Merit Pay Can Be a Hard Sell

Howard Risher

"Merit" and "pay." When these two words are combined, the resulting phrase falls somewhere behind "Remember the Alamo!" as an effective rallying cry.

It is a rare public organization whose employees embrace a new merit pay policy with open arms. The track record among public employers is a long road littered with failed and discarded policies. It's difficult even to find public organizations in which management is confident that it has a successful merit policy.

Despite these points, evidence is mounting that interest in merit pay is growing and that an increasing number of public employers will be working to gain acceptance for policies that tie wage and salary adjustments to employee performance. This has been the focal issue in Colorado's Peak Performance initiative. It's also an issue under study in Maryland, Georgia, the District of Columbia, and undoubtedly a number of other local governments.

This past January, Vice President Gore announced that he "plans to push for significant changes in the [federal] civil service system aimed at more strongly linking the pay of federal employees to their job performance." The Clinton administration is currently working to gain support for enabling legislation to make this stronger link a reality.

This article discusses some of the factors that have con-

tributed to the interest in this policy alternative and provides some advice for public employers that are ready to shift to merit pay. Merit pay is more than a change in an administrative policy. Its introduction will change the organization. This point needs to be reemphasized: the organization will not be the same afterward; the change will trigger a high level of anxiety among employees and managers alike and could well be disruptive. The change process needs to be carefully planned and managed. A goal of the article is to help employers avoid the landmines and realize the expected benefits of rewarding employees for their performance.

What Is Merit Pay?

The term "merit pay" generally refers to a policy that links annual wage and salary increases to employee performance over the prior year. Every employer has a need to review base pay levels annually. Employee performance is a widely accepted rationale for determining the increases that employees are granted.

The goal of merit pay systems is to use pay increases as a tool to focus more sharply on performance and to influence or change employee behavior. A change to merit pay is more than a change in administrative policy, more than an alteration in fiscal management strategy.

Merit pay is not handled in the same way by every organization. At one extreme, the pay increases are determined by formula, with virtually no managerial discretion. At the other extreme, supervisors have broad discretion in deciding how to adjust subordinate salaries. The goal is to develop a policy that fits the organization.

In the private sector, merit increase policies are virtually universal for managerial, professional, and office support employees. Surveys of company practice show that 97 percent of respondents have a merit pay policy. In fact, the companies responding affirmatively to these surveys have increased slightly in the past decade. In effect, the only people working in the private sector who are not covered by merit policies are in what are traditionally called blue-collar jobs.

In the typical corporate environment, merit pay ranks close to apple pie and motherhood as an indisputable value. It has become the only accepted rationale for determining annual increases. Any pay practice that is based on automatic formulas or treats everyone the same, regardless of performance, is unacceptable to corporate leaders.

The merit pay philosophy permeates U.S. culture. In fact, the phrase "meritocracy" was coined to differentiate our society from others. Few among us would argue with statements like "Hard work should be rewarded." Americans also place considerable emphasis on recognizing and celebrating outstanding achievements. That's true in every walk of life and at all ages.

The intention of merit pay, of course, is to provide an incentive for employees to perform at higher levels. If we focus narrowly on the prospect of, say, an extra $25 a week, it's hard to argue convincingly that merit pay is really going to have much impact on an individual's performance. However, that's ignoring the context in which merit policies operate. Any other policy (e.g., cost-of-living increases) sends a clear message that individual performance is not important. At a minimum, merit pay and the related performance management systems contribute to a performance culture.

It also is important to consider the impact of merit pay over a longer period of time. The annual difference in dollars may not seem a sufficient incentive, but with compounding, the salaries of high performers pull ahead of others' salaries over time. These same individuals are likelier to be selected for promotions to higher pay levels. This combination of advantages makes hard work and above-average performance pay off.

What Makes Corporations Different from Local Governments?

Merit pay in corporations is an accepted part of the environment. To be sure, there are problems, and corporate HR departments frequently tinker with their performance appraisal systems and related practices. Despite the problems, though, the emphasis on performance at all levels makes merit pay the only acceptable policy.

