychological (e.g., Herzberg), while studies that include "hard" data often do not inclue psychological or perceptual data. The most common interpretation from studies that have tried to bridge the gap between hard data and perceptual data is that satisfaction concerning pay is more a function of individual goals and backgrounds than of absolute levels of pay. For example, Gellerman places great importance on the symbolic value of money for producing motivation and reducing dissatisfaction. In describing the value of a pay "increment", he says, "Whatever symbolism money has for the individual and whatever presumptions and illusions he has about how added income would affect the way

he lives, are as much a part of the increment for him as is the money itself" [Ref. 10].

Wernimont and Fitzpatrick's (1972) research supports the notion that money has a great deal of symbolic value and means different things to different types of people. Their work suggests that as an incentive, money is also valued very differently by different groups and is, therefore, not a universally motivating force [Ref. 11].

The research of Hinrichs (1969) found that an individual's current level of earnings is one of the most powerful variables affecting how he or she perceives a given salary increase [Ref. 12]. His findings suggest that individuals with characteristics normally associated with higher levels of earnings potential (e.g., college education, youth, males) will tend to have higher expectations with regard to salary than will others and will in turn have a higher threshold of what is perceived as an acceptable salary increase. This has similarities to the expectancy theory with its individual perceptions of "where I am now" and "where I should be based on my education, age, skills, etc."

Some studies support Herzberg's view of money as a hygiene factor. One survey revealed that out of 18 job-related factors, salary was ranked twelfth in importance by those surveyed, 60% of whom were managers and supervisors [Ref.13]. Another survey of middle managers at 2,867

companies supports the premise that salary increases generally fail to motivate employees [Ref. 14].

However, Gellerman notes that primarily because of such studies and the conclusions drawn by behavioral scientists many people have wrongly determined that money has little or no motivating power. He contends that money would be an effective motivator if its distribution were properly administered. Gellerman also argues that if pay is to motivate performance, very large amounts of pay must be involved. Additionally, he points out that these large amounts of pay must be perceived to be dependent upon performance [Ref. 15].

Lawler, among others, contends that when certain specified conditions exist, pay and other rewards have been demonstrated to motivate performance. These necessary conditions are that "important rewards must be perceived to be tied in a timely fashion to effective performance" [Ref. 16].

This view is supported by other researcgers, such as Atkinson and Reitman, who showed that the offer of a financial incentive led to increased job performance in general but especially among people who were low on achievement motivation. They found that people who were high on achievement motivation worked hard without the offer of a financial reward [Ref. 17].

Locke and Bryan present data from various studies concerning the effects of monetary incentives. Overall, their data suggest that offering financial incentives will increase performance when rewards are tied to performance [Ref. 18].

The importance of employees' perceptions of the relationship between pay and performance was stressed by Vroom [Ref. 19] as a factor in work motivation. Related to this is the work of McGeoch and Irion [Ref. 20], who found that rewards are most effective when employees perceive a direct connection between the behavior and the reward. How infrequently this happens is highlighted by the results of a national survey of randomly selected employed individuals. Only 27.2% of those surveyed said they were likely to get a bonus or pay raise if they did their job well [Ref. 21].

There are several case studies that have been concerned with the degree to which blue-collar employees see their pay being determined by job performance. In general, the data indicate that many of the pay plans that are called incentive plans by management are not seen as incentive plans by employees. Further, data show that if employees do not consider the basis upon which pay is determined to be legitimate, they exhibit resistance that often leads to the failure of the programs. It seems obvious that when employees feel there is little relationship between what they

achieve and the salary they get, then wages will have little, if any, motivational value.

However, this should not suggest that all an organization has to do is effectively relate pay to performance in order to achieve increased motivation and productivity. Other things (e.g., developing a good measure of performance) are just as important, and are very difficult to do. The complexity of the issues involved has led some researchers to conclude that it is not worth trying to relate pay rewards to performance.

The real conclusion that comes out of the numerous and conflicting studies is that people differ substantially and in meaningful ways about what is important to them. Some individuals value and are highly motivated by entrinsic rewards (e.g., pay, additional holiday time, more perks); others with different personal and background characteristics will value intrinsic rewards (e.g., an interesting job) more highly. In the author's view, the studies merely reinforce Maslow's theory. In some cases an individual will be motivated by money and the security or physiological needs it can meet; however, when those needs are met, money will cease to be a motivating force. Self-actualization will inherently come to mean self-motivation.

III. PAY-FOR-PERFORMANCE SYSTEMS

A. PRIVATE SECTOR EXPERIENCE

1. Pay for Performance Systems

Systems that tie pay to performance have been in existence in private industry for several years and have assumed various forms. These forms include gain sharing, bonuses, merit pay, and combination plans.

a. Gain Sharing

Gain sharing involves paying a bonus to employees based upon improvements in the operating results of an organization. A formula is designed to generate a bonus pool which is divided up among the members of the plan. Gain sharing plans have been in existence for up to 30-40 years and include the Scanlon Plan, profit sharing, and the Lincoln Electric Plan.

(1) The Scanlon Plan. The Scanlon Plan is a common sharing between management and employees of problems, goals, and ideas, as well as economic gains. Monetary payouts are distributed as a percentage of an employee's gross income. Two of the companies that have used this plan are Parker Pen Company and the Atwood Vacuum Machine Company. Research of these and other companies using the Scanlon Plan indicates that it is successful in contributing to organizational effectiveness at least 50% of the time [Ref. 22].

(2) Profit Sharing. Profit sharing involves sharing the profits of the company with its employees. Usually, however, these plans defer the payments until retirement and are, therefore, not true incentive plans. Others combine a partial payout with deferment of the rest. According to one study [Ref. 23], over 350,000 firms in the United States have some form of profit sharing. However, in most companies, profits are so far beyond the direct influence of employees that profit-based bonuses are simply not likely to be, nor used as, effective motivators.

(3) The Lincoln Electric Plan. Under this plan, a bonus pool is determined based on company performance but is distributed to based on their individual performance. This plan is actually a combination of gain-sharing and merit pay.

b. Bonuses

Bonuses are special lump-sum payments made to individual employees for meeting goals or performing at a certain level. In most companies, bonuses are used in combination with across-the-board base pay increases that reflect changes in market conditions. The principle behind bonuses is the same as that behind merit pay; the systems differ in that bonuses do not increase base pay and are usually paid in one lump sum.

c. Merit Pay

Salary adjustments based on the performance or achievements of individuals are referred to as merit pay. Most of these salary increases reflect changes in both market conditions and in performance. In periods of high inflation, much of the increase may be just an adjustment for changes in the market, leaving the "merit" portion rather small and discouraging. The result is often the perception by employees that there is not much merit in merit pay plans. The salary increases also are spread out over an annual basis rather than given as a lump-sum payment. Despite the drawbacks, a majority of companies use merit pay increases rather than bonuses or gain-sharing plans. Kaiser Aluminum uses a merit pay system as well as providing additional lump-sum bonuses to top performers.

d. Combination Plans

These involve using a combination of the plans cited above, or using one or more of these in conjunction with non-merit plans such as regular general wage adjustments, periodic cost-of-living adjustments, length-of-service increases, or wage progression schedules. Parts of AT&T use regular salary increases (up to a control point set at market value) for satisfactory performers; additional increases are given to the top performers in the form of bonuses.

2. <u>Results of Private Sector Experience</u>

A survey of basic pay policies and practices was conducted by the Bureau of National Affairs' 1979-1980 <u>Personnel Policies Forum</u> [Ref. 24]. One hundred eighty-three executives, mostly from manufacturing firms, responded to the survey. Other respondents represented educational institutions, hospitals, government agencies, and non-manufacturing business firms. The survey found that increases in basic pay rates were usually made through merit pay adjustments. Plant/service workers, who normally received increases through wage progression schedules or length-of-service provisions. Formal wage progression schedules were also established for supervisors/managers in 30% of the responding firms. Another thirty percent indicated that they also provided regular, across-the-board increases for supervisors/managers. Three major problems, all relating to pay for performance, were cited by these 183 employers:

1. Trying to maintain a pay adjustment program based strictly on merit in a period of high inflation. The size of the increases falls short, in most cases, to the cost of living.

2. Salary compression among middle managers; i.e., the perceived shrinking of middle managers' salaries relative to the faster-rising pay rates of nonmanagement employees. Recommendations from the firms to alleviate this included making periodic "equity adjustments" and providing managers the same general increases given to nonmanagement.

3. Difficulties in performance review for purposes of merit increases. Objectivity, accuracy, and timeliness were among the areas in which performance reviews are deficient.

It is precisely because of these types of problems that some private corporations are moving away from pay for performance. There is, in fact, almost as much literature on the failure of incentive systems in private industry as there is on their success. Some researchers, such as Frederick Thayer [Ref. 25] therefore dispute the assumption of the Civil Service Reform Act that business organizations have superior incentive systems which should be imitated by the Government. They argue that there is no clear evidence that private sector organizations are particularly effective in making performance-based pay plans work.

For example, one study of a group of research organizations found that only 67% of the scientists said merit pay existed despite the fact that management claimed it was present in all the organizations [Ref. 26].

In another instance, a survey of the 500 largest industrial firms in the U.S.--the Fortune 500--examined the relationship between salaries and job performance [Ref. 27]. It found that although 93% of the firms claimed to have a merit system that advanced salaries on the basis of job performance, less than 19% in fact attempted to use some form of a performance-oriented appraisal device. Without this type of device, a company is simply not able to relate job performance to salary progression with any degree of reliability or validity.

The Federal Merit Pay System uses a performance-oriented objective-setting process based on the practices claimed to be used in the private sector. However, the management-by-objectives system has enjoyed only limited success in industry. In another survey of Fortune 500 companies [Ref. 28], 45% of the 403 respondents said that they had an MBO program; of these programs, only 19% were rated as successful. The major problems centered around the difficulty in defining objectives with any degree of precision and in obtaining measurable criteria. Other major complaints concerned an excess of paperwork and the difficulty of stating quantitative goals for all aspects of the job.

