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Merit-based Pay and Employee Motivation in Federal Agencies

Sungjoo Choi and Andrew B. Whitford

EXECUTIVE SUMMARY

Since the 1990s, the New Public Management agenda has spurred critical changes to the federal government's merit system. One example is limits on job security; a second is the innovation of merit-based pay systems.[1] The movement toward merit-based pay systems, such as those seen in the Department of Homeland Security (DHS) and the Department of Defense (DOD), is rooted in a desire to better align pay and performance. Yet, governments have often failed in such attempts and many conclude that merit-based pay may not work in public organizations. Public administration scholars have sought to understand those implementation failures.[2]

Most research has focused on the effects of merit-based pay on individual and organizational performance. We focus here on the effects on job satisfaction. Job satisfaction is often a good predictor of performance, so understanding the effects of merit-based pay helps us better understand whether it makes government more effective. We discuss findings from the federal government that federal employees subject to merit-based pay are consistently less happy with their job, with their organization, and with their pay than those in agencies with traditional compensation systems. Such employees are most negative about their own organization.

This leads to questions about the long-term effects of merit-based pay systems in public organizations. Despite efforts over more than three decades, there are very few signs of desirable outcomes from merit-based pay in government. It is time to reconsider the effectiveness of merit-based pay in the public sector.

Sungjoo Choi is an assistant professor in the Department of Public Administration at Kyung Hee University, in Seoul, South Korea.

Andrew B. Whitford is Crenshaw Professor of Public Policy at the University of Georgia. He is currently a Co-Editor for the *Journal of Public Administration Research and Theory*.

INTRODUCTION

Despite continuing concerns in many agencies, public administrators remain attracted to the concept of merit-based pay. Numerous state governments and federal agencies have launched competitive, merit-based pay systems as part of governmental reform efforts. However, concerns remain about the challenges of implementing incentive systems like those found in firms in public institutions – especially since we do not know much about how such systems perform in different organizational contexts. There is evidence from the private sector that merit-based pay can enhance worker productivity, but few studies explore these questions in the context of public organizations.

We discuss evidence from the Federal Employee Viewpoint Survey about how merit-based pay influences employees' satisfaction with their pay, job, and organization. Job satisfaction is a key measure of organizational effectiveness because it is a strong predictor of attributes like organizational commitment, absenteeism, and turnover that help explain individual performance improvements.[3] We believe that the relationship between merit-based pay and job satisfaction limits the effective implementation of merit-based pay in public organizations.

MERIT-BASED PAY IN FEDERAL AGENCIES

Broadly speaking, merit-based pay was introduced in the federal government by the Civil Service Reform Act of 1978, and later changed in the Public Management Reform Act of 1984. Experiments with merit-based pay in setting managerial compensation soon revealed problems, including inadequate funding, inaccurate performance appraisals, and reports of perceived unfairness. Despite frustrating experiences in the early days, policymakers often insist on implementing merit-based pay, in part because of the belief that financial incentives are effective motivators if implemented properly.[4] The New Public Management movement refocused attention on the potential for successful implementation of merit-based pay, as seen in compensation innovations in large federal agencies such as DOD and DHS. These moves come from broader governmental reform efforts to make public personnel systems "mission-centered, fair, effective, and flexible."[5]

For instance, since the enactment of the IRS Restructuring and Reform Act in 1998, the Internal Revenue Service (IRS) has also led the implementation of merit-based pay systems with broad pay band systems for managers; in 2000, IRS put in place a similar system for frontline employees. Research by the Government Accountability Office[6] noted that the IRS systems failed to align performance and the organization's goals.

In particular, the behaviors of frontline employees were not consistently aligned with their defined job responsibilities. While most managerial commitments were aligned with organizational goals, they were not clear, specific, easily monitored, or outcome-oriented. Such concerns show how difficult it is to use such pay systems to support accountability: if commitments are not clear, evaluators cannot rate managers.

