

PERFORMANCE-RELATED PAY FOR GOVERNMENT EMPLOYEES

Executive summary

Introduction

Twenty years ago, nearly all civil servants in the central government of OECD member countries were paid according to service-incremental salary scales. This is not to say that civil servants previously lacked performance incentives. Promotions, and especially those into senior management, were rigorously controlled, serving partly as an incentive but partly also as a way of ensuring the independence of the public service with regard to the executive and thus its ability to serve governments of different political persuasions. However, socio-economic pressures have led to the need for types of incentives other than “promotion” to strengthen performance management. Remuneration has been seen as an alternative or a complementary incentive to promotion.

By the turn of the millennium, significant numbers of civil servants were covered by performance-related pay (PRP) schemes of one kind or another in most OECD member countries, particularly senior managers, but increasingly also non-managerial employees. The introduction of performance pay policies occurred in the context of the economic and budgetary difficulties faced by OECD member countries from the mid-1970s. Reasons for introducing PRP are multiple, but focus essentially on improving the individual motivation and accountability of civil servants as a way to improve performance. PRP is seen as a signal of change for civil servants and as a way of indicating to citizens that performance is regularly assessed in public administration.

In this book, the terms “performance-related pay” and “performance pay” are used as synonyms to refer to a variety of systems linking pay to performance. Performance-related pay systems are based on the following assumptions: i) organisations can accurately measure individual, team/unit or organisation outputs; ii) individual and team/unit outputs contribute to organisational performance; iii) pay can be administered in a way which capitalises on its expected incentive value for potential recipients.

The adoption of performance-related pay in the public sector reflects the influence of the private sector culture of incentives and individual accountability on public administration. Civil services have increasingly sought to manage service production tasks on similar lines to those in the private sector. In the private sector, pay for performance is the norm in most companies: managers usually receive cash incentives and stock ownership opportunities that link rewards to the success of the company as well as individual performance, and lower level employees receive individual or group bonuses for good performance.

The introduction of PRP in OECD public sectors is only one facet of a wider movement towards increased pay flexibility and individualisation. Another important change – especially at the managerial level – is the attempt to base individual salary on the specific difficulties of the post or the level of responsibilities. In most countries, the salary policy for civil servants now consists of three key components: base pay, remuneration linked to the nature or duties of a post, and performance-related pay elements. The two elements of variable pay should not be confused. The first relies on an *ex ante* evaluation of “anticipated” or “likely” performance based on job demands (for example, by assessing the qualities needed for the particular duties associated with the position) while the other relies on an *ex post*

evaluation. Variability of pay in almost all OECD member countries at the managerial level tends to depend more on prior job evaluation than on the *ex post* evaluation necessary for a PRP scheme.

Two-thirds of OECD member countries have implemented PRP or are in the process of doing so (OECD, 2004). However, there are wide variations in the degree to which PRP is actually applied throughout an entire civil service. In many cases, PRP concerns only managerial staff or specific departments/agencies. Very few OECD civil service systems can be considered to have an extensive, formalised PRP system. PRP is sometimes more rhetoric than reality, as some systems actually base the assessment of performance on inputs – which cannot really be qualified as “performance-related”. In some cases as well, performance rewards are distributed without any formal assessment of individual performance. In fact, there is often a gap between the stated existence of a so-called “performance-related pay scheme” and its concrete functioning, which may be barely linked to performance.

The goal of this book is to provide a comprehensive overview of the different trends in performance pay policies across government employees of OECD member countries and to draw some lessons from their experience. The book focuses on PRP policies applied to ministries/departments/agencies of the central/federal government level. The report explores the various PRP designs and emerging trends, investigating the reasons why PRP policies are being implemented and how the policies operate concretely. The report also aims to analyse the apparent impacts of PRP policy. The book is organised as follows: Chapter 1 sets performance-related pay policies in the wider management context; Chapter 2 analyses key trends in performance pay policies in OECD member countries; Chapter 3 assesses the impact of PRP policies and draws lessons from the experience of implementing them.

The book is based primarily on twelve country reports that were presented at an OECD expert meeting in October 2003¹: Denmark, Finland, France, Germany, Hungary, Italy, Korea, Spain, Sweden, Switzerland and the United Kingdom – all OECD member countries – and Chile, which is an observer to the OECD Public Governance Committee. The other main sources for the book are the answers given to the 2003 OECD/GOV Survey on Strategic Human Resources Management² and the research on performance-related pay conducted by Professor David Marsden of the Centre for Economic Performance at the London School of Economics³.