The American Management Association's magazine, Personnel, queried its readers with regard to the impact of inflation and small merit increases on motivation of employees. Of 24 respondents, 14 felt that pay increases drawn from a merit increase budget that is only 1-2 percent above the inflation rate would have very little or no positive motivational effect. Only one respondent said that such a budget would have no negative effect. David S. Novick, manager of personnel administration at Nestle Company, Inc., said,

> "When employers award increases that don't keep pace with cost-of-living factors, management's credibility is severely strained and its ability to 'motivate' has to be hampered. A good many salaried employees are distracted and frustrated by their inability to keep up, even when they turn in good job performances" [Ref. 29].

When asked if a small pay increase could positively affect otherwise highly motivated employees, 16 said either that it could not or that it would have a negative effect. For example, Bruce Ellig, vice-president of compensation for Pfizer, Inc., said that a "small merit increase will negatively affect otherwise highly motivated performers. Most will recognize they have been shortchanged by the company; they have received an inadequate reward for the level of contribution they have made" [Ref. 30], Taking another viewpoint, David Novick of Nestle said that "people value the recognition that goes along with even a minimal increase, if others are getting smaller amounts or nothing. Thus there is still some benefit ...." [Ref. 31].

3. Summary

It is evident, then, that private sector experience with pay-for-performance systems has met with mixed results. Although many companies believe in the concept, they appear to be overcome by problems of implementation.

B. PUBLIC SECTOR EXPERIENCE

1. Merit Pay in 1980: The First Year

Eight federal agencies implemented merit pay in October 1980, one year earlier than the rest of the Government. Results of the payouts were as follows [Ref. 32]:

- Merit pay employees rated "Satisfactory" received an average increase of 14.38%; those rated "Exceeds Expectations", 12.76%; and those rated "Outstanding",

10.60%. This compares with increases of between 9.1% through 12.3% for GS employees , depending on their eligibility for within-grade increases.

- More than 93% of the merit pay employees received payouts equal to or greater than the full comparability adjustment of 9.1%.

However, in a subsequent study of merit pay, the General Accounting Office (GAO) found that OPM's method for computing merit pay funds was faulty and resulted in increased costs of about $1 million more than was warranted. This added almost 1.2% to the average merit pay increase for 1980 [Ref. 33].

The merit pay experience in 1980 revealed a number of problems in the implementation process. Specifically,

- The agencies experienced difficulty with performance standard-setting. Typical problems included the lack of employee participation in setting standards and the use of standards which were overly vague, overly specific, overly quantitative, or obsolete. The results of these problems was that supervisors found it difficult to rate accurately, and a number of employees felt their standards were not rational.

- Rating distributions were for the most part negatively skewed (i.e., a disproportionate number of people were rated in the top two categories). Consequently, some managers requested that performance ratings be changed to more closely approximate a bell curve, a practice expressly forbidden by OPM. Not surprisingly, these cases generated friction and discontent among employees, who felt the merit pay system was unfair and that ratings were based on favoritism rather than on performance.

- Performance appraisal systems were not completely or adequately pretested before being used to make merit pay determinations. Performance appraisal experts in private industry say that good performance appraisal systems take from 3-5 years to develop, with extensive pretesting and evaluation. Pretesting is considered to be extremely valuable in that it gives managers the opportunity to refine their appraisal skills prior to making pay decisions and identifies the "bugs" that are inevitable

in any new program. As a result of inadequate or absent pretests, some agencies had problems which affected the integrity of their merit pay systems.

- The guidelines provided by OPM concerning who is and who isn't covered by merit pay were inadequate. Most of the problems centered around the definition of "management official" (i.e., the determination of whether an employee is in a policy making role that requires a good deal of judgment). As a result of the unclear guidelines, some employees who were not actually management officials were included in the merit pay, while some who were management officials were not included.

- The technical assistance given by OPM to the agencies was neither timely or adequate. When the eight agencies were developing their merit pay systems for 1980 implementation, OPM inexperienced technical staff was at the start of its own learning curve and was just beginning to issue guidelines relative to merit pay. As a result, agencies were asking for guidelines which had not been formulated or even considered by OPM, and assistance was limited.

Results of the GAO study were summarized in the Comptroller General's Report to Congress which concluded: concluded:

> "We do not believe OPM has provided the leadership, guidelines, and assistance needed to assure quality pay-for-performance programs are implemented. ... We believe OPM's lack of commitment and unwillingness to undertake a dynamic leadership role has raised serious doubts about the success of the merit pay program ..." [Ref. 34].

The Comptroller General also recommended to the President that agencies be excluded from the October 1981 mandatory merit pay implementation date if they had not pre-tested their entire systems. That recommendation was not accepted.

2. Merit Pay in 1981: The Second Year

In October 1981, the remaining 90-odd Federal agencies covered by merit pay implemented their systems as required by law. However, because of a Comptroller General decision of 8 September 1981 (Appendix C), merit pay for 1981 did not operate as intended by the CSRA. The Comptroller General's decision touched off a controversy between GAO and OPM that was not resolved until just before payouts were made. The controversy surrounded an interpretation of the statute relative to the determination of funds available for the merit pay program. The merit pay provisions of the CSRA stipulated that the merit pay system would cost no more than the pre-merit pay system. However, GAO found that "the method used by OPM to calculate amounts available for merit pay payouts by agencies does not conform to the requirements of the Act" [Ref. 35]. Specifically, the GAO audit staff found that the method used by OPM to calculate merit pay funds would "make available to all executive agencies, collectively, approximately $58 - $74 million dollars more every year for merit pay expenditures would have been expended under the pre-merit pay system" [Ref. 36]. Accordingly, ruled the Comptroller General, "OPM should take immediate action to revise its merit pay implementation plan to bring it into compliance with this restriction" [Ref. 37].

Although OPM disputed the GAO findings, the Comptroller General's decision stood. Since all this occurred less than a month before the full implementation of merit pay in October 1981, OPM was now obviously in a time bind and felt its best recourse was to provide merit pay employees with the full portion of the general schedule comparability increase (4.8%). The funds for merit adjustments came from a vastly reduced pool of money calculated from estimates of within-grade and quality step increases which would have been given if GM employees had remained under the general schedule. Merit adjustments for 1981 therefore were quite small, with the majority of individuals (65%) receiving from .7 to 2.1%. In comparison, GS employees received from 0 to 3% over and above the 4.8 comparability increase, depending on their eligibility for within-grade increases.

It was painfully clear to merit pay employees what had happened: GM employees who would have received a within-grade increase under the General Schedule "lost" money, while those who would not have been eligible for a within-grade increase "won" more than they would have. Additional problems with the merit pay system surfaced:

- In January 1981, OPM issued a legal opinion prohibiting agencies from extrapolating a performance rating more than one level above or below a defined standard. This meant that agencies with five performance levels had to have written standards defined for each employee for at least two levels. Unfortunately, OPM had already

approved the merit pay performance appraisal plans for 33 agencies who intended to operate with a single performance standard against five rating levels. The plans of these agencies were now in violation of the law. OPM gave these agencies the alternative of redefining standards in the midst of the October 1981 appraisal cycle or waiting until the next year (1981) to bring their plans into compliance. Many agencies chose to wait until 1981 to comply and thus paid merit pay increases based upon illegal performance appraisals, thereby leaving themselves vulnerable to lawsuits over any personnel decisions resulting from the appraisals.

- Pretesting of systems was again seen to be inadequate or simply not done GAO audit staff found that the majority of agencies weren't conducting pre-tests because agency officials said they didn't have enough time before the October 1981 deadline.

- Until late 1981, OPM had an unwritten but strict policy requiring agency merit pay plans to grant the highest level performers two to four times as much merit pay than the lowest of the fully satisfactory level performers. Then, at an emergency session of an official interagency group, OPM encouraged agencies to adjust their plans to grant the highest performers a 5-6 times larger portion of the merit pay fund than the lowest fully satisfactory performers. Any pre-testing that had been done, and more than a year's worth of planning, was suddenly worthless. Agency personnel officers reacted with confusion and bitterness, rumors flourished, and the merit pay system lost much of whatever credibility it had.

- In spite of all the manipulations, merit pay for 1981 did not result in pay distinctions between performance levels. The end result yielded pay variances of less than 1% between top and average performers [Ref. 38].

The Defense Communications Agency, a major Defense Agency, conducted a survey among its 420 merit pay employees immediately after the 1981 payout [Ref. 39]. Only 24% said the payouts were fair; and 70% said they did not perform better because of the merit pay system. Over 70% objected to the way in which the merit pay system affected them

personally or the way in which it was implemented. Comments included:

- "I would have gotten a lot more with my normal step increase. It's going to take me twice as long to get to the same salary level as I would have with normal step increases."

- "This whole system is the most demoralizing thing to come along and is making some of us think about leaving the government."

- "True merit workers were not rewarded as promised. Many people are still not sure as to what program they belong under, GS or GM."

- "There is not one positive feature which can be found about this program. If anything, [it] ... should serve as a prime disincentive for doing quality work."

Comments from executive level individuals at DCA, who are not covered by the merit pay system, include:

- "Almost everyone involved is very dissatisfied. It is perceived that rating criteria were not consistently applied ... This has resulted in dissatisfaction of both rate and rater, damaged their relationship, and caused a significant loss of respect for ... management."

- "... the Merit Pay System operation in [1981] was generally unsatisfactory."

3. <u>Merit Pay 1982: The Third Year</u>

Merit pay for 1982 represented the first year that merit pay was fully operatiing as intended by the law. All agencies covered by merit pay had made the conversion to that system, and differences between OPM and GAO had been ironed out, thereby insuring that funding for the system was properly computed. Results of the payouts were as follows [Ref. 40]:

- Ninety-one percent (91%) of merit pay employees received payouts equal to or greater than the full comparability adjustment of 4%.

