Text Version

A WHITE PAPER

A FRESH START FOR FEDERAL PAY: THE CASE FOR MODERNIZATION

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OFFICE OF THE DIRECTOR

To the Public Service Community:

I am extremely pleased to be able to share the U.S. Office of Personnel Management's White Paper, *A Fresh Start for Federal Pay: The Case for Modernization*. This thought-provoking document offers a timely and comprehensive examination of the way the Federal Government currently determines employee pay. It is merely intended to open the conversation on the possibilities for a modernized Federal pay system for the 21st century.

We find ourselves in a time of extraordinary opportunity. Americans are expressing an interest in public service unseen in recent decades. This renewed desire to serve occurs at the very time that the Federal Government is looking to bring new talent, new skills, and new energy into its workforce.

To attract the best and the brightest in this next generation into public service, we need a pay system that reflects the realities of the modern workforce where performance and results are emphasized and rewarded. What will such a system look like?

My hope in sharing this OPM White Paper is that it will help to bring that vision into focus. It contains insights on the Federal Government's compensation system, its origins, how it upholds the merit system principles, and its operation in current labor markets and as an important component of the Government's performance culture. This paper is the result of extensive research and stakeholder discussions through OPM's Strategic Compensation Initiative. I was delighted to learn that this thoughtful dialogue was already well underway when I arrived at the U.S. Office of Personnel Management.

Now we move to the next phase. I invite you to become an active participant in the broader discussion. The possibilities are truly exciting, and our workforce deserves nothing less than our best efforts at modernizing our pay system.

Sincerely,

Kay Coles James
Director

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Executive Summary

An ongoing objective of the Office of Personnel Management is to explore ways to make Federal pay more performance-oriented and a better tool for improving the strategic management of human capital. As recent events have shown all too clearly, Government performance is critically important. To meet the challenges of the present – and to anticipate and overcome the challenges of the future – Government must design and use merit-based policies and systems that are more modern, strategic, and results-focused. If the Government is to recruit, manage, and retain the human capital needed to accomplish and sustain this transformation, its white-collar pay system would need to:

- Achieve the principle of providing equal pay for work of equal value;
- Provide agencies the means to offer competitive salary levels on a timely, rational basis;
- Recognize competencies and results, at both the individual and organizational level; and
- Orient employee efforts and pay expenditures toward mission accomplishment.

This White Paper examines the extent to which the current Federal white-collar pay system – the General Schedule covering 1.2 million employees – achieves these objectives. OPM believes the system would have to be judged as failing this examination, for several reasons:

- ***The Government asks its agency leaders to face new and unprecedented management challenges using an antiquated pay system.*** Work level descriptions in law that date back more than 50 years are not meaningful for today's knowledge-driven organizations.
- ***The current pay system does not reflect market pay levels.*** Instead, pay increases and locality adjustments result from a cumbersome and costly measurement system that may be trying to answer the wrong questions.
- ***It has minimal ability to encourage and reward achievement and results.*** Over 75 percent of the increase in Federal pay bears no relationship to individual achievement or competence.

- ***Its structure suits the workforce of 1950, not today's knowledge workers.*** In 1950, over 75 percent of Federal workers – mostly clerical – were in grade GS-7 or below; today that percentage has dropped to less than 30 percent.
- ***Its prescribed procedures and practices effectively preclude agencies from tailoring pay programs to their specific missions and labor markets.*** It is unlikely that a common and highly structured system is appropriate for positions as diverse as those found in agencies such as the National Weather Service, the Social Security Administration, the Defense Finance and Accounting Service, and the Centers for Disease Control.
- ***It is disintegrating.*** Through special authorities, a number of agencies already have begun to move toward more modern systems, and our ability to promote common policies across the Government where appropriate is diminishing.

OPM does not fault the framers of the General Schedule for designing pay and job evaluation systems that reflected their world of work. But neither can a compensation system that was designed in the middle of the 20th century be expected to function well in the 21st century where organizations use a broader view of strategic rewards. The result of OPM's examination is clear: seizing systemic, governmentwide opportunities for changing the white-collar pay system is no longer a luxury, but a necessity. In its current condition, the system is an impediment to the Government's critical efforts to enhance security and replace technical and scientific expertise in the face of looming retirements.