One of the obvious differences, of course, is that corporate pay programs still are, by policy, shrouded in secrecy. Individual pay levels and pay increases still are confidential. This makes it easier to live with differences in pay rates. Another difference is that corporate employees do not commonly have a protected right to file grievances if they are dissatisfied.

An intangible difference is the virtual obsession with performance. Every cor-

Bismarck, North Dakota

Bismarck's merit pay policy was adopted starting in 1995. It is based on a so-called 360-degree appraisal process, in which each employee and his or her supervisor agree on three to five peers to give performance feedback. This approach was chosen after a series of focus-group meetings held to select the best system for the city.

Increases are based on individual performance and on position in the salary range, with those who are low in the range eligible for larger increases. There are no step increases or general increases.

Employees have been satisfied with the system and have started to voice their negative views of the old system with such statements as "I didn't like the old system; it never recognized what I was doing" or "I'm starting to see that performance makes a difference." Human Resources Director Chuck Klein is convinced that employees never liked the way increases were handled in the past but were afraid to say anything.

porate employee knows the bottom line and the need to perform better than the competition—the first and realistically the only priorities. The need to improve or sustain high performance is an accepted goal. This acceptance provides an unquestioned justification for merit pay.

Another intangible factor is the way in which managers and employees view merit pay. This may be the most telling difference. For reasons that go back in history, the public sector has often pushed for merit pay as a rationale for denying increases to poor performers. In contrast, the emphasis in the corporate world is on recognizing and rewarding the better performers. Few corporate employees are denied increases, and that possibility is almost forgotten. The emphasis on granting extra money means that merit pay is much more positively perceived in the private sector than in the public one.

Realistically, if corporations were trying to shift from an entitlement policy, such as a general increase policy, to one of merit pay, the change would be met with resistance as it is in the public sector. Employees would be anxious and would voice their concerns. It's never easy for people who are comfortable with a current practice to accept change. Corporations, however, would overcome that problem by making certain that employees understood why the change was necessary.

Greensboro, North Carolina

Greensboro adopted its merit pay policy in 1974. The city's decision to adopt merit pay was driven at the time by local corporate leaders, who were not comfortable with the traditional step-in-grade approach and relied on merit pay practices in their own companies.

Greensboro's salary program and its merit policy involve assigning jobs to specific salary ranges that have defined minimums, midpoints, and maximums. Salary midpoints are aligned with prevailing labor-market pay levels, and the ranges are adjusted annually to maintain the alignment. The merit budget is planned so that increases will keep pace with the labor market.

Employees' salaries are reviewed by their supervisors on a set schedule. Increases (if any) are based on assessed performance and relationship to the midpoint of the range. There are no general or cost-of-living adjustments. Supervisors receive 12 hours of training on appraising performance and on salary management.

What the Critics Say

Merit pay has had its critics. The most prominent was undoubtedly Dr. W. Edwards Deming, the guru of total quality management (TQM), who argued that individual performance appraisal was one of the "deadly diseases" of management. His argument focused on the assumptions (1) that workers are integral components of a production or business process, and (2) that the focus should be on the process or team rather than on the individual. He was not opposed to financial incentives but rather thought they should be linked to group or team performance. Significantly, his argument had virtually no impact on corporate merit practices.

His was essentially the cog-in-the-wheel argument. His point is valid if one accepts the premise that when job duties and work methods are tightly defined by management, the job incumbent has little, if any, discretion in what he or she does and in how the work is performed. But there are fewer and fewer jobs in which this is true. The trend toward empowerment clearly looks to workers to think and make job-related decisions. Discretion leads to variation in performance, thus making appraisal and feedback on performance necessary for improvement.

There also have been critics who contend that financial incentives are either counterproductive or inappropriate. The most recent of these critics is Dr. Alfie Kohn, whose book *Punished by Rewards* was published a few years ago. Kohn is opposed to any rewards for any activity, including the use of rewards for children in school or at home. He argues that we should rely on intrinsic rewards, which are those derived from the work itself (including the love of learning). When we introduce extrinsic rewards, they divert the individual's attention and weaken the impact of intrinsic rewards.