- The majority of merit pay employees (62%) received payouts between 4.1 and 7.0%. A smaller number (26%) received payouts in the range of 7.1 to 10%.

- In comparison, General Schedule employees received increases of between 4 and 7%, depending on their eligibility for within-grade increases. Those employees who performed exceptionally well and received quality step increases received approximately 3% more; for some, this represented a total increase of 10%.

Other issues surfaced during this year which raised additional concern with merit pay:

- Up to 1982, OPM officials had interpreted the regulations as forbidding agencies to guarantee a specific portion of the merit pay fund for a certain level of performance. There was significant resistance to this interpretation, since many agencies wanted to guarantee full comparability to merit pay employees who performed at the "satisfactory" level. In 1982, however, the same OPM officials made a complete about-face by inviting agencies to revise merit pay plans to target full comparability to satisfactory performers. This new policy was welcomed by agencies; however, new doubts about OPM's knowledge and guidance were raised since the 180° turn in interpretation occurred without any related change to the regulations. At best, OPM looked "wishy-washy"; at worst, incompetent.

- In 1982, pay distinctions were only slightly better than in 1981. The pay variances between top and average performers was only about 3%--the value of a quality step increase under the longevity-based GS system.

After the 1982 payouts, a merit pay employee survey was once more conducted at the Defense Communications Agency [Ref. 41]. The bottom line was that while there was some greater acceptance of the merit pay system, employee attitudes remained for the most part negative. Additionally,

the surveyed showed that the system did not meet the major objective of providing an incentive for better performance by merit pay employees. Employee comments included the following:

- "The merit pay system appears to require outstanding performance for little or no reward--such a system will not cause performance to improve."

- "This system is a paperwork nightmare yielding no results."

- "I was only marginally better off after an outstanding [rating] than if I were not under the merit pay--not much incentive based on merit pay."

- "I strongly approve of the merit pay system in principle. I find that in its application and administration it is not meeting its stated objectives, i.e., to motivate and reward merit pay employees to more efficient and effective performance."

- "Merit pay is a demotivator due to the extreme amount of paperwork, the miniscule amount of money at stake, and the inequity that occurs."

IV. DISCUSSION

With an objective of more closely aligning pay to productivity, the merit pay system was hailed as the way to improve the Federal Government's employee compensation practices. Not only did it not do this, it replaced a previously stable compensation system with one which was ineffective. The reasons for the failure encompass both the general problems inherent in any pay-for-performance system and the specific problems of implementing merit pay in the public sector. These problems can be categorized into seven major areas:

- difficulties in performance evaluation,
- insignificant monetary rewards,
- extraordinarily complex and time-consuming systems,
- inconsistent employee treatment,
- inept OPM assistance,
- administrative errors, and
- pay inequity.

A. DIFFICULTIES IN PERFORMANCE EVALUATION

One of the most frequent complaints of employees in both the private and public sectors has been that performance appraisals are not accurate. In fact, performance evaluations are generally notorious for being invalid and

biased. The Federal Government merit pay appraisal system is no different.

The system requires that performance requirements or elements be identified, and a standard or measure be defined against which an employee's performance is evaluated. The final evaluation serves as the basis for determining the amount of the merit pay increase. In some jobs, performance can be accurately measured through time-study methods. However, most supervisory or managerial jobs do not lend themselves to this approach, and other techniques must be used. When the validity of these techniques is in serious question, as they are, employees do not feel that the performance appraisal is very accurate, and thus have little reason to believe that performance and pay are linked. One researcher notes the inevitable results:

> "If the system ... doesn't have adequate performance appraisal, you find that people develop a wide range of very different perceptions of what pays off ... If you interview subordinates in an organization that 'has a merit pay system' but has poor performance appraisal, you will find a wide range of opinion about whether the system works or not, and what it means to get a merit increase. Often the perceptions are very cynical, they are counterproductive, and indeed they are really not motivating anything except what we would properly call superstitious behavior" [Ref. 42].

Another issue revolves around the inconsistency of performance standards and appraisals. Employees who performed essentially the same job, but worked for different supervisors, invariably had very different standards by which

their performance was measured. Often one employee would do little and still receive an "Outstanding", while another was required to go to extraordinary lengths in order to achieve the same rating. Generally, the latter employee received a lower rating. As one individual noted, "Disparity of standards breeds inequity, and therefore distrust and contempt for the system" [Ref. 43]

A last issue deals with the distribution of performance ratings. In order to have any meaningful pay distinctions between the top and average performers, the majority of performance ratings had to fall at the satisfactory level. To insure that this happened, some agencies used a forced distribution scheme, limiting the number of "Outstanding" and "Highly Successful" ratings. This type of practice was not publicized since it is expressly forbidden by regulation; however, employees were aware of it and, not surprisingly, reacted with bitterness, distrust, and a total lack of belief in the system.

B. INSIGNIFICANT MONETARY REWARDS

One of the fundamental beliefs of merit pay is that money can be used to motivate employees. Even the group of researchers who subscribe to this belief, however, are quick to point out that to be motivating, salary increases must be large enough to be perceived as being worth the extra effort.

No one figure has been identified by researchers as being "large enough" to motivate, primarily because this figure changes in times of inflation and is highly dependent on the individual employee's perceptions. A few researchers contend that increases must be around 7% to motivate; however, another says that "if 4 to 5 percent increases are rather standard anyway, it is doubtful that the potential of 7 will do much to motivate anyone" [Ref. 44].

The "standard" merit increase for 1982 ranged from 4.1 to 7%. A small number of employees received increases of 10%. This 3% differential is so small that it is essentially meaningless in terms of motivation. The incremental input required to obtain the incremental outcome is generally not perceived as being worth the effort. As one researcher notes, "Analogically, the salary differential in an equity sense is probably equivalent to telling a 17-year old that if the finishes high school he'll get a new car, but if he finishes high school with a B-plus average, he'll also receive a tape deck for that new car" [Ref. 45].

A more basic problem is that merit pay fails to take into account the results of numerous studies which indicate that money has little value as a motivator and that if individuals are already motivated to perform because of innate or learned drives. Some people point out that if performance is a result of ability plus effort, and if motivation is already present,

the differences in performance are a function of differences in ability. Pay for performance systems, therefore, reward differential ability rather than differential motivation.

C. EXTRAORDINARY COMPLEX AND TIME-CONSUMING SYSTEMS

The literature on designing incentive systems emphasizes the importance of keeping these systems simple. Designers of pay for performance plans are told to make the link between performance and pay clear and obvious, and to avoid complex bonus pools or combinations of numerous interrelated factors. The Federal merit pay system, however, is immersed in complexity. One example is the General Services Administration system entitled "Linking Individual Pay to Performance (LIPP)." As a former OPM official said, it requires a quantitative background just to understand:

> "A set of adjustable mathematical formulas can be derived to calculate an employee's total salary increase once the comparability adjustment, distribution of performance ratings, and amount in the merit pay fund for a particular pool is known .... Employees will be able to estimate their salary increases from the LIPP Scale by finding their current salary (before the comparability adjustment) on the horizontal axis, following that salary up to their performance curve and then left to the vertical axis, where they will find their new salaries (just after the comparability adjustment). The point at which each performance curve crosses the comparability line marks the performance level salary ceiling for that performance level" [Ref. 46].

The cost of administering these complex merit pay systems has been estimated by an economist at $1 Billion [Ref. 47].

Taxpayers would no doubt be upset over the added administrative cost of the merit pay program if they knew that the payouts made to merit pay employees were generally comparable to the very simple GS system.

People outside the public sector generally see the merit pay system and its complexities as being ludicrous. One merit pay employee authored a paper which proposed to use a compensation system for baseball players which was based on the Federal Government's merit pay system. When submitted to the Harvard Business Review, the article was slotted for publication as a satirical piece. Upon being told that the article was serious and that the Government was in fact using such a system, the piece was scrapped for publication. The system it proposed just could not be taken seriously by the editors.

Not only is the system overly complex, it is too time-consuming. Prior to merit pay, performance appraisals did not require written standards, and only required extensive documentation if the rating was "Outstanding" or "Unsatisfactory". The merit pay system represented a quantum leap in paperwork, requiring written standards as well as extensive written justification for <u>all</u> employee performance ratings. The 1981 GAO Report to the Congress states in part that "one reason that the Government has not been successful in attempting to base pay on performance was that too much

managerial time was needed to document performance distinctions among employees" [Ref. 48].

D. INCONSISTENT EMPLOYEE TREATMENT

Inconsistencies in the treatment of employees were apparent from the beginning, when decisions on merit pay coverage were made. Some agencies identified virtually all their GS-13, 14 and 15 employees as supervisors or management officials and thus to be covered under merit pay, while other agencies were much narrower in their interpretations. This resulted in cases where employees performing essentially the same jobs but at separate agencies were treated differently--one group under merit pay, the other remaining under the old GS system.

Payouts among comparable employees also varied from one agency to another. A good deal of these differences stemmed from the fact that merit pay design was decentralized and that, therefore, different agencies had very different merit pay plans. An employee's payout could vary by as much as 10% depending upon the merit pay plan that was utilized. Besides the obvious problems in pay equity, this caused difficulties when employees transferred from one agency to another.

Even within the same agency, employees at the same grade level and with the same performance rating could receive different pay increases. Due to peculiarities in the allotment of merit pay funds, an employee placed in a unit

comprised mainly of individuals at the top end of their pay ranges would receive a smaller increase than a comparable employee in a unit comprised mainly of employees at the lower end of the pay range. Moreover, a "Satisfactory" employee in a unit of "outstanding" employees received far less than a "Satisfactory" employee of the same grade in a unit of employees with "Satisfactory" ratings. Needless to say, this generated a great deal of comparison and dissatisfaction.