This White Paper is pre-decisional: although it documents many problems in our current pay and job evaluations systems, it does not describe the solutions to those problems. Its objectives are to help stakeholders learn from the Government's history and experience and to inform the debate over how the Government can preserve core values of public service – such as equity, procedural justice, openness, and accountability – while modernizing its compensation practices. OPM will distribute the paper widely to stimulate dialogue and discussion. The aim is to surface areas of agreement and disagreement and concern and consensus so that the Federal community may be fully informed as we pursue future directions for improving pay as a strategic tool for managing human capital.

Introduction

This White Paper takes an in-depth look at the way the Federal Government pays its white-collar employees. Any comprehensive improvements to our pay system that may be needed would be momentous. Consequently, they should be considered only after carefully examining the means and implications of ensuring that the white-collar pay system is an effective tool for the strategic management of human capital. To that end, any changes in the pay system must support the various other initiatives that are underway to improve Federal recruitment, hiring, and retention and to focus on meaningful performance distinctions as the key drivers for human resources and reward decisions. Those reform efforts have surfaced recurring themes concerning the constraints and contradictions the pay system imposes. That system, in turn, must operate under significant fiscal constraints where costs must be forecast, managed, and contained. Unless the Federal Government develops a system that is affordable during difficult budget times, there is no hope for success. Such realities and relationships characterize our complex employment environment.

In the White Paper presented here, the Office of Personnel Management (OPM) focuses only on the General Schedule (GS) pay and job evaluation systems that cover the Federal Government's white-collar work. A number of pay-related issues that affect other systems and pay structures have also received attention and deserve consideration in another forum. OPM acknowledges that such other systems, including the Federal Wage System that covers blue-collar work, have a relationship to GS pay. For example, the pay compression that currently affects members of the Senior Executive Service (SES) could have a significant, if indirect, effect on proposals that might be developed to address the pay of GS employees. However, SES compensation design and administration involve additional factors – such as their relationship to the Executive Schedule rates of pay for the most senior positions in Government – that this White Paper is not intended to address.

This White Paper lays bare the problems with the Federal Government's current white-collar pay and job evaluation[1] systems that years of experience, research, and discussion have exposed. Significant portions of that research and discussion

[1] The term "job evaluation" refers to the process for establishing the relative value of a position in a hierarchy of jobs, in the Federal Government, by classifying positions. The term does not mean performance evaluation or appraisal.

have occurred most recently as OPM staff launched an effort known as the Strategic Compensation Initiative.

Framed around a combination of research and outreach, the initiative included an extensive examination of the current Federal white-collar pay and classification systems. OPM sought insights from the private sector, the non-Federal public sector, and those portions of the Federal sector that have already moved beyond the system established under title 5 of the United States Code.

- The research included staying current on developments and trends in compensation, including practices that developed as employers waged the war for information technology talent during the "dot.com" bubble. However, to preclude misleading conclusions based on generalizing from short-lived "schemes du jour" that might lack strategic staying power, the research OPM undertook concentrated on employers whose size and functions made them comparable to Federal agencies. For example, a specific alignment of general governmental functions with private sector counterparts led to surveys of utilities, banking, accounting, and telecommunications firms, but not retail sales or entertainment enterprises.

- Research on non-Federal public sector entities surfaced a variety of systems and approaches – principally in State governments – where settings ranged from States where comprehensive collective bargaining agreements are negotiated at the State level to States that have no bargaining units at all. States that recently reformed their pay systems to be more performance and results driven were of particular interest.

- Finally, OPM made a thorough review of Federal settings where alternative pay and job evaluation systems had been established, including demonstration projects and agencies that Congress granted independent compensation and classification authority. These situations offered particularly useful evidence about the kinds of alternatives that have been implemented successfully with Federal workforces and cultures.