However, now most Title-5 exempt agencies (see Appendix) have attempted to tailor such pay systems to their unique environments and needs (e.g., pay-for-performance systems, broad bands, variable pay, and others).[7] Examples of agencies working with such systems include the Federal Aviation Administration, GAO, several intelligence agencies, and the National Institute of Standards and Technology.

MERIT-BASED PAY AND JOB SATISFACTION

Financial incentive schemes have long been thought to motivate workers and to bring about desirable outcomes such as high performance and productivity.[8] Despite such promise, early evaluations were decidedly pessimistic about merit-based pay in public organizations.[9] Mainly, merit-based pay was seen to be limited in government settings by the inherent features of public organizations and the role of environmental factors in such settings.[10]

...early evaluations were decidedly pessimistic about merit-based pay in public organizations.

Proponents contend that increased earnings can increase the pay satisfaction of employees if workers prefer work environments that financially reward productivity and contribution to organizational goals – the result being worker optimism about future employment.[11] When workers perceive that their efforts are recognized and rewarded, they experience feelings of accomplishment, belonging, and esteem.

Opponents see several reasons that financial incentive schemes may not be beneficial for the mental wellbeing of employees. For instance, merit-based pay may have unintended negative effects on employees through the mechanisms of competition, lack of job security, risk, and perceived unfairness. Evaluating individual performance may undermine important goals like teamwork and cooperation and, in doing so, promote destructive competition.[12] Even in firms, schemes like group profit sharing can lead to peer pressure that reduces workers' job satisfaction regardless of pay raises.[13] For some types of workers, merit-based pay may be especially detrimental to their job satisfaction.

Because merit-based pay does not always guarantee constant earnings, the earnings risk that comes with such a pay scheme may negatively influence satisfaction for risk-averse workers.[14] In addition, increased earning dispersion within the organization may cause negative consequences for workers that perceive unfairness, leading to frustration and lower morale.[15]

The difference depends on comparing the short-run benefits and long-run costs of such pay schemes. One reason for this reaction in workers is that financial incentive schemes are attempts at "coercive control," which seeks to increase effort coercively instead of voluntarily.[16] While coercive control can initially work, as measured by improved views of empowerment, belongingness, task involvement, and other "affective" outcomes (e.g., job satisfaction, commitment, or self-esteem), these positive effects tend to diminish over the long-term. On one hand, these pressures and performance norms may make workers more motivated; on the other, they also increase stress and diminish the quality of the work experience.[17] These stress levels often offset the benefits, with the result that in the end work performance suffers.[18] Over time, workers in such environments often experience reduced empowerment, involvement, and job satisfaction.

Intrinsic motivation has been repeatedly emphasized as important for public employees who serve the public.[19] The worry, though, is that financial incentives can drive out that intrinsic motivation. An external intervention can alter a worker's preferences and behavior, changing how the worker perceives the task environment, the task itself, and the self-perception of her role in solving the task. Such extrinsic incentives as pay increases can come to dominate – to "crowd out" – intrinsic motivation to do a good job. Workers who see an external intervention as replacing their self-determination can come to reject their intrinsic motivation, with the result that self-esteem falls and effort is damaged.[20] In the end, intrinsic attributes of the job, such as work satisfaction, decrease due to worries about risk and lower morale.[21]

Subjective performance evaluations are especially likely to cause frustration and dissatisfaction. Such evaluations and the general lack of objective measures of performance encourage employees to work to curry the favor of supervisors, or to focus on measureable goals that may not increase overall organizational performance.[22] The various errors or biases that can find their way into a supervisor's evaluation also affect employees' perceptions of unfairness in pay distribution.[23] Such perceptions, in turn, can demotivate employees and reduce trust toward management and supervisor.[24] One survey of state government employees after the implementation of merit-based pay showed employees were skeptical about the fairness of evaluations and the motivational effectiveness of financial incentives.[25]

MERIT-BASED PAY REDUCES EMPLOYEE SATISFACTION

...working in an organization that has a merit-based pay system consistently and negatively affects employees' satisfaction with their pay, their organization, and their job.