E. INEPT OPM ASSISTANCE

The OPM staff members from whom agencies expected to obtain guidance and assistance were themselves inexperienced in the area of pay for performance and unsure of the method in which it should be implemented in the Federal Government. Agencies calling OPM for assistance generally found that the guidance given was either inadequate or erroneous. With no definitive stand on the issues, different offices within OPM often provided conflicting guidance or regulatory interpretations leaving agencies at a loss when trying to design their individual merit pay plans.

The various agency merit pay plans had to be approved by OPM prior to implementation. OPM placed few regulatory requirements on the design of merit pay plans, preferring instead to take a decentralized and nonprescriptive approach in order to give agencies flexibility in designing their systems. However, agencies soon discovered that unless their

plans conformed to certain unstated preferences of some OPM officials, disapproval was likely. It was not unusual for agencies to submit merit pay plans that had the unofficial blessing of OPM staffers, only to find that the plan was disapproved by a higher level official who had an entirely different concept of merit pay. Confusion was the order of the day, both at agencies and within OPM, and merit pay was the casualty. OPM's emphasis was on insuring that agencies met the October 1981 deadline for merit pay implementation, rather than on monitoring the quality of merit pay systems design. The Comptroller General's Report to the Congress criticized OPM for providing "late, confusing, and everchanging policy guidelines and regulations" and stated that OPM's lack of leadership "raises serious questions about the merit pay program's chance for success" [Ref. 49].

F. ADMINISTRATIVE ERRORS

The errors made by OPM in calculating the money available for the 1981 payouts effectively sabotaged merit pay for the first year of Government-wide implementation. Moreover, the reassuring charts prepared by OPM to convince employees of the "advantage" of being under merit pay were suddenly without force, being based on erroneous computations. These errors, and the last-minute adjustments to correct them, generated doubts and disillusions about the system in the minds of affected Federal employees.

G. PAY INEQUITY

Equity theory states that employees will make comparisons of their efforts and rewards with those of others in similar work conditions. As stated earlier, merit pay employees at the same grade and with the same performance rating usually received different pay increases, due to fund allocation practices and to the composition of the various merit pay units. These pay inequities not only caused dissatisfaction, but also damaged cooperation between organizational units by stimulating unhealthy competition.

A more predominant source of dissatisfaction arose, however, when merit pay employees compared their increases to the amount they would have received under the GS system. In most cases, the merit pay increase was smaller--particularly if the merit pay employee would have been eligible for a within-grade increase under the old system. This resulted in the inevitable perception that merit pay individuals, who had attained their supervisory and/or managerial positions because they were high caliber employees, were being "punished" by their very success.

V. CONCLUSIONS

The previous chapter examined the reasons that merit pay failed in the Federal Government. However, most individuals would agree with a former OPM official that "Regardless of the reasons for the billion dollar program's failure, Congress should demand hard evidence of a meaningful advantage over the longevity-based general schedule step system applied before the advent of merit pay and still i use for employees not covered by merit pay."

After the third year of operation, the politicians who had approved the system by passing Public Law 95-454 were indeed viewing it with distrust and demanding an evaluation. The GAO was commissioned by Congress to conduct a new study of merit pay, and although they do not expect to complete it until September 1983, GAO officials state that changes will have to be made to the current system if it is to succeed. Congresswoman Rosemary Oakar's Subcommittee on Compensation and Employee Benefits under the Post Office and Civil Service is currently awaiting the GAO Report, which will be used in hearings conducted by the Subcommittee.

Congresswoman Pat Schroeder of the Post Office and Civil Service Subcommittee feels merit pay is a poorly designed system that hasn't worked and was probably designed so it can't work.

Congressman Frank Wolf of Virginia referred to the system as a "shambles" and affirmed that the "program has not lived up to its intent." Although he personally supports the notion of pay-for-performance, Congressman Wolf believes the present system lacks sufficient reward to be an incentive and further that it penalizes merit pay employees in relation to their GS counterparts. He cites the inequities of payouts among merit pay employees as another major problem, and stresses the need to have a system that is consistent throughout the Government. To that end, Congressman Wolf has introduced legislation (H.R. 1841) which, in effect, returns merit pay employees to the longevity-based compensation system and provides incentive pay in the form of bonuses (Appendices D and E). Hearings on the legislation began during the last week in May 1983. If passed, his system should save the Government $91 million in payroll costs, thereby reducing the $5.4 billion payroll costs of the current merit pay system.

Many government officials and employees believe that merit pay is good in theory, but that it hasn't worked in practice. However, if a system can't work in practice, it is hard to believe that its theoretical basis is sound. The consensus throughout the Government is that the current merit pay system does not work. The question is whether it can ever work even after extensive revisions and pre-testing.

Probably not. Even a short review of the literature demonstrates that the fundamental beliefs upon which merit pay is based are contested by a significant number of the researcher community (e.g., the use of money as a motivator). Futhermore, research into comparable private sector pay-for-performance plans shows that these plans have, for the most part, been unsuccessful. By modelling itself on these largely unsuccessful plans, and by further adding a myriad of regulatory restrictions and procedures, the Government is destined to have a system which shows even less promise than those in the private sector.

A total return to the old GS system would seem to be in order, and would certainly be preferred by the vast majority of merit pay employees. However, it would no doubt be impossible politically to do this, since Congress would have to do an embarrassing about-face. Nonetheless, some action must be taken to rid the Government of its $1 billion albatross and return to a sensible and stable compensation system. The Wolf proposal appears to have the most promise, both in its simplicity and in its pay-for-performance bonus provisions. If it does not pass, the Government faces the monumental task of revising a system which now breeds inequity, fosters disharmony, and often creates demotivation.

APPENDIX A

TEXT OF THE LAW

Text of the Law

For the use of readers in understanding the regulations, the text of the relevant laws is set forth below:

(1) The principal statutory provisions concerning the Merit Pay System appear in chapter 54 of title 5, United States Code, the text of which follows:

Public Law 95-454—October 13, 1978

"Chapter 54—Merit Pay and Cash Awards

"Sec.
"5401. Purpose.
"5402. Merit pay system.
"5403. Cash award program.
"5404. Report.
"5405. Regulations.

"§ 5401. Purpose

"(a) It is the purpose of this chapter to provide for—

"(1) a merit pay system which shall—

"(A) within available funds, recognize and reward quality performance by varying merit pay adjustments;

"(B) use performance appraisals as the basis for determining merit pay adjustments;

"(C) within available funds, provide for training to improve objectivity and fairness in the evaluation of performance; and

"(D) regulate the costs of merit pay by establishing appropriate control techniques; and

"(2) a cash award program which shall provide cash awards for superior accomplishment and special service.

"(b)(1) Except as provided in paragraph (2) of this subsection, this chapter shall apply to any supervisor or management official (as defined in paragraphs (10) and (11) of section 7103 of this title, respectively) who is in a position which is in GS-13, 14, or 15 of the General Schedule described in section 5104 of this title.

"(2)(A) Upon application under subparagraph (C) of this paragraph, the President may, in writing, exclude an agency or any unit of an agency from the application of this chapter if the President considers such exclusion to be required as a result of conditions arising from—

"(i) the recent establishment of the agency or unit, or the implementation of a new program,

"(ii) an emergency situation, or

"(iii) any other situation or circumstance.

"(B) Any exclusion under this paragraph shall not take effect earlier than 30 calendar days after the President transmits to each House of the Congress a report describing the agency or unit to be excluded and the reasons therefor.

"(C) An application for exclusion under this paragraph of an agency or any unit of an agency shall be filed by the head of the agency with the Office of Personnel Management, and shall set forth reasons why the agency or unit should be excluded from this chapter. The Office shall review the application and reasons, undertake such other review as it considers appropriate to determine whether the agency or unit should be excluded from the coverage of this chapter, and upon completion of its review, recommend to the President whether the agency or unit should be so excluded.

"(D) Any agency or unit which is excluded pursuant to this paragraph shall, insofar as practicable, make a sustained effort to eliminate the conditions on which the exclusion is based.

"(E) The Office shall periodically review any exclusion from coverage and may at any time recommend to the President that an exclusion under this paragraph be revoked. The President may at any time revoke, in writing, any exclusion under this paragraph.

"§ 5402. Merit Pay System

"(a) In accordance with the purpose set forth in section 5401(a)(1) of this title, the Office of Personnel Management shall establish a merit pay system which shall provide for a range of basic pay for each grade to which the system applies, which range shall be limited by the minimum and maximum rates of basic pay payable for each grade under chapter 53 of this title.

"(b)(1) Under regulations prescribed by the Office, the head of each agency may provide for increases within the range of basic pay for any employee covered by the merit pay system.

"(2) Determinations to provide pay increases under this subsection—

"(A) may take into account individual performance and organizational accomplishment, and

"(B) shall be based on factors such as—

"(i) any improvement in efficiency, productivity, and quality of work or service, including any significant reduction in paperwork;

"(ii) cost efficiency;

"(iii) timeliness of performance; and

"(iv) other indications of the effectiveness, productivity, and quality of performance of the employees for whom the employee is responsible;

"(C) shall be subject to review only in accordance with and to the extent provided by procedures established by the head of the agency; and

"(D) shall be made in accordance with regulations issued by the Office which relate to the distribution of increases authorized under this subsection.

"(3) For any fiscal year, the head of any agency may exercise authority under paragraph (1) of this subsection only to the extent of the funds available for the purpose of this subsection.

"(4) The funds available for the purpose of this subsection to the head of any agency for any fiscal year shall be determined before the beginning of the fiscal year by the Office on the basis of the amount estimated by the Office to be necessary to reflect—

"(A) within-grade step increases and quality step increases which would have been paid under subchapter III of chapter 53 of this title during the fiscal year to the employees of the agency covered by the merit pay system if the employees were not so covered; and

"(B) adjustments under section 5305 of this title which would have been paid under such subchapter during the fiscal year to such employees if the employees were not so covered, less an amount reflecting the adjustment under subsection (c)(1) of this section in rates of basic pay payable to the employees for the fiscal year.