In addition to conducting and sponsoring specialized research, OPM invited stakeholders from agencies, Federal employee unions, associations of managerial and professional employees, and the public administration community to join in examining existing systems and mechanisms, as well as alternatives, and considering possibilities that could improve their strategic value for the 21st century.

The White Paper is structured around some broad themes and supplemented with more in-depth analyses – a series of "Closer Looks" that explore or illustrate particular issues. By this means, beyond merely cataloguing faults, the White Paper also surfaces opportunities and the nature of the solutions they represent. However, it lays out no specific proposals for changing the General Schedule system. The purpose here is to create a shared understanding across the public service community can be applied to discussing and shaping approaches that may be appropriate to ensure that agencies can use the Federal Government's white-collar pay system effectively to improve the strategic management of their human capital.

A System Whose Time Has Come – and Gone

The fundamental nature of the Federal compensation system was established at the end of the 1940s, a time when over 70 percent of Federal white-collar jobs consisted of clerical work. Government work today is highly skilled and specialized "knowledge work." Yet in the age of the computer, the Federal Government still uses – with few modifications – pay and job evaluation systems that were designed for the age of the file clerk. The divergence between the Federal pay system and the broader world of work where the war for talent must be fought has led observers to call for reform of the Federal system. To support achievement of the Government's strategic goals, a new, more flexible system may be called for, one that better supports the strategic management of human capital and allows agencies to tailor their pay practices to recruit, manage, and retain the talent to accomplish their mission.

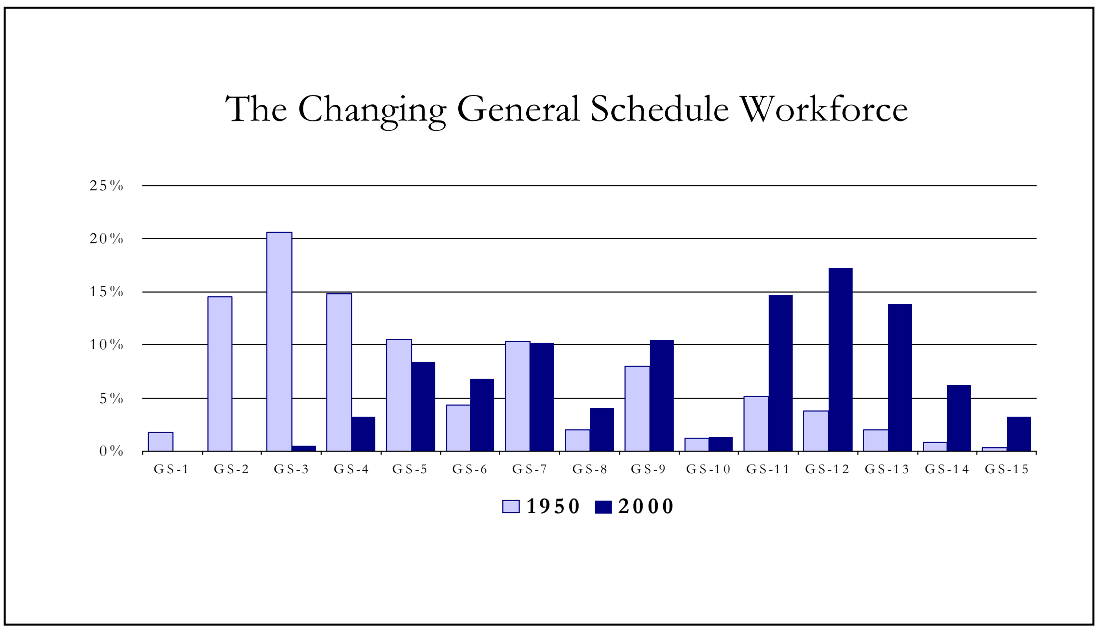
The formidable challenges of World War II were overcome by breaking them into their component problems and solving those problems through centralized planning and the application of uniform methods. At the end of the 1940s, the Federal Government's civilian workforce was ripe for application of this scientific management approach, as embodied in the Classification Act of 1949. Over 70 percent of Federal white-collar jobs consisted of clerical work – work such as posting census figures in ledgers or retrieving taxpayer records from vast file rooms. It made sense to manage this work by breaking it into clearly describable positions. It made sense to sort these positions based on clear-cut, enduring differences in the difficulty, responsibility, and skill requirements of the work employees carried out. It made sense to use such differences as the foundation for all aspects of human resources management, such as setting pay, thus making position the principal driver of most Federal personnel administration systems.