In the corporate world, Kohn's argument was never accepted. He overlooked the simple fact that every organization, including those that depend on volunteers, has a reward system. There are a broad range of extrinsic rewards, from a simple smile from a supervisor to the public accolade given to "MVPs." All employees in all work settings get feedback that either reinforces the acceptability of their behavior or tells them how they need to change. The feedback may not be formal, but it is given in any number of ways.

Dr. Frederick Herzberg is a widely cited critic of financial rewards who wrote in an earlier era. In several books and articles of the late 1950s, he argued that financial rewards like merit pay were much more likely to trigger dissatisfaction and did not have the power to create true job satisfaction. That, he argued, can come only from the work itself. His conclusions were based on research conducted in the factories of that time, which focused on production jobs. He was undoubtedly influenced by the strife and animosity that existed between blue-collar workers and their employers.

Are the critics wrong? There is clearly some truth to their arguments. If we could eliminate pay, it would eliminate one of the points of contention between workers and management. However, we can eliminate neither pay nor the broader organizational rewards. We also cannot eliminate the need for feedback on performance or the pressure for improved performance. Merit pay is certainly not perfect, but it seems to meet an organization's needs better than the alternatives.

Planning the Mechanics Of a Change to Merit Pay

Merit pay is best managed as a complex policy change. Every organization is different, but at their cores are two interrelated elements: the budgeting process and the performance rating scale. These elements are at the heart of the control mechanism.

Merit increases are best controlled through the budget. Every manager is given a budget of X percent of his or her payroll to allocate for pay increases, which limits the increases that can be granted. Currently in the private sector, merit budgets are running around 4.2 to 4.5 percent of payroll. There might be an additional 0.2 or 0.3 percent for promotions, but the total defines the dollars available for pay increases. If the percentage is the same in every department, it means that the increases on the average will be consistent.

The budgeted percentage should be based on labor market trends and on the increases needed to stay competitive. Most salary surveys track budgeted increases. The problem for supervisors, of course, is that with a fixed budget it's impossible to give everyone above-average increases. But then everyone cannot perform above average. To give one employee a big increase means that someone else's increase has to be below average. This internal "competition" often is cited as one of the problems with merit policies.

To alleviate (but not eliminate) this problem, it may make sense to take a portion of the budget, perhaps 0.5 percent, and set it aside in a separate budget to recognize and reward the high performers. This approach changes the rules of the game because supervisors can make these decisions without reducing the increases for other employees. If the total budget comes to 4.5 percent, and if 0.5 percent is set aside, it means that the "average" employees can all expect 4.0 percent increases. When the funds in the special increase budget are allocated as grants to the high performers, the increases—or lump-sum awards, if that is preferable—can be significant.

The rating scale, then, is another important element of the policy. Until recently, the typical appraisal system had five rating levels, with the highest reserved for outstanding employees. That practice has been criticized by Deming and others as invalid because one supervisor might rank an employee as a "3," while another might argue that the employee should be a "4." Deming was correct on this point.

Because of rating problems, some public employers have opted to adopt a simple two-level rating scale, essentially a pass/fail system. The weakness in this approach is that it shifts the focus to questions of the minimal acceptable performance. Generally, everyone gets his or her increase, and there is no incentive to perform above the average. It also sends the message that the only real goal is to deny increases to poor performers.

A more effective policy is to define three levels of performance: "failed to meet expectations," "meets expectations," and "exceeds expectations" or "outstanding." A three-level scale adds a focus on what an employee needs to do to be outstanding. The Colorado Peak Performance policy, for example, is based on three levels. Research shows that there is typically wide agreement on which employees are outstanding and on which have failed to meet expectations. The former are typically 15 to 20 percent of a work group, while the latter might only be 2 to 4 percent. This distribution is common in most groups.

This means that "meets expectations" people account for roughly 80 percent of the total. They are solid performers and should continue to receive "normal" increases (4 percent, with the illustrative budget numbers). They are for the most part unaffected by the merit policy. The high performers, on the other hand, can expect the normal increase plus the special award money.

For merit pay to be effective, there has to be an assurance that performance that exceeds expectations will lead to above-average pay opportunities. This is a key issue in the expectancy theory of motivation. The mechanics described in this section of the article should accomplish this aim.