"(c)(1) Effective at the beginning of the first applicable pay period commencing on or after the first day of the month in which an adjustment takes effect under section 5305 of this title, the rate of basic pay for any position under this chapter shall be adjusted by an amount equal to the greater of—

"(A) one-half of the percentage of the adjustment in the annual rate of pay which corresponds to the percentage generally applicable to positions not covered by the merit pay system in the same grade as the position; or

"(B) such greater amount of such percentage of adjustment in the annual rate of pay as may be determined by the Office.

"(2) Any employee whose position is brought under the merit pay system shall, so long as the employee continues to occupy the position, be entitled to receive basic pay at a rate of basic pay not less than the rate the employee was receiving when the position was brought under the merit pay system, plus any subsequent adjustment under paragraph (1) of this subsection.

"(3) No employee to whom this chapter applies may be paid less than the minimum rate of basic pay of the grade of the employee's position.

"(d) Under regulations prescribed by the Office, the benefit of advancement through the range of basic pay for a grade shall be preserved for any employee covered by the merit pay system whose continuous service is interrupted in the public interest by service with the armed forces, or by service in essential non-Government civilian employment during a period of war or national emergency.

"(e) For the purpose of section 5941 of this title, rates of basic pay of employees covered by the merit pay system shall be considered rates of basic pay fixed by statute.

"§ 5403. Cash Award Program

"(a) The head of any agency may pay a cash award to, and incur necessary expenses for the honorary recognition of, any employee covered by the merit pay system who—

"(1) by the employee's suggestion, invention, superior accomplishment, or other personal effort, contributes to the efficiency, economy, or other improvement of Government operations or achieves a significant reduction in paperwork; or

"(2) performs a special act or service in the public interest in connection with or related to the employee's Federal employment.

"(b) The President may pay a cash award to, and incur necessary expenses for the honorary recognition of, any employee covered by the merit pay system who—

"(1) by the employee's suggestion, invention, superior accomplishment, or other personal effort, contributes to the efficiency, economy, or other improvement of Government operations or achieves a significant reduction in paperwork; or

"(2) performs an exceptionally meritorious special act or service in the public interest in connection with or related to the employee's Federal employment.

A Presidential cash award may be in addition to an agency cash award under subsection (a) of this section.

"(c) A cash award to any employee under this section is in addition to the basic pay

of the employee under section 5402 of this title. Acceptance of a cash award under this section constitutes an agreement that the use by the Government of any idea, method, or device for which the award is made does not form the basis of any claim of any nature against the Government by the employee accepting the award, or the employee's heirs or assigns.

"(d) A cash award to, and expenses for the honorary recognition of, any employee covered by the merit pay system may be paid from the fund or appropriation available to the activity primarily benefiting, or the various activities benefiting, from the suggestion, invention, superior accomplishment, or other meritorious effort of the employee. The head of the agency concerned shall determine the amount to be contributed by each activity to any agency cash award under subsection (a) of this section. The President shall determine the amount to be contributed by each activity to a Presidential award under subsection (b) of this section.

"(c)(1) Except as provided in paragraph (2) of this subsection, a cash award under this section may not exceed $10,000.

"(2) If the head of an agency certifies to the Office of Personnel Management that the suggestion, invention, superior accomplishment, or other meritorious effort of an employee for which a cash award is proposed is highly exceptional and unusually outstanding, a cash award in excess of $10,000 but not in excess of $25,000 may be awarded to the employee on the approval of the Office.

"(f) The President or the head of an agency may pay a cash award under this section notwithstanding the death or separation from the service of an employee, if the suggestion, invention, superior accomplishment, or other meritorious effort of the employee for which the award is proposed was made or performed while the employee was covered by the merit pay system.

"§ 5404. Report

"The Office of Personnel Management shall include in each annual report required by section 1308(a) of this title a report on the operation of the merit pay system and the cash award program established under this chapter. The report shall include—

"(1) an analysis of the cost and effectiveness of the merit pay system and the cash award program; and

"(2) a statement of the agencies and units excluded from the coverage of this chapter under section 5401(b)(2) of this title, the reasons for which each exclusion was made, and whether the exclusion continues to be warranted.

"§ 5405. Regulations

"The Office of Personnel Management shall prescribe regulations to carry out the purpose of this chapter.".

Incentive Awards Amendments

Sec. 502. (a) Section 4503(1) of title 5, United States Code, is amended by inserting after "operations" the following: "or achieves a significant reduction in paperwork".

(b) Section 4504(1) of title 5, United States Code, is amended by inserting after "operations" the following: "or achieves a significant reduction in paperwork".

Technical and Conforming Amendments

Sec. 503. (a) Section 4501(2) of title 5, United States Code, is amended by striking out "; and" and inserting in lieu thereof ", but does not include an employee covered by the merit pay system established under section 5402 of this title; and".

(b) Section 4502(a) of title 5, United States Code, is amended by striking out "$5,000" and inserting in lieu thereof "$10,000".

(c) Section 4502(b) of title 5, United States Code, is amended—

(1) by striking out "Civil Service Commission" and inserting in lieu thereof "Office of Personnel Management";

(2) by striking out "$5,000" and inserting in lieu thereof "$10,000"; and

(3) by striking out "the Commission" and inserting in lieu thereof "the Office".

(d) Section 4506 of title 5, United States Code, is amended by striking out "Civil Service Commission may" and inserting in lieu thereof "Office of Personnel Management shall".

(e) The second sentence of section 5332(a) of title 5, United States Code, is amended by inserting after "applies" the following: ", except an employee covered by the merit pay system established under section 5402 of this title,".

(f) Section 5334 of title 5, United States Code (as amended in section 801(a)(3)(G) of this Act), is amended—

(1) in paragraph (2) of subsection (c), by inserting ", or for an employee appointed to a position covered by the merit pay system established under section 5402 of this title, any dollar amount," after "step"; and

(2) by adding at the end thereof the following new subsection:

"(f) In the case of an employee covered by the merit pay system established under section 5402 of this title, all references in this section to 'two steps' or 'two step-increases' shall be deemed to mean 6 percent.".

(g) Section 5335(e) of title 5, United States Code, is amended by inserting after "individual" the following: "covered by the merit pay system established under section 5402 of this title, or,".

(h) Section 5336(c) of title 5, United States Code, is amended by inserting after "individual" the following: "covered by the merit pay system established under section 5402 of this title, or,".

(i) The table of chapters for part III of title 5, United States Code, is amended by inserting after the item relating to chapter 53 the following new item:

"54. Merit Pay and Cash Awards .... 5401".

Effective Date

Sec. 504. (a) The provisions of this title shall take effect on the first day of the first applicable pay period which begins on or after October 1, 1981, except that such provisions may take effect with respect to any category or categories of positions before such day to the extent prescribed by the Director of the Office of Personnel Management.

(b) The Director of the Office of Personnel Management shall include in the first report required under section 5404 of title 5, United States Code (as added by this title), information with respect to the progress and cost of the implementation of the merit pay system and the cash award program established under chapter 54 of such title (as added by this title).

APPENDIX B

FY 1980 GENERAL SCHEDULE PAY RATES
Effective 10-05-80

New General Schedule Pay Rates

The following is the Alternative Plan Adjustment for October 1980, for General Schedule employees, submitted to Congress by President Carter:

	Steps									
GS	1	2	3	4	5	6	7	8	9	10
1	7960	8225	8490	8755	9020	9069	9189	9144	9699	9954
2	8951	9069	9242	9531	9820	10109	10398	10687	10976	11265
3	9766	10092	10418	10744	11070	11396	11722	12048	12374	12700
4	10963	11328	11693	12058	12423	12788	13153	13518	13883	14248
5	12266	12675	13084	13493	13902	14311	14720	15129	15538	15947
6	13672	14128	14584	15040	15496	15952	16408	16864	17320	17776
7	15193	15699	16205	16711	17217	17723	18229	18735	19241	19747
8	16826	17387	17948	18509	19070	19631	20192	20753	21314	21875
9	18585	19205	19825	20445	21065	21685	22305	22925	23545	24165
10	20467	21149	21831	22513	23195	23877	24559	25241	25923	26605
11	22486	23236	23986	24736	25486	26236	26986	27736	28486	29236
12	26951	27849	28747	29645	30543	31441	32339	33237	34135	35033
13	32048	33116	34184	35252	36320	37388	38456	39524	40592	41660
14	37871	39133	40395	41657	42919	44181	45443	46705	47967	49229
15	44547	46032	47517	49002	50487*	51972*	53457*	54942*	56427*	57912*
16	49198	50838*	52478*	54118*	55758*	57398*	58500*	58500*	58500*	
17	53849*	55644*	57439*	58500*	58500*					
18	58500*									

*The rate of basic pay payable for employees at these rates is limited to the rate for level V of the Executive Schedule, $50,112.50.

COMPTROLLER GENERAL DECISION B-203022

DECISION **THE COMPTROLLER GENERAL OF THE UNITED STATES** WASHINGTON, D.C. 20548

FILE: B-203022 **DATE:** September 8, 1981

MATTER OF: Office of Personnel Management's Implementation of Merit Pay

DIGEST:

1. The merit pay provisions of the Civil Service Reform Act (5 U.S.C. § 5401 et seq.) require that the merit pay system cost no more than the pre-merit pay system Merit pay system is only meant to redistribute funds which would otherwise have been spent on certain salary increases under pre-merit pay system. Accordingly, OPM should revise its merit pay calculations for within-grade step increase and quality step increase components of merit pay pool according to what agencies would have otherwise spent on these types of salary increases under the merit pay system.