That focus on position rather than performance made sense for this army of clerks in the late 1940s. Indeed, it made little sense for pay to reflect variations in employee performance – most of the work was so cut and dried that employees had scant opportunity to distinguish themselves from their peers. As for using comparisons with pay outside the Government, that was not even on the map yet. Specific pay rates and pay raises for Federal employees were established by Congress through legislation, not through any sort of administrative, market-based procedure.

The Classification Act of 1949 used work level descriptions that date to 1912 to extend a centralized job evaluation system to all white-collar positions, thereby establishing internal equity – a fairness and consistency criterion aimed at ensuring that each job is compensated according to its relative place in a single hierarchy of positions – as the centerpiece of Federal compensation. The Act also merged several separate "schedules" of pay rates into one "General Schedule." Finally – and fatefully – it defined the Federal Government's pay and job evaluation structure in statute, where it has remained essentially unchanged for over 50 years.

During this 50-year period, much has changed, including:

- **The nature of work.** When the General Schedule was created, the Federal Government was largely a "Government of clerks." But most Government work no longer revolves around the execution of established, stable processes or the application of physical effort. Instead, as illustrated in the chart below, Federal white-collar work has become highly skilled and increasingly specialized "knowledge work" that is properly classified at higher grade levels.



Some of the work-related features of the General Schedule are not just dated, they are counterintuitive. If two employees perform similar jobs but one employee has a much greater workload, can that employee's salary be higher? Not under the General Schedule – if the level of difficulty of two jobs is the same, they are in same salary range. If one employee performs a wider variety of tasks than other employees, can that result in higher pay? Not if the tasks are at the same level. If the busier employees complain that this is inequitable, what can the agency do? Take work away from the busier employees. Years ago, spreading clerical tasks across similar, stable positions made sense; in today's multi-tasking workplace, the system appears illogical.

- **The role of compensation in organizations.** In most organizations, particularly those in the private sector, compensation management has become considerably more than simply calculating and paying the bill for employee efforts. The concept of compensation and rewards has broadened. Organizations have come to view their compensation and reward systems as much more than schemes managed out of the comptroller's office and designed to contain salary and related benefits costs.[1] Today, organizations manage their rewards systems out of their human resources offices.[2] They design them to use pay, awards, benefits, learning and development, challenging and satisfying work, work-life balance, and a supportive work environment strategically to attract, manage, develop, and retain high-quality, diverse workforces that meet their specific human capital needs. This paper's first Closer Look: *A Framework for Strategic Rewards* (pages 40–42) provides more detail about this broader view of what employees find rewarding.

  The purpose and tactics of compensation have also broadened. Organizations no longer view their annual compensation budgets simplistically as the bill for "another year's worth of labor inputs." Instead, they use flexible, targeted compensation tools to acquire and retain critical talent. Compensation's role in recruiting gets considerable attention from both employers and potential employees. Organizations no longer use compensation principally to encourage and reward unquestioning loyalty from undifferentiated "human resources"; instead, they use compensation to communicate and reward desired values, behaviors, and outcomes. Federal agencies are similarly poised to use compensation as a strategic tool, rather than a merely administrative tool. This shift is already visible in a wide variety of demonstration projects and alternative personnel systems that align agency pay practices and bonus and award programs with agency strategic goals.

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1 For every dollar increase in basic pay, or "benefits-bearing compensation," agencies routinely budget an additional 20 to 30 cents as an estimate of related benefits cost obligations that dollar will generate. In a related development within the Federal Government, President Bush's FY 2003 Budget for the first time displays agencies' future cost accruals for employee benefits at the agency level, thereby reinforcing this Administration's policy that agencies must be strategic in their use of all human resources-related funding. The President's proposed Managerial Flexibility Act includes statutory changes that would effect this accounting change permanently.