Performance-related pay in the wider management context

PRP fits within the wider performance budgeting and management developments in vogue over the past two decades, which emerged against the background of the economic and budgetary difficulties in OECD member countries. These developments have been characterised by an attempt to systematically

¹ Reports were prepared by delegates within the framework of guidelines set by the Secretariat. The guidelines were structured around four key points: i) background, scope and coverage of PRP policy; ii) design of PRP policy: performance appraisal, rating and payment systems; iii) implementation and assessment of impact of PRP policy; iv) difficulties facing PRP policy, lessons learnt and prospects.

² The Survey on Strategic Human Resources Management [PUMA/HRM(2002)3/FINAL] was answered by 29 OECD member countries (Turkey was not included). It was completed by ministries/departments in charge of human resources management in the public sector, and one official answer was provided by each country. This book relies in particular on sections 7 and 8 of the survey which deal with performance management and pay determination systems.

³ See the bibliography. The results of this research are based on a series of attitudinal surveys of employees and line managers in several areas of the United Kingdom public service: the Inland Revenue, the Employment Service, NHS Trust Hospitals, and head teachers in primary and secondary schools.

incorporate – at least formally – performance objectives and indicators into human resource management and budgeting processes and to move towards pay flexibility and individualisation in OECD public sectors. The introduction of PRP is only one facet of this wider movement towards an increased focus on defining and achieving organisational objectives and targets.

The impact of the introduction of PRP has to be analysed according to the multiplicity of objectives for introducing it. The main argument put forward for implementing PRP, is that it acts as a motivator, by providing extrinsic rewards in the form of pay and intrinsic rewards through the recognition of effort and achievement. Overall, however, the types of objectives pursued with PRP vary across countries, with Nordic countries focusing more on the personnel development aspects, most Westminster countries focusing more on the motivational aspect and others such as France or Italy, stressing the leadership and accountability of top civil servants.

There are large variations in the degree to which PRP is actually applied throughout an entire civil service. Only a handful of member countries can be considered to have an extended, formalised PRP policy (Denmark; Finland; Korea; New Zealand; Switzerland; the United Kingdom). Mostly, countries which have developed the strongest links between performance appraisals and pay as employee incentives, are those which have the highest delegation of responsibility for human resources and budget management – usually position-based systems. This illustrates the importance of such delegation to the development of PRP. Until recently, countries with a low degree of delegation – mainly career-based systems – tended to focus primarily on promotion to motivate staff. However, this has started to change and PRP policies have now been introduced into some career-based systems in such a way as to increase flexibility and to promote individual accountability (Hungary, Korea and France, for instance).

Key trends in performance-related pay

There is no single model of PRP across OECD member countries. Models are diverse and vary according to the nature of the civil service system, the pay determination system and the degree of centralisation or delegation in financial and human resources management. However, common trends are clearly emerging across groups of countries and across the OECD as a whole:

- PRP policies have spread from management level to cover many different categories of staff in the past ten years
- Among PRP policies, there has been some increase in the use of collective or group performance schemes, at the team/unit or organisational level.
- Long-running standardised PRP schemes have evolved into more decentralised systems, which facilitate delegation of managerial functions.
- There is an increased diversity of the criteria against which performance is assessed. Both career-based and position-based civil service systems tend to converge in the attention given to outputs, but also on competencies and social skills in general.
- Performance rating systems are less standardised, less formalised and less detailed than ten years ago. Performance appraisals rely more on the assessment of pre-identified objectives and on dialogue with line management than on strictly quantifiable indicators. On the other hand, systems of rating performance which impose quotas on the numbers who can succeed under them, are more widespread across OECD member countries.

- The size of performance payments is generally a fairly modest percentage of the base salary, especially among non-managerial employees. Merit increments tend to be smaller than one-off bonuses, they are often below a maximum of 5% of the base salary. PRP bonuses, which tend to supplement or replace merit increments, are in general higher – but overall, maximum awards usually represent less than 10% of the base salary for civil servants. At the management level, performance payments are generally higher, around 20% of the base salary.

Implementation and impact

Performance pay is an appealing idea, but the experiences reviewed in this study indicate that its implementation is complex and difficult. Previous OECD studies on the impact of performance pay at the managerial level concluded that many of the schemes had failed to satisfy key motivational requirements for effective performance pay, because of design and implementation problems, but also because performance assessment is inherently difficult in the public sector (OECD, 1993; OECD, 1997). Performance measurement in the public sector requires a large element of managerial judgement. The notion of performance itself is complex, owing to the difficulty of finding suitable quantitative indicators and because performance objectives often change with government policy. Many studies have concluded that the impact of PRP on performance is limited, and can in fact be negative.