2. OPM should not add "capped" funds, which would have been paid to certain merit pay employees if not for the salary ceiling, to the fund to be used for merit pay awards. The ceiling imposed on salaries pursuant to certain appropriations restrictions is a limitation on the merit pay system in that funds which could not have been paid under the pre-merit pay system are not to be included in the merit pay pool.

During the course of an audit of the implementation by the Office of Personnel Management (OPM) of the Merit Pay System under the Civil Service Reform Act (CSRA), we have found that the method used by OPM to calculate amounts available for merit pay payouts by agencies does not conform to the requirements of the Act.

Under provisions contained in 5 U.S.C. § 5402(b)(4), OPM is required to determine the amount of funds available for the merit pay program of each Executive agency and department prior to the beginning of each fiscal year. OPM construes this provision of the merit pay statute differently than does this Office. These differences center upon the extent of the discretion granted OPM by this statute to calculate the amount available to each agency and department for merit pay. This statute reads as follow:

"(4) The funds available for the purpose of this subsection to the head of any agency for any fiscal year shall be determined before the beginning of the fiscal year by the Office [of Personnel Management] on the basis of the amount estimated by the Office to be necessary to reflect--

"(A) within-step increases and quality step increases which would have been paid under subchapter III [General

Schedule Pay Rates] of chapter 53 [Pay Rates and Systems] of this title during the fiscal year to the employees of the agency covered by the merit pay system if the employees were not so covered; and

"(B) adjustments under section 5305 [annual pay reports and adjustments] of this title which would have been paid under such subchapter during the fiscal year to such employees if the employees were not so covered, less an amount reflecting the adjustment under subsection (c)(1) of this section in rates of basic pay payable to the employees for the fiscal year." [Subsection (c)(1) allows OPM to reduce annual cost of living increases for merit pay participants by as much as 50 percent.] (Emphasis added.) 5 U.S.C. § 5402(b)(4).

It is OPM's position, in essence, that the statutory authorization to OPM to estimate the amount necessary to reflect salary increases which would have been received by merit pay participants under the pre-merit pay system was intentionally drafted to give OPM the broadest possible discretion in determining the merit pay pool. OPM also relies on its statutory responsibilities under the Civil Service Reform Act as a whole to devise an equitable merit pay system which will be accepted as such by merit pay participants. Thus, OPM believes it is authorized to add funds to the merit pay pool in excess of what actually would have been spent had merit pay not been implemented, to satisfy certain objectives such as ensuring that no employee be penalized due to the implementation of merit pay and ensuring that the average annual salary rate of all employees subject to merit pay be equivalent to what their average annual salary rate would have been under the pre-merit pay system.

Our Office's position, on the other hand, is that the quoted provision limits OPM to estimates of the amounts which would have been paid for within-grade, quality step, and comparability increases if merit pay employees were still under the old system.1/ Further, this

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1/ In this regard this Office does not object to regulations promulgated by OPM at 5 CFR 540.103(d) which permit agencies to expend an amount no less than 95 percent and no greater than 105 percent of the merit pay figure provided annually by OPM. OPM's formula is based on estimates of events which would not be susceptible to precise determination before the fact even in the absence of the merit pay situation. In view of the imprecise nature of the estimates, we believe that OPM has properly incorporated a degree of flexibility into the system.

provision's legislative history convincingly demonstrates that Congress intended for the merit pay system to cost no more than the amount expended under the pre-merit pay system. It was the intent of the Congress that the implementation of the merit pay system would only redistribute an amount essentially equal to the amount expended under the pre-merit pay system.

This intent is clearly expressed in statements made by President Carter, by the Chairman and Deputy Executive Director of the Civil Service Commission (currently OPM), and by statements contained in the Senate and House Committee Reports. President Carter, in a message to the Congress, stated that the merit pay system "* * * would not increase payroll costs * * *." (Weekly Compilation of Presidential Documents, March 2, 1978). This position was reiterated by The Honorable Alan K. Campbell, Chairman, U.S. Civil Service Commission when he stated: "The net effect of these changes [the merit pay system] is that employees as a group will receive neither more nor less than they presently do, but those individuals performing in a superior fashion will receive higher salary increases." (Civil Service Reform Act of 1978 and Reorganization Plan No. 2 of 1978: Hearings on S. 2640, S. 2707, and S. 2830 before the Committee on Governmental Affairs United States Senate, 95th Cong., 2d Sess. 36 (1978)). Also, Mr. George J. McQuoid, Deputy Executive Director, U.S. Civil Service Commission, in responding to questions from the staff of the Senate Committee on Governmental Affairs in the above cited hearings stated:

> "There will be no impact, either plus or minus, on overall payroll and benefit costs as a result of the introduction of the merit pay program. Under the program, funds which, under the present system, would be expended automatically would be redistributed based upon meritorious performance rather than time in grade."

Moreover, in a section-by-section analysis of S. 2640, The Civil Service Reform Act, by the Senate Governmental Affairs Committee, it is stated:

> "The merit pay system would not require additional expenditure of money. The money saved from not awarding full across-the-board comparability increases and automatic step increases would be used to reward those employees who deserve pay raises or bonuses." S. Rep. No. 95-969, 95th Cong., 2d Sess. 88 (1978).

Finally, both the Senate and House Committee Reports contain cost estimates from the Congressional Budget Office stating that the implementation of the merit pay system would have no effect on the total amount of funds expended for personnel compensation. S. Rep. No. 95-969,

95th Cong., 2d Sess. 123 (1978); H.R. Rep. No. 95-1403, 95th Cong., 2d Sess. 94 (1978).

The fundamental issue, as we see it, centers around proper determination of the size of the "appropriation" Congress has made available for merit pay purposes. In our opinion, the terms of § 5402(b)(4), quoted above, coupled with the completely consistent legislative history, clearly demonstrate that the Act was only meant to redistribute funds and not to provide additional funds for salary increases. OPM's development of the merit pay formula must comply with this restriction. In our view, it is not permissible under the CSRA for OPM to calculate funds available for agency merit pay programs which would result in more money being expended under the merit pay system than would have been spent under the pre-merit pay system. Calculations by our audit staff demonstrate, however, that the amounts allowed by OPM's formula for pre-merit pay within-grade and quality step increases overstates by $58 to $74 million dollars the amounts which would have been paid to merit pay employees if they were still under the previous system. Furthermore, OPM's formula includes amounts for within-grade, quality step, and comparability increases which would be due merit pay employees who are at or above the statutory pay cap of $50,112.50 if the cap did not exist or were lifted. This has the potential of permitting these funds, none of which would have been spent under the pre-merit pay system, to be used for merit pay awards to employees whose salaries are not limited by the pay cap.

Our analysis of how OPM's computation of these three facets of the merit pay formula will result in additional money being spent on merit pay is as follows:

<u>Within-grade Step Increases</u>

When determining the within-grade step increase component of merit pay, OPM assumes that each employee eligible for merit pay would have received a within-grade step increase under the prior program on October 1, the beginning of the fiscal year. By computing the within-grade increase component of the merit pay pool as if it were due at the beginning of the fiscal year, OPM is establishing a formula which overstates the amount of money which would have been expended on within-grade increases but for merit pay. This is because eligible employees under the pre-merit pay system would have received within-grade increases on their particular anniversary dates, which dates fall throughout the fiscal year. OPM believes that this is necessary because only by using this formula can it assure that the group of employees who would have received within-grade increases during the period October 5, 1981 to April 5, 1982, if not for the implementation

of merit pay will not be penalized. OPM also maintains that use of the October 1 date is necessary for it to ensure that the average annual salary rate of all employees subject to merit pay will be equivalent to what the average annual salary rates of these employees would have been under the pre-merit pay system.

In our opinion, the computing of the within-grade increase component of the merit pay pool in this manner does not conform to the mandates of the CSRA. To ensure compliance with the CSRA, this component of the formula should reflect as precisely as possible what otherwise would have been actually spent on within-grade increases. Thus, OPM should compute the percentage agencies would have actually allocated from their payrolls for the awarding of within-grade increases but for merit pay in a given year and this figure should be used as part of the determination of the funds available for merit pay increases. While OPM's method of calculating within-grade increases apparently will assure that the average annual salary rate of employees under merit pay will be equivalent to what it would have been under the pre-merit pay system, this is not required by the CSRA. Similarly, the CSRA does not authorize OPM to adjust the merit pay formula to assure that employees who would have been due within-grade increases during the first half of fiscal 1982 will receive under merit pay what they would have otherwise received under the pre-merit pay system. Moreover, this seems contrary to the CSRA's basic concept of rewarding meritorious performance rather than longevity of service.

Quality Step Increases

When calculating the quality step increase component of the merit pay pool, OPM includes what it believes agencies should have spent on this type of salary increase in the past rather than the amount agencies have historically spent. It is true that the CSRA does not mandate that in calculating the quality step increase or within-grade increase component of the merit pay pool, OPM compute these components to reflect what agencies have historically spent on these two types of salary increases. Instead, the Act only requires OPM to estimate what would have been paid to employees during the fiscal year if they were not covered by merit pay. This can most logically, in our view, be achieved by referring to historical data. However, there may be other ways to satisfy this requirement and it is in OPM's discretion to determine the best possible method to meet this requirement for the various components of the pool. Thus, although agencies have historically only spent .1 percent of their payrolls on quality step increases, OPM would be authorized to use the .4 percent of payroll costs for this component it is proposing to use if OPM can show that a change in historical practice would have resulted in .4 percent of payroll costs being paid as

quality step increases in fiscal year 1982. However, if agencies will continue to spend only .1 percent of their total payroll costs on quality step increases for non-merit pay employees in fiscal year 1982, in our view, OPM in computing this portion of the pool should only use .1 percent of total payroll costs even if OPM maintains that this will effectively result in the continued underutilization of quality step increases. In other words, unless OPM takes positive steps to assure that non-merit pay quality step increases total .4 percent of salaries Government-wide, we can see no justification for using such a percentage for merit pay pool purposes.