2 *Private Sector Compensation Practices*, Booz•Allen & Hamilton – Report to the U.S. Office of Personnel Management, Washington, DC, February 2000.

- **Employee expectations.** The employees of the 1940s and 1950s shared the experiences of economic depression and war. They sought stability and security. The Federal compensation system, with its career ladders (where employees start their careers in positions at low grades with the prospect of advancement over time to higher-grade positions), time-based pay increases, and benefits keyed to length of service, reflects a conception of employment predicated on a 30-year career with the same employer. That model is designed to reward loyalty by providing stable and secure employment, reflecting and meeting those needs. But increasingly employees neither expect nor seek that form of security from their employer. Instead, they expect immediate rewards and recognition for their individual accomplishments and consider continued employability the key to security.

- **Stakeholder expectations.** Employees and their representatives, as well as agencies and other stakeholders, have expectations about how human resources management systems are developed and implemented today. With a consistent migration away from tightly legislated systems to administrative authorities that lend themselves to decentralization and delegation, stakeholders expect to influence how those administrative authorities will be designed and used. Agencies want the latitude to adapt system features to support their strategic needs. At the same time, elected employee representatives expect to have a voice in systems affecting their members. Engaging unions in fundamental workplace change is a sound human capital practice and recognizes that labor and management have a shared stake in building a more effective Government that delivers results to the American people.

Although the Federal white-collar pay system has been refined in response to these changes, these refinements have not changed its fundamental character, which remains focused on internal equity (to reflect relative place in a hierarchy of positions) and leaves little meaningful room for external equity (to accommodate changes in labor market rates for different occupations) or individual equity (to reward excellent performance). Consequently, the outdated beliefs and expectations underlying our pay and classification systems have diverged from those of the broader world of work where the war for talent must be fought today. This divergence has led observers and architects of Government human resources management systems to contemplate possible modernization of the

Federal compensation system.[3] During the 1980s and early 1990s, these observers advocated reform of various aspects of the Federal compensation system, such as the classification system[4] and the pay-setting process,[5] as well as benefits.[6] The calls for reform continue, but their character has changed.

Observers continue to recommend measures such as simplifying the classification system, but an increasing number believe that incremental changes will not suffice. For example, when the National Academy of Public Administration (NAPA) examined Federal information technology (IT) recruitment and retention issues in 2001, it recommended that the Federal Government reexamine the core values of its compensation system, and noted:

> By focusing on internal equity, the federal government's human resources management system is severely constrained in competing for IT talent and effectively managing the IT talent that it already has. . . . A new federal IT compensation system should move to a better balance between and among internal equity, external equity, and contribution equity.[7]

Other observers have reached similar conclusions,[8] and some now contend that the current system is unsalvageable:

> Title 5 provides a rigid, rule-based system that is unlikely to provide the needed flexibility to compete for talent in the twenty-first century.[9]

> [The Administration] is quite right to keep pushing for greater flexibility. If that means abolishing the current system and its 450 job classifications, all the better. This is one case where nothing is truly better than something.[10]

These calls for pay and classification reform have gone largely unheeded. Although Congress has, in selected instances, acknowledged the inadequacies of

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3 The possibility of a need for systemic change was acknowledged and anticipated in the Civil Service Reform Act of 1978, which authorized the establishment of "demonstration projects" by the Office of Personnel Management under 5 U.S.C. §4703 to test progressive human resources practices for possible governmentwide adoption.

4 See *Modernizing Federal Classification: An Opportunity for Excellence*, National Academy of Public Administration, Washington, DC, 1991.

5 See Robert W. Hartman, *Pay and Pensions for Federal Workers*, The Brookings Institution, Washington, DC, 1983.

6 Ibid.

7 *The Transforming Power of Information Technology: Summary Report*, National Academy of Public Administration, Washington, DC, August 2001, pp. 7–8.