Evidence from the 2008 Federal Employee Viewpoint Survey shows that working in an organization that has a merit-based pay system consistently and negatively affects employees' satisfaction with their pay, their organization, and their job. The relationship between merit-based pay and pay satisfaction may be negative because employees do not see their performance reflected in pay[26] or pay raises may be too small to make them satisfied.[27] The problem may be one of expectations: while some employees may perceive that they have received sufficient pay raises, it is likely that more employees are frustrated because of higher expectations about pay increases. Since earning increases are usually limited to a small number of employees, average pay satisfaction is likely to be lower than that in agencies without merit-based pay. Note that this is likely a special feature of the unique financial condition of governmental organizations that rely on appropriations. Limited funds in government have long hindered successful implementation of merit-based pay. In one state-level survey, employees suspected their performance ratings were intentionally downgraded due to budgetary constraints.[28]

Perceptions about proper implementation of such systems are crucial to system success.[29] This likely explains our findings that merit-based pay is negatively related with organizational satisfaction. If employees are frustrated and experience stress due to unmet expectations and perceived unfairness in the system (e.g., perceived unfairness in performance evaluation), they may blame their organizations for their own failure to earn bonuses. Also, since highly competitive work environments with financial incentive schemes usually impose greater burdens on employees, this also creates more work stress.[30] Such pressures and performance norms probably contribute to negative experiences in the workplace.[31]

...public employees value pay less than their counterparts in the private sector.

Finally, we find that financial incentive schemes affect intrinsic motivation negatively by decreasing job satisfaction. Many studies have found that public employees value pay less than their counterparts in the private sector.[32] Rather, public employees are motivated by public service,[33] and such employees report higher job satisfaction.[34] Perhaps such employees have "public service motivation,"[35] or value "self-determination."[36] If either is true, then such motivations are fundamental for developing compensation systems that better fit the kinds of people who work in government.

Comparing how merit-based pay affects these three different measures of job satisfaction - satisfaction with one's job, pay, and the organization itself - helps us better understand the potential negative consequences of such systems. Foremost, such systems are most likely to reduce employee satisfaction with the organizations where they work. We believe that many employees experience unmet expectations and are frustrated with how such systems are implemented in their organizations: they worry about unfair performance evaluations and evaluators; they know that funding constraints can lead to performance mis-measurement; they experience uncomfortable performance norms and intense work. Of course, employees may also be dissatisfied with their pay and job, but they seem more likely to blame their organization and the implementation of the system.

IMPLICATIONS

Despite three decades of experience in implementing merit-based pay systems, we still see little evidence of the outcomes promised by such systems. We worry about whether merit-based pay is appropriate for public organizations. If employees are less satisfied with their workplaces when exposed to financial incentive schemes, this has long-term implications for turnover and future hiring initiatives. It may be that merit-based pay is inherently flawed[37] or that public organizations are bad places to implement it. The simple answer is that we should evaluate the effects of these situations more – especially so in small experiments – rather than making prospective promises of such systems' efficacy.

APPENDIX

Title 5 of the US Code in the federal government defines the majority of civil service protections, for example, hiring and recruiting standards (e.g., rule of three, veterans' preferences), banning nepotism, and protecting federal employees from political coercion.[i] Exemption from Title 5 of the US Code thus increases managerial discretion and flexibility and relaxes rules in public personnel management. Agencies exempted from Title 5 are allowed to develop their agency-specific systems such as pay for performance, streamlined hiring process, and stricter disciplinary systems.[ii]

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Governance Studies
The Brookings Institution
1775 Massachusetts Ave., NW
Washington, DC 20036
Tel: 202.797.6090
Fax: 202.797.6144
www.brookings.edu/
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