Increments Above the Statutory Pay Ceiling

OPM includes, as part of its merit pay pool computations, amounts for within-grade step increases, quality step increases, and comparability increases which would have been paid to employees under the pre-merit pay system if it were not for the statutory cap imposed on salaries, currently fixed at $50,112.50. OPM's procedures require that employees whose salaries exceed the cap receive accounting or "paper" increases in order that their proper pay rate will be established if the cap is ever lifted. This Office agrees that these employees must receive "paper" increases. We do not believe, however, these increases may be included in the merit pay pool if the possibility exists that these capped funds might be distributed to employees eligible for merit pay who have not reached this ceiling. A distribution of this sort will result in additional funds in the merit pay pool because these funds would not have been expended under the pre-merit pay system, given the continued existence of the pay cap. In our view, this is not permitted by the CSRA. In this regard, we would not object, in principle, to the use of "paper" salary increases which would otherwise be due capped employees for purposes of calculating how much money would be in the merit pay pool for capped and non-capped employees if the cap did not exist. However, we can see no justification for distribution to non-capped merit pay employees of any of these "paper" increases because none of these funds would be payable under the pre-merit pay system.

Conclusion

As indicated above, our audit staff has determined that the above-described OPM calculations of the various components of merit pay will make available to all executive agencies, collectively, approximately $58 - $74 million dollars more every year for merit pay expenditures than would have been expended under the pre-merit pay system. In our opinion, the computation of the merit pay pool in a

manner which leads to this result is contrary to the language and intent of the CSRA. Accordingly, OPM should take immediate action to revise its merit pay implementation plan to bring it into compliance with this restriction.

APPENDIX D

H.R. 1841

98TH CONGRESS
1ST SESSION

H. R. 1841

To amend chapter 54 of title 5, United States Code, to reform the merit pay system.

IN THE HOUSE OF REPRESENTATIVES

MARCH 2, 1983

Mr. WOLF (for himself, Mr. WHITEHURST, and Mr. PARRIS) introduced the following bill; which was referred to the Committee on Post Office and Civil Service

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A BILL

To amend chapter 54 of title 5, United States Code, to reform the merit pay system.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Merit Pay Reform Act of 1983".

PERFORMANCE MANAGEMENT AND RECOGNITION SYSTEM

SEC. 2. (a) Chapter 54 of title 5, United States Code, is amended to read as follows:

"CHAPTER 54—PERFORMANCE RECOGNITION

"§ 5401. Purpose

"It is the purpose of this chapter to provide for a performance management and recognition system which shall—

"(1) use performance appraisals as the basis for determining basic pay and performance awards;

"(2) within available funds, recognize and reward quality performance by varying levels of performance awards;

"(3) within available funds, provide for training to improve accuracy and fairness in the evaluation of performance;

"(4) regulate the costs of performance awards by establishing funding level restrictions; and

"(5) provide the means to reduce or withhold pay increases for less than fully successful performance.

"§ 5402. Coverage

"(a) This chapter shall apply to any supervisor or manager who is in a position which is in GS–13, 14, or 15 of the General Schedule described in section 5104 of this title and whose responsibilities include supervising the work of one or more professional-level employees. For the purposes of this chapter, managerial or supervisory status shall be determined

in accordance with Office of Personnel Management classification standards.

"(b)(1) Upon application under paragraph (3) of this subsection, the President may, in writing, exclude an agency, any unit of an agency, or any class of employees within any such unit from the application of this chapter if the President considers such exclusion to be required as a result of conditions arising from—

"(A) the recent establishment of the agency, unit, or class, or the implementation of a new program,

"(B) an emergency situation, or

"(C) any other situation or circumstance.

"(2) Any exclusion under this subsection shall not take effect earlier than 30 calendar days after the President transmits to each House of the Congress a report describing the agency, unit, or class to be excluded and the reasons therefor.

"(3) An application for exclusion under this subsection of an agency, any unit of an agency, or any class of employees within any such unit shall be filed by the head of the agency with the Office of Personnel Management, and shall set forth reasons why the agency, unit, or class should be excluded from this chapter. The Office shall review the application and reasons, undertake such other review as it considers appropriate to determine whether the agency, unit, or

class should be excluded from the coverage of this chapter, and upon completion of its review, recommend to the President whether the agency, unit, or class should be so excluded.

"(4) Any agency, unit, or class which is excluded pursuant to this subsection shall, insofar as practicable, make a sustained effort to eliminate the conditions on which the exclusion is based.

"(5) The Office shall periodically review any exclusion from coverage and may at any time recommend to the President that an exclusion under this subsection be revoked. The President may at any time revoke, in writing, any exclusion under this subsection.

"(c) This chapter shall not apply to individuals employed under the Office of the Architect of the Capitol or the Botanic Garden.

"§ 5403. Performance management and recognition system

"(a) In accordance with the purpose set forth in section 5401 of this title, the Office of Personnel Management shall establish a performance management and recognition system which shall provide for—

"(1) a range of basic pay for each grade to which the system applies, which range shall be limited by the minimum and maximum rates of basic pay payable for

each grade under chapter 53 of this title, except as otherwise provided for in this section;

"(2) pay increases within such range, consisting of comparability pay increases and periodic step-increases (under section 5335 of this title), to the extent provided under subsection (c), based upon performance; and

"(3) performance awards, to the extent provided under subsection (d), based upon performance.

"(b) Under regulations prescribed by the Office, the head of each agency shall provide for increases within the range of basic pay for any employee covered by the performance management and recognition system.

"(c)(1) Determinations to provide comparability pay increases under subsection (a)(2) shall, for any pay adjustment period, be made based upon the level of performance of the employee involved, as most recently determined under chapter 43 of this title. If the employee's performance is rated at—

"(A) either of the two levels below fully successful, no comparability increase shall be provided; or

"(B) the fully successful level or either of the two levels above fully successful, the full comparability increase shall be provided.

"(2)(A) For purposes of section 5335 of this title, the performance of an employee under this chapter shall be considered to be of an acceptable level of competence, within the meaning of subsection (a) of such section, if such employee's most recent rating under chapter 43 of this title was at the fully successful level or either of the 2 levels above fully successful.

"(B) For purposes of section 5335 of this title, and notwithstanding subsection (c) of such section, a determination that the work of an employee under this chapter is not of an acceptable level of competence (as described in subparagraph (A)) shall be subject to review only in accordance with and to the extent provided by procedures established by the head of the agency.

"(d)(1) If the employee's performance is rated above fully successful, the employee may be paid a performance award in accordance with the provisions of this subsection. Any such award shall be in addition to any increase in basic pay provided under subsection (c).

"(2) A performance award under this subsection may be made in such amount as the head of the agency considers appropriate, except that any such award may not exceed an amount equal to 20 percent of basic pay.

"(3)(A) For any fiscal year, the head of any agency may exercise authority under this subsection only to the extent of the funds available for the purposes of this subsection.

"(B) Performance awards under this subsection shall be paid from funds or appropriations available to the agency for pay of employees.

(C) The funds available for the purposes of this subsection with respect to any agency may not exceed an amount equal to one and one-half percent of the aggregate amount of basic pay which will be payable to the employees of the agency who are covered by the performance management and recognition system for the fiscal year involved. Such amount shall be determined by the Office of Personnel Management before the beginning of such fiscal year.

"(e)(1) The comparability increase, for purposes of subsection (c)(1), shall be an amount equal to the basic pay of the employee involved multiplied by the percentage increase applicable to the grade or level of the position of such employee under section 5305 of this title at the beginning of the pay adjustment period.

"(2) For purposes of determining the comparability increase applicable to an employee under paragraph (1), such employee's rate of basic pay as of the day immediately preceding the pay adjustment period involved shall be used.

"(f) The pay adjustment period in any fiscal year shall be the period beginning on the first day of the first applicable pay period commencing on or after the first day of the month in which an adjustment takes effect under section 5305 of this title and ending at the close of the day preceding the following pay adjustment period.

"(g) Any employee whose position is brought under the performance management and recognition system shall, so long as the employee continues to occupy the position, be entitled to receive basic pay at a rate of basic pay not less than the rate the employee was receiving when the position was brought under the performance management and recognition system.

"(h) Under this section, an employee may be paid less than the minimum rate of basic pay of the grade of the employee's position to the extent that it is the result of a performance evaluation of less than fully successful.

"(i) Under regulations prescribed by the Office, the benefit of advancement through the range of basic pay for a grade shall be preserved for any employee covered by the performance management and recognition system whose continuous service is interrupted in the public interest by service with the armed forces, or by service in essential non-Government civilian employment during a period of war or national emergency.

"(j) For the purpose of section 5941 of this title, rates of basic pay of employees covered by the performance management and recognition system shall be considered rates of basic pay fixed by statute.

"§ 5404. Cash award program

"(a) The head of any agency may pay a cash award to, and incur necessary expenses for the honorary recognition of, any employee covered by the performance management and recognition system who—

"(1) by the employee's suggestion, invention, superior accomplishment, or other personal effort, contributes to the efficiency, economy, or other improvement of Government operations or achieves a significant reduction in paperwork; or

"(2) performs a special act or service in the public interest in connection with or related to the employee's Federal employment.

"(b) The President may pay a cash award to, and incur necessary expenses for the honorary recognition of, any employee covered by the performance management and recognition system who—

"(1) by the employee's suggestion, invention, superior accomplishment, or other personal effort, contributes to the efficiency, economy, or other improve-

ment of Government operations or achieves a significant reduction in paperwork; or

"(2) performs an exceptionally meritorious special act or service in the public interest in connection with or related to the employee's Federal employment.

A Presidential cash award may be in addition to an agency cash award under subsection (a) of this section.

"(c) A cash award to any employee under this section is in addition to the basic pay of the employee, or any performance award paid to such employee, under section 5403 of this title. Acceptance of a cash award under this section constitutes an agreement that the use by the Government of any idea, method, or device for which the award is made does not form the basis of any claim of any nature against the Government by the employee accepting the award, or the employee's heirs or assigns.