8 See David Walker, Comptroller General of the United States, testimony before the Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Committee on Governmental Affairs, U.S. Senate, July 17, 2001.

9 *Civilian Workforce 2020: Strategies for Modernizing Human Resources Management in the Department of the Navy*, National Academy of Public Administration, Washington, DC, August 2000, p. 44.

10 Paul C. Light, "The Battle of the Bureaus," *The Washington Post*, March 11, 1999.

the Federal compensation system by authorizing individual agencies to design their own systems, this has not led to broader reform.

The phrase "haves and have nots" is often used to contrast conditions. When it comes to compensation in the Federal Government, a more apt phrase might be "cans and cannots." A few agencies "can" design, modify, and manage their own compensation systems. But most agencies "cannot" and must follow the General Schedule. More than 10 percent of white-collar employees are in such "can" organizations that have been granted the opportunity to manage compensation in ways that meet their strategic goals, from the General Accounting Office in the 1970s to the Securities and Exchange Commission in 2001. All other agencies – operating in the same economic environment as the "cans" and faced with the same expectations to achieve important goals – are forced to press on as "cannots."

The Federal white-collar pay system continues to be defined by the General Schedule – the pay and classification structure established by the Classification Act of 1949 – and thus remains essentially unchanged. Readers less familiar with the workings of the General Schedule will find a description of its current design and operation in the second Closer Look: *A Primer on the General Schedule* (pages 43–44).

The General Schedule and its supporting practices have served us well. But it is not realistic to expect it to remain functional forever. The third Closer Look: *Why Not Preserve the General Schedule?* (pages 45–47) considers the pros and cons of sustaining it further. The fact that a system like the General Schedule may be at the end of its useful life is nothing new in modern post-industrial organizations, as the Federal Government must become. Here is one compensation consultant's description of the futility of expecting any private sector compensation system to endure indefinitely:

> If an organization is within a stable economy, in a stable industry, and operating in a status-quo operation, a pay program can be designed and forgotten. It [will not] need to change. But, for most organizations, the macroeconomy is constantly changing, as is the industry and the company. . . . Unfortunately, many organizations put a pay design in place and, other than periodic market-

> based pay level adjustments, forget about it. Unfortunately, this does not work. The business world is dynamic.[11]

This point is equally applicable to the Federal Government. In the age of the computer, the Federal Government is still using – with relatively minor modifications – a compensation system that was custom-built for the process-obsessed age of the file clerk. A structure that regarded performance differences as negligible in the context of highly standardized clerical routines has lasted to a time when the nature of knowledge work makes performance differences a crucial element in the value of many jobs. A structure made to maximize internal equity has lasted to a time when the Government may need to make more useful comparisons to non-Federal rates of pay. The result is that many observers believe our pay system no longer works and is not a useful tool for the strategic management of human capital. Kay Frances Dolan, Deputy Assistant Secretary for Human Resources at the Department of the Treasury, offered this perspective:

> We have critical occupations at Treasury that range from economists, to criminal investigators, to computer specialists and accountants. A pay system needs to be flexible and responsive so we can compete with other employers in the marketplace, and also take into account an individual's competencies and performance. Our current system wasn't built with these goals in mind.

Even more important, however, is whether the pay system is congruent with the values and objectives that 21st century public sector leaders have embraced. Our pay system has significant features that are antithetical to the performance-based and results-rewarding Government that the framers of the Government Performance and Results Act of 1993 on both sides of the aisle had in mind.

If What We've Got Is Wrong, What Would Be Right?