Managing the "Softer" Side of Merit Pay

Merit pay doesn't exist in a vacuum. The intention is to improve employee and organizational performance, and this means that the policy and the prospects for rewards have to be perceived as positive incentives. Employee reactions will be affected by a long list of organizational and individual circumstances.

Shreveport, Louisiana

The merit pay system in Shreveport was developed in 1996 by a facilitated employee group. The policy covers 1,400 out of roughly 3,000 city employees but does not cover fire or police.

Employee appraisals are based on five performance standards that are common to all covered employees. There are also up to eight job-specific criteria that are defined jointly by the employee and the supervisor.

Employees who fail to meet either the common or the specific criteria do not earn increases. This group has amounted to 10 percent of the workforce. Those who meet requirements receive a 4 percent increase. And those who exceed the standards receive the 4 percent increase plus a lump-sum award that in total comes to about 8 percent. This group also has accounted for about 10 percent of the workforce.

The system is funded with 2 percent of gross payroll. This is more than a sufficient amount because awards are granted throughout the year on anniversary dates. Employee acceptance has been good. There are fewer complaints and grievances than under the prior rating system.

It's easier to develop an effective policy in a corporation in which performance and financial incentives are important to the culture. Government is obviously different, and this difference makes the problem more complicated.

One consideration that is common across all organizations is that the merit decision process is dependent on people, both supervisors and subordinates. Only a few employees generate tangible outputs that are easy to measure, but for most employees the differences in performance are intangible. The few objective measures that exist never capture the whole job. Supervisors and their people should be able to agree on what's expected, but some of these standards inevitably depend on judgment.

Merit pay needs to be planned and managed in the broader context of performance management. If it is out of sync with the way people in the organization think about performance, it is going to be ignored or become a source of disruption. Managers will find it advantageous to assess the way in which performance management is handled and to decide how merit pay can best support that process.

In this regard, here are some "softer" considerations that can increase the prospects that a new merit pay policy will succeed:

- A well-reasoned goal in moving to a merit policy. There needs to be a credible purpose that will benefit the organization. Plan a communications campaign to convince employees and stakeholders that the change is important.
- Treatment of the switch to merit pay as an organization development (OD) initiative. The process and communications issues are much more important than any technical considerations. The new policy will change the organization and will affect supervisor/subordinate relationships—acknowledging this realization should be a goal.
- Top management leadership and commitment. The new policy cannot be seen as just another personnel policy. Senior managers have to be directly involved and prominent in planning discussions. Someone has to champion the change in policy.
- A task force of local corporate executives who also can champion the change. Such a task force may be helpful. The corporate model is, for better or worse, the starting point, as the idea of pay-for-performance has its origins in the corporate world. Private sector leaders' imprint could be useful. A prominent corporate CEO gets a lot of the credit for the changes in Charlotte, North Carolina, for instance.
- Managers' and employees'—preferably those who are seen as top performers—playing a role in planning the new system, which must become an accepted management system. Asking groups of employees how to measure performance is an effective way to gain their buy-in and also makes it that much more difficult for them to shoot the new system down.
- Spending time discussing agency or work-group goals and how each employee is expected to contribute to the achievement of these goals. The discussion does not necessarily have to lead to a specific end product, but it should end with a shared understanding of the mission and priorities. The importance of these should be clear; progress toward achieving them tracked; and success celebrated.
- The setting of performance standards for each position. The discussions just described should lead naturally to this step. This is not a new concept. What may be new is the idea of defining something more than a yes/no basis for assessing an individual's performance. The standards should focus on real accomplishments that are clearly tied to the organization's mission. There should be a clear and understandable linkage to the performance standards for coworkers and for the work group as a whole.
- (In work situations in which team performance is important) Standards that reflect the team's shared responsibility but also specify how individuals contribute to team success.
- Relying on lump-sum awards for at least a portion of the increase for the better performers. This is a way to avoid big differentials in salaries for people in comparable jobs and may be a way to recognize outstanding performance while minimizing any contentious salary comparisons throughout the year.
- Keeping pay levels at least close to the prevailing market rates, and making certain that employees know that pay levels are competitive. Employees who already think they are underpaid often react negatively when they are told they will have to work harder to earn a pay increase. Low salaries could undermine the acceptance of a merit policy.
- Keeping in mind that the format of the appraisal is not important. That's been confirmed by research. The discussions between a supervisor and a subordinate are the keys to success. If the performance standards are solid, the form is immaterial.
- The recognition that merit pay may not be a viable answer for workers in some positions. There are jobs in

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which differences in individual performance are not possible or desirable. When performance is directly tied to and dependent on a static process, i.e., tending a machine, merit pay may not make sense.

