Avoiding “Pain for Performance”: How to Design and Implement an Effective Pay-for-Performance System

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Introduction

A growing number of Federal agencies are transitioning to Alternative Personnel Systems (APSs) in an effort to attract, reward, and retain employees. These APSs are intended to give managers the ability to provide monetary rewards to outstanding performers. This represents a significant change from the legacy government services (GS) system by collapsing the current 15 government pay grades into broader pay bands. Having broader stratification of positions across fewer pay bands is intended to give managers more flexibility in hiring and promoting employees, and to reduce the amount of cumbersome paperwork required of unique position descriptions for each job series across multiple GS levels. The mind-boggling complexity of instituting such a large change requires much forethought and planning. Unfortunately, many APS implementations occur with short timelines and without adequate understanding of the essential elements that must be addressed in order to be successful.

The goal of modernizing the government’s hiring, promotion, and compensation systems is long overdue and has the potential to greatly increase agency effectiveness and accountability in carrying out the mission. However, initial APS efforts in the Federal Government have come under scrutiny from political leaders, oversight organizations, Federal unions, and President Obama. An APS has several components including new rules around job classification, pay setting, promotion, termination, and performance management. The most elusive piece in the APS is the notion of “pay-for-performance.” This involves strategic planning, goal setting, tracking of performance, employee/supervisor dialogues, assessing annual performance, and adjudicating the final payout that each performer receives based on their performance scores.

Although President Obama supports pay-for-performance as a management method to attract, recruit, and retain top talent, he emphasizes effective and fair merit pay policies. Before the election, Obama said that as President, he would alter or repeal the Department of Defense’s (DOD) National Security Personnel System (NSPS). “I have several concerns about the NSPS pay system,” then-Senator Obama wrote in a letter to the President of the International Federation of Professional and Technical Engineers in September 2008. His concerns include restrictions on bargaining rights, the disconnect between pay and performance, requiring performance ratings to be pushed into a forced distribution, suppressing wages by permitting bonuses instead of base salary increases, and the “virtual elimination of merit consideration in the promotion process.”

Congress seems to agree with the President. In a February 11, 2009 letter to Defense Secretary Robert Gates, house committee members urged DOD to stop converting employees to NSPS until Congress and the administration has completed a thorough review of the system. NSPS induced “widespread distrust and discontent within the ranks of...dedicated DOD employees,” wrote Representatives Ike Skelton, D-Mo., chairman of the House Armed Services Committee, and Solomon Ortiz, D-Texas. Transitioning from NSPS to a new system will not be easy, and will take time and effort. As Congress decides its next steps, there are immediate best practices that should be considered in order to realize an effective pay-for-performance system, within DOD as well as throughout other organizations. So, what does it take to have a successful pay-for-performance system within a Federal agency?

“I cannot and will not support a pay system which ultimately is designed to suppress wages for civilian DOD employees over time.”
—Senator Obama
Overview

There are several possible reasons why any organization undertakes a pay-for-performance system, including an attempt to reward the highest performers, to eliminate the lowest performers, to attract and retain talent, or to offer competitive salaries within tight labor markets. Regardless of the reason, migrating to such a system is always far more difficult and complex than anticipated. In 2008, ICF International assembled a consortium of consultants who have extensive experience assisting Federal and private organizations with the implementation of pay-for-performance systems. All of these consultants have experienced APS implementations (including NSPS implementations) either as internal and/or external practitioners. Over the course of six months, the team captured, cataloged, and analyzed hundreds of “lessons learned” that were experienced through dozens of APS implementations. The team identified five primary categories of issues and crafted key elements for mitigating these pitfalls. These elements include:

- Culture and Leadership
- Resources
- Policies and Procedures
- Performance Objectives
- Evaluation Plans

Addressing these elements before implementing a pay-for-performance system can save costs, enhance the organization’s mission, and preserve trust within the organization. The core issues associated with each of these elements are briefly described in this article.

Culture and Leadership

Because culture and leadership both describe how the societal system within an organization adapts to large-scale changes, they should be addressed together. The topics of culture and leadership abound in nearly all of the literature that deals with organizational change. The role of culture and leadership is no less important within the pay-for-performance world. Regardless of how well the technical elements of a pay-for-performance system are put together, without clear and continuous advocacy for the system by top leadership, there is little chance of the new system taking hold.

Similarly, leadership must also provide specific avenues for addressing concerns and for promoting transparency around the system. While the topics of pay and performance are typically treated as “confidential information” when attributed to individuals, in the aggregate there must be an open sharing of what is/is not working in the system, where the average scores and payouts fall, and what steps management is taking to continuously improve the system. If leadership is functioning in this manner, the over-arching culture of the organization will support the new system and the focus of employees will migrate towards performance rather than just pay.
Resources

Cynical opponents of pay-for-performance will claim that an APS is nothing but a thinly veiled attempt to drive down labor costs. In our experience, an APS never achieves lower payroll costs and when the additional administrative time to implement these systems is considered, they often represent much higher costs when compared to traditional GS systems. However, these higher costs are justifiable if higher levels of performance are achieved.

The monetary infrastructure must exist to support the change, including a plan for a fiscally sustainable compensation system. In a private organization, additional gains in performance typically lead to additional profits that can be used to fund the pay-for-performance system. However, public institutions typically have a fixed financial resource pool that is calculated based on historical spending on salaries, bonuses, and forecasted pay increases such as locality pay and adjustments for inflation. Few Federal agencies obtain financial returns from their work. Most agencies are funded through appropriations, and the relationship between performance and appropriations is nebulous at best.