"(d) A cash award to, and expenses for the honorary recognition of, any employee covered by the performance management and recognition system may be paid from the fund or appropriation available to the activity primarily benefiting, or the various activities benefiting, from the suggestion, invention, superior accomplishment, or other meritorious effort of the employee. The head of the agency concerned shall determine the amount to be contributed by each activity to any agency cash award under subsection (a) of this section.

The President shall determine the amount to be contributed by each activity to a Presidential award under subsection (b) of this section.

"(e) A cash award under subsection (a) may not exceed 20 percent of the basic pay of the employee involved.

"(f) The President or the head of an agency may pay a cash award under this section notwithstanding the death or separation from the service of an employee, if the suggestion, invention, superior accomplishment, or other meritorious effort of the employee for which the award is proposed was made or performed while the employee was covered by the performance management and recognition system.

"§ 5405. Report

"The Office of Personnel Management shall submit an annual report to the President and each House of Congress evaluating the effectiveness of the performance management and recognition system. Each such report shall be prepared after consultation with the respective heads of a sufficient range of agencies so as to permit an adequate basis for making a meaningful evaluation.

"§ 5406. Regulations

"The Office of Personnel Management shall prescribe regulations to carry out the purpose of this chapter.".

(b)(1) Title 5, United States Code, is amended—

(A) in sections 4501(2)(A), 5332(a), 5334(f), and 5336(c), by striking out "the merit pay system established under section 5402" each place it appears and inserting in lieu thereof "the performance management and recognition system established under section 5403";

(B) in section 5361(5), by striking out "merit pay system" and inserting in lieu thereof "performance management and recognition system"; and

(C) in section 5948(g)(1)(C), by striking out "Merit Pay System" and inserting in lieu thereof "performance management and recognition system".

(2) Section 1602 of title 10, United States Code, and section 5(b) of the General Accounting Office Personnel Act of 1980 (31 U.S.C. 52–4(b)) are each amended by striking out "5401(a)" and inserting in lieu thereof "5401".

PERIODIC STEP-INCREASE CONFORMING AMENDMENT

SEC. 3. Section 5335 of title 5, United States Code, is amended by striking out subsection (e) and inserting in lieu thereof the following:

"(e) This section does not apply to the pay of an individual appointed by the President, by and with the advice and consent of the Senate.

"(f) This section applies to individuals covered by the performance management and recognition system under

chapter 54 of this title, as provided in section 5403(c)(2) of this title.".

PERFORMANCE APPRAISAL SYSTEM CONFORMING AMENDMENTS

SEC. 4. (a) Chapter 43 of title 5, United States Code, relating to performance appraisals, is amended by inserting after section 4302 the following new section:

"§ 4302a. Establishment of performance appraisal systems for performance management and recognition system employees

"(a) Each agency shall develop a performance appraisal system for employees covered by the performance management and recognition system established under section 5403 of this title which—

"(1) provides for periodic appraisals of job performance;

"(2) requires that the supervising official consult with the employee before establishing performance standards; and

"(3) uses the results of performance appraisals as a basis for setting the base pay and performance awards for an employee in accordance with section 5403 of this title.

"(b) Under regulations which the Office of Personnel Management shall prescribe, each such performance appraisal system shall provide for—

"(1) 5 levels of performance ratings as follows:

"(A) 2 levels which are below fully successful;

"(B) a fully successful level; and

"(C) 2 levels which are above fully successful;

"(2) establishing performance standards and critical elements which will, to the maximum extent feasible, permit the accurate evaluation of job performance;

"(3) at the beginning of each appraisal period, communicating to each employee covered by the performance management and recognition system the performance standards and critical elements of the employee's position;

"(4) during the appraisal period, evaluating each such employee on the basis of such standards;

"(5) assisting such employees in improving less than fully successful performance;

"(6) reassigning, reducing in grade, or removing such employees who continually perform below fully successful, after providing an opportunity to provide fully successful performance; and

"(7) making base pay increase and performance award decisions as a result of annual performance appraisals made under this section.

"(c) Appraisals of performance under this section—

"(1) shall take into account individual performance,

"(2) may take into account organizational accomplishment, and

"(3) shall take into account such factors as—

"(A) any improvement in efficiency, productivity, and quality of work or service, including any significant reduction in paperwork;

"(B) cost efficiency;

"(C) timeliness of performance; and

"(D) other indications of the effectiveness, productivity, and quality of performance of the employee or other employees for whom the employee is responsible; and

"(4) shall be subject to review only in accordance with and to the extent provided by procedures established by the head of the agency.

"(d) The Office of Personnel Management may not prescribe, or require agencies to prescribe—

"(1) any preestablished distribution of levels of performance ratings among employees covered under chapter 54 of this title; or

"(2) any specific performance standard or element.".

(b) The table of sections for chapter 43 of title 5, United States Code, is amended by inserting after the item relating to section 4302 the following new item:

"4302a. Establishment of performance appraisal systems for performance management and recognition system employees.".

EFFECTIVE DATE; SAVINGS PROVISIONS; CONTINUATION OF AMENDMENTS

SEC. 5. (a) The amendments made by this Act shall take effect on the first day of the first applicable pay period commencing after the first September 30th following the date of the enactment of this Act.

(b)(1) An employee whose position was covered by the merit pay system immediately before the effective date of this Act but is determined not to be covered by the performance management and recognition system as a result of this Act shall be converted on such effective date to the General Schedule in accordance with regulations issued by the Office of Personnel Management pursuant to section 5334(a) of this title.

(2) The rate of basic pay for any employee whose position was covered by the merit pay system immediately before

the effective date of this Act and is determined to be under the performance management and recognition system as a result of this Act shall be at least equal to the rate of basic pay payable for the position held by such employee immediately before the effective date of this Act.

(c)(1) The amendments made by this Act shall continue to have effect unless, during the first period of 60 calendar days of continuous session of the Congress beginning after 5 years after the effective date of such amendments, a concurrent resolution is introduced and adopted by the Congress disapproving the continuation of the performance management and recognition system. Such amendments shall cease to have effect on the first day of the first fiscal year beginning after the date of the adoption of such concurrent resolution.

(2) The continuity of a session is broken only by an adjournment of the Congress sine die, and the days on which either House is not in session because of an adjournment of more than 3 days to a day certain are excluded in the computation of the 60-day period.

O

CONGRESSMAN FRANK WOLF

MERIT PAY REFORM LEGISLATION

SECTION - BY - SECTION ANALYSIS

TITLE: Merit Pay Reform Experiment of 1983

SECOND SECTION, Amendments to Chapter 54 of Title 5, U.S. Code

This section replaces the former Merit Pay System with a five year experimental performance recognition system for improving the performance of key supervisory and managerial personnel in Grades 13 through 15 of the General Schedule.

Under the former Merit Pay System, supervisory and non-supervisory management officials in Grade 13 through 15 of the General Schedule were eligible for base pay increases and cash awards based on performance. In addition, they received one-half of the annual comparability adjustment without regard to their performance. The new Merit Pay Reform system will cover only supervisors and managers with supervisory responsibility. It will continue to tie base pay increases to performance. Within grade increases and the annual comparability adjustment will be granted only for fully successful performance or better.

For less than fully successful performance, however, no within grade increases or annual comparability adjustment will be granted. Performance recognition and other incentive awards for special acts or achievements may be granted to recognize on-the-job performance or inventions, suggestions and other improvements to the Federal service. In no event, however, will agency funding for performance recognition awards exceed 1½ percent of the total base salaries of the supervisors and managers covered by this program.

At the end of the five-year period, a decision to continue or stop this experimental program will be made by Congress based on agency recommendations.

SECTION 5401. Sets forth the purpose of the Merit Pay Reform system. It shall provide performance-based pay recognition for high quality supervisory and managerial performance. Less than fully successful performers, however, will receive no pay increases. Within available funds, continuing training is to be provided to supervisors and managers to improve the accuracy and effectiveness of the Merit Pay Reform system.

SECTION 5402. Defines the coverage of the system. Any GS 13 through 15 employee who supervises at least one professional level employee will be included in the system. Office of Personnel Management classification standards for supervisors and managers will be used to provide coverage guidance instead of the current practice of using the labor relations definition of supervisor and management official codified in 5 USC 7103.

SECTION 5403. Establishes uniform performance rating levels for simplicity and equity. Ratings will be based on a 5-point scale ranging from unsuccessful, marginally successful to fully successful, highly successful, and outstanding.

In accordance with this 5-point scale, comparability increases and within grade increases would be granted only to those with a fully successful rating or better. For those rated below fully successful, no comparability increase or within grade increase would be provided.

At no time could such an award exceed 20 percent of basic pay. Such an award would not affect the base pay of an individual -- rather it would be a lump sum payment.

Awards provided under Chapter 45 of Title 5 for inventions, helpful suggestions, achievements, and other special acts would be retained for these mid-level supervisors as well.

Funding for performance awards would not exceed 1½ percent of total base salaries of the agencies' supervisors and managers covered by this program.

SECTION 5404. Each year, OPM, in consultation with the agencies, shall submit a report on the operation of the experiment to the President and Congress evaluating the effectiveness of the Merit Pay Reform system.

SECTION 5405. This section outlines technical and conforming amendments

Under the Merit Pay Reform experiment, supervisors of employees covered by this system will be required to discuss the critical elements and standards used to appraise the performance of covered employees prior to the start of the appraisal period.

A five-level appraisal system is established. In addition, there will be no forced ratings distribution under the experiment.

This section delegates authority to OPM to issue implementing regulations and to prescribe any reporting requirements needed to set up and operate this experiment.

At the end of the 5-year experiment, within 60 days of the issuance of OPM's final report on the project, Congress must adopt a concurrent resolution to disapprove the continuation of the program.

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