- At the same time, the parallel recognition that experts on performance measurement claim they can develop measures for any job. If incumbents have any discretion in what they do or how they do it, or if they are expected to satisfy any customers, or if results differ from worker to worker, then their performances can be assessed.
- An explicit reconsideration of the merit principles that have served as the foundations for the existing pay system. The idea that everyone has to be paid the same makes sense when the differences among employees are inconsequential. But try selling this idea to your best performers, who consistently exceed your expectations. Try selling this to IT specialists in high-demand areas. The world of work is changing, employee expectations are changing, and employer needs are changing. The merit principles of the last century may need to be reconsidered.
- An ongoing communication strategy to keep employees abreast of the agency's progress in achieving its mission and in meeting its goals. Employees need to understand that performance is an ongoing concern and a management priority. It will be advantageous to recognize publicly any group and individual success stories and accomplishments.
- Bearing in mind that these are pocketbook issues that will make virtually everyone anxious. Inevitably, some employees will feel like losers because, from their perspective, they were in a better position under the prior policy. Keep in mind that they are not the best performers.
- Identification of the stakeholders, and provision of a mechanism to consider their views and to reflect their concerns in planning. Think in terms of the proverbial train that is leaving the station. The goal is to get everyone on board as it pulls out.
- Training, both for supervisors and for employees, that stresses two-way communication. Everyone also may need training in goal setting and performance planning. This training should be repeated at least once in the first year.
- The possibility of adding cash incentives for managers, with payouts tied to the performance levels of their units. This step will make the achievement of goals important to them, and they in turn will communicate this importance to their subordinates. At a minimum, managers' salary increases should be tied to their performance.
- Flexibility. Feedback on the new policy. And a readiness to refine the system based on lessons learned. The new process does not have to be textbook-perfect to be effective. It will be several years before merit pay is accepted and the organization realizes the benefits.

ICMA Resource

"The New Compensation Model," an *IQ Report* written by Howard Risher and published by ICMA in 1998, suggests ways to improve the traditional pay system and describes elements of the new compensation model, including broad banding, salary surveys and market considerations, merit pay and other forms of pay tied to performance, and group incentive plans (gain sharing).

Examples of the pay structures, a case study of gain sharing in Charlotte, North Carolina, and a discussion of implementation issues will help the reader evaluate the next steps to take in his or her own jurisdiction.

To order, phone 800/745-8780, or visit ICMA's on-line bookstore at http://bookstore.icma.org. The *IQ Report* is item number 42397 and sells for $14.95.

Not So Quick or Simple

No one said it was going to be easy. Realistically, the planning and roll-out strategy can ignore some of these points and still succeed. At times, the situation dictates that a new policy be implemented within a compressed time frame, but there is a risk in this demand. The administrative changes needed are not complicated, but success depends on organizational changes, which are not quick or simple problems under the best of circumstances.

Fortunately, there is no reason to push toward some universal model. There are no off-the-shelf answers. The new policy can be anything from a full-blown corporate approach to a simple grant of an extra step increase to high performers. The best answer, actually, is the one that works. Research shows that employees prefer merit pay. They want to have their value and their contributions recognized.

Virtually everyone, of course, thinks he or she is above average. Moreover, many are anxious about how their supervisors will handle the change. In the end, however, the people who are going to react best to a new merit policy are the high performers, and it is important to keep these people satisfied.

Merit pay is here to stay. It is directly linked to cultural values in the United States. Other concepts, like gain sharing, may be adopted as more explicit incentives, but they cannot supplant the need for an acceptable salary increase policy. The external pressures to end automatic increases and to improve performance will continue to be important to elected officials. PM

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