Evidence cited in this book indicates that the impact of PRP on motivation is ambivalent: while it appears to motivate a minority of staff, it seems that a large majority often do not see PRP as an incentive. While base pay as it relates to the wider “market” is important, supplementary pay increases for performance are a second-rank incentive for most government employees, especially those in non-managerial roles. Job content and career development prospects have been found to be the strongest incentives for public employees. PRP is unlikely to motivate a substantial majority of staff, irrespective of the design.

Despite such cautions, the interest in performance pay has continued unabated over the past two decades. This paradox arises from the fact that, despite the overall consensus on the types of problems raised by performance pay, PRP policies continue to be introduced on a large scale in many OECD member countries. There are few examples of public organisations having withdrawn their PRP policy.⁴ But the fact that organisations do not withdraw PRP is not necessarily a very good indication of its effectiveness, because the costs of doing so are a deterrent. However, one of the key reasons why PRP continues to be introduced on such a large scale across civil service systems, appears to be its role in facilitating other organisational changes.

It seems that, in the right managerial framework,⁵ the processes that accompany PRP have made such changes both possible and positive. When performance pay is introduced, there is a window of opportunity for wider management and organisational changes. These include effective appraisal and goal setting processes, clarification of tasks, acquisition of skills, creation of improved employee-manager dialogue, more team work and increased flexibility in work performance. Introducing PRP can be the catalyst that allows these changes to occur and, at the same time, facilitates a renegotiation of the “effort bargain” thus assisting in recasting the culture at the workplace. These dynamics have positive impacts on work performance. It appears that it is not through the financial incentives it provides that PRP can contribute to improving performance, but rather through its secondary effects, that is the changes to work and management organisation needed to implement it.

4. The New Zealand police is one example.

5. The right managerial framework means the basics of sound management; that is transparency within the organisation, clear promotion mechanisms and trust in top management.

Recommendations

The design of PRP is a trade-off between various options which have to take into account the background culture of each organisation/country. There is no “best” solution. When designing new schemes, management should consider what will prove acceptable to large numbers of the staff in its organisations. Management should seriously consider team/unit PRP systems for employees, which can be introduced in a less disruptive way and appear to be able to produce more positive results than strictly individualised PRP. The balance of individual and team PRP is a key design issue.

The performance appraisal process is at the heart of the whole system. It is recommended that performance appraisal be based on goal setting rather than on standard criteria for a job. Performance rating should not be too detailed and should avoid rigidity. The objectives set for an individual’s performance appraisal should act as a basis for ongoing dialogue throughout the year between the manager and the employee. Detailed feedback on the appraisal undertaken at the end of the year should be provided. Transparency in the whole process is the key factor in ensuring its success, which ultimately relies more on an effective measurement of performance than on the distribution of payment.

Implementation problems need to be anticipated. This implies primarily co-ordination with staff and unions on the implementation of PRP; the preparation of top and line management; clear anticipation of the budget needed for, and the costs linked to, PRP and of the ways of funding PRP; and of the time and work that the introduction and monitoring of the system requires.

Performance pay goes hand in hand with human resources management delegation. Some delegation of human resources and pay management is crucial for the effective implementation of performance pay. This is because of the close link between goal setting and performance pay. The more successful schemes appear to rely upon a close integration of these two functions, in contrast to more traditional models which tended to award PRP against standardised performance criteria. It is easier to articulate individual employees’ objectives and those of their organisation in a meaningful way if the local management has a degree of autonomy to adapt the scheme to its own needs.

Evaluations need to be conducted regularly and a PRP system needs to be revised from time to time.

The significance and impact of PRP on motivation should not be overestimated. PRP is of secondary importance as a managerial tool for improving motivation. Criteria such as satisfying job content, promotion possibilities or flexibility in work organisation come far ahead of performance pay in motivating for staff. The evidence points, therefore, to the need for a broad approach to better performance management as against a narrow preoccupation with performance-related compensation.

PRP should be applied in an environment that maintains and supports a trust-based work relationship. In such an environment there is a balance between formal and informal processes, with on-going dialogue, information sharing, negotiation, mutual respect, and transparency being prioritised. It is also suggested that PRP requires a mature and well-established civil service culture and a stable political and policy environment.

PRP should be used, above all, as a stimulus and a lever for the introduction of wider management and organisational change, rather than solely as a motivational tool for staff. Pay for performance should be viewed essentially as a management tool. The objectives of PRP should be set accordingly.