Therefore, most Government agencies must allocate funding for performance-based salary increases and bonuses from their existing salary budgets (e.g., funds that might otherwise be used for scheduled step increases, “on the spot” awards, quality step increases, and cost of living adjustments). This typically limits pay increases to a relatively small amount even for exceptional performance (e.g., in the DOD NSPS program, a perfect performance score of “5” would typically provide a pay increase or bonus of no more than 10%). As pointed out by McPhie1, “the amount available each year for pay increases is typically quite limited—regardless of whether agencies have met or exceeded their performance goals” (McPhie 2006). This limitation has consequences that should be factored into the system at its inception, namely the financial ceiling or limits on the pay out employees can expect from the new system. Adequate funding to support the system is required to make pay outs meaningful and to differentiate between performers.

Policies and Procedures

For a pay-for-performance system to work effectively and to assist in the smooth transition, policies and procedures must be accurately defined and documented. Effective policies ensure that the system functions as intended and employees and supervisors know how to use the system. Policies are particularly important during the implementation of a new pay-for-performance system. For example, most organizations initially focus on what steps will be necessary to close out the performance period (e.g., writing the final assessments) rather than on what steps can be taken during setup to ensure that the final review is efficient and effective. This initial focus on the end of the performance year also leads to a misconception that “we have time to develop the policy and guidance.” Several organizations rush head-long into implementation of the system because they believe that the required guidance is not needed until the actual “work” begins at the end of the year. This leads to a tumultuous and painful close-out of the first performance cycle.

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Performance Objectives

Determining clear, relevant, and measurable performance objectives is the cornerstone of an effective pay-for-performance system. The success of all other elements is dependent on high-quality performance objectives; if performance objectives are written effectively, the pay-for-performance system will be successful. Here is why:

Performance objectives are the ultimate means for determining an employee’s level of compensation. The performance objectives determine whether an individual is successful and meets the goals of the organization. If an organization is measuring the “wrong” thing, or does not measure employees’ performance accurately, in most instances the intention of implementing a pay-for-performance system has been lost (e.g., to attract, award, and retain the highest performing individuals and to precipitate high levels of performance for the organization as a whole).

Organizations encounter several primary issues when developing performance objectives:

- The organization does not have clear and measurable goals, thereby eliminating the necessary context for deriving individual performance objectives.
- Individual performance objectives are not aligned with the organization’s goals.
- Individual performance objectives are not written clearly and objectively.
- “The bar” for performance achievement is not determined at the beginning of the performance period, thereby making meaningful measurement of progress impossible.

Evaluation

Although evaluation is a very broad topic, three distinct components were isolated as they pertain to design and implementation of the pay-for-performance system:

1. The quality of the supervisor and employee written evaluations.
2. The process used to adjudicate the final assessments and to prevent bias.
3. The process of determining if the overall pay-for-performance program is working.

In the first topic, it was often the case where there was inconsistency between the written performance objective and the supervisors’employees’ descriptive pros that should justify the level of accomplishment. This inconsistency makes it difficult to rate performance of the individual fairly against the objectives.

Once this issue is resolved, the next step is to ensure that an adjudication process is in place (and being followed) to guarantee there is an overarching assessment of how fairly the collection of performance plans are being judged. Even if each individual performance assessment is high-quality, the issue of “easy” versus “hard” grading supervisors exists. There must be a process that allows senior management to assess whether there is bias in the

“While I strongly believe that workers can and should be rewarded for high quality work, the administration’s failure to fund the [pay-for-performance] initiative guaranteed that rewarding one employee would be at the expense of another. This is unfair and serves to reduce morale, rather than improve it.”

Barack Obama
system, and to determine whether the overall level of employee performance matches their understanding of overall organizational performance (e.g., they should expect the overall scores to trend high if the organization has had a very successful year, and should trend low if the organization has failed to meet its annual goals).

Finally, the overall pay-for-performance system must be evaluated to determine whether the programmatic goals are being met. There must be clear evidence that the system is promoting high-performance, rewarding the right employees, providing constructive feedback for improvement, and allowing the organization to reach its mission.

**Conclusion**

Building a pay-for-performance system is an evolutionary process that must begin with the basics. While ideally all five of the primary elements presented should be addressed before a pay-for-performance system is instituted, in reality most agencies are not afforded the time. Agencies must focus on the essentials through a careful assessment of the most relevant issues to their particular environment.

An APS can only succeed when organizations are able to resist the temptation to focus only on pay. This paper is a platform to raise awareness that the focus should remain on performance, thereby providing lasting results for the organizations.

**About the Authors**

This paper was written by Mr. Ethan S. Sanders, Ms. Kate Harker and Ms. Lisa Gabel of ICF International. Mr. Sanders, a fellow at ICF, has provided human performance consulting services to clients in the public, non-profit, military, and private sectors for nearly 20 years. Ms. Harker, an organizational effectiveness consultant at ICF is an expert in measurement and evaluation. Ms. Harker has provided consulting services to numerous government entities transitioning to pay for performance systems. Ms. Gabel, an organizational effectiveness consultant at ICF, has extensive experience in performance and change management. Through work conducted for the Federal and State governments, Ms. Gabel has first-hand knowledge of the design of performance objectives, evaluation plans, and policy related to pay for performance systems. The views expressed in this paper and any errors are those of the authors and not necessarily those of ICF International.

**About ICF International**

ICF International (NASDAQ:ICFI) partners with government and commercial clients to deliver consulting services and technology solutions in the energy, climate change, environment, transportation, social programs, health, defense, and emergency management markets. The firm combines passion for its work with industry expertise and innovative analytics to produce compelling results throughout the entire program life cycle, from analysis and design through implementation and improvement. Since 1969, ICF has been serving government at all levels, major corporations, and multilateral institutions. More than 3,000 employees serve these clients worldwide. ICF’s Web site is [www.icfi.com](http://www.icfi.com).