To support achievement of the Government's strategic goals, a more modern pay system is needed. A modernized system could allow agencies considerable flexibility so that each agency might develop specific pay programs and practices to recruit, manage, and retain the results-oriented competencies necessary to accomplish its mission. Specific elements of effective strategic compensation programs – salary levels that target specific labor markets, means of adjusting individual pay within a pay range, use of performance-based pay – tend to vary

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[11] Paul Gilles, "Building a Foundation for Effective Pay Programs," *Workspan*, vol. 44, No. 9, WorldatWork, Scottsdale, AZ, September 2001, p. 31.

with the nature of the workforce needed by different agencies to achieve their unique strategic goals. Allowing agencies to tailor their practices to their strategic human capital management needs would permit them to reorient their rewards systems and reach performance goals and objectives more effectively and efficiently. Changes made to the Government's compensation system would impact the working lives of more than a million Federal employees. While in OPM's opinion, bargaining pay should not be part of a new system, it is recognized that Congress would establish whether and to what extent that system will be subject to collective bargaining. In advance of any potential legislative action, it is also recognized that the only effective way to bring about change on this scale is to involve all stakeholders, including employee unions, in the redesign process. The challenge will be to formulate and design a modern, more strategic approach to Federal pay that effectively serves the shared interests of Federal employees and their representatives, Federal agencies and their missions, and the American people in the 21st century.

The System Is Market Insensitive

One of the precepts embodied in the Federal Government's merit system principles is market sensitivity. Even with the reforms in the Federal Employees Pay Comparability Act of 1990 (FEPCA), however, the Federal concept of comparability is two dimensional, reflecting only grade (level of work) and locality. This conception bears little resemblance to established compensation practice. Labor market shortages and excesses are described and analyzed in terms of occupations, skills, specialties, and locations, not grade level. Private-sector employers tend to respond to labor markets in similar terms. FEPCA's Achilles heel is its inability to reflect pay differences across occupations at the same level of work; the auxiliary mechanisms under the General Schedule are simply inadequate to recognize occupational differences. In addition, FEPCA's survey methodology loses relevance owing to its pretense of precision and its lengthy deliberations. Alternative means of following the merit system principle and giving "appropriate consideration to both national and local rates" need to be investigated.

The Federal Government's merit system principles include several precepts for governing the pay of Federal employees, including:

> Equal pay should be provided for work of equal value, with appropriate consideration of both national and local rates paid by employers in the private sector.[1]

Commonly, that principle is cited only in terms of its first element, and even that is often misquoted as "equal pay for equal work." However, as the fuller text indicates, the conception of merit includes considering the pay offered by employers outside the Federal Government, and thus comprises the principle of external equity. One of the reasons the Federal compensation system falls short of this ideal is that it may fail to provide "appropriate consideration" of those external rates. As Gail T. Lovelace, Chief People Officer at the General Services Administration put it: "Under the current system we are unable to compete in the labor market for candidates for our most important occupations."

This failure in considering external rates, however, is not simply reflected in an overall "gap" between Federal and non-Federal pay. Many observers argue that at least some gaps exist for some occupational categories and should be addressed

1 5 U.S.C. §2301(b)(3)

appropriately. Under the current methodology for calculating pay gaps, the gaps vary significantly by occupational group. For example, some occupational groups in some locations show little or no pay gap, while the gap is as much as 40 percent for other occupations in other locations.

The current system does not address such differences effectively. This is because the system recognizes imperfectly – if at all – that:

- Labor market rates differ across occupations, as well as across pay grades;
- Labor market rates differ within an occupation;
- Labor market rates differ across individuals;
- Labor markets can change rapidly; and
- Organizations do not respond uniformly to labor market changes, because they are not affected uniformly by those changes.

In the late 1980s, legislation was proposed to address these shortcomings. A key element of the proposal would have aligned the Federal pay structure more closely with labor markets. The initial proposal would have replaced the General Schedule with a national pay structure covering professional and administrative positions and a set of local pay structures covering clerical and support positions.[2] This proposal encountered substantial opposition reflecting concerns that the two pay structures would diverge and that one group of employees might benefit at the expense of the other. Eventually, a compromise was reached in which the General Schedule would remain intact, but would be supplemented by locality-based payments, which could be extended to other employees. This compromise, enacted in the Federal Employees Pay Comparability Act of 1990 (FEPCA), has proved problematic. Although FEPCA was acceptable enough to be enacted into law, it was not plausible enough to be fully implemented:

> In the 10 years since the FEPCA was enacted, annual pay increases have not followed official recommendations to close the "pay gap." The main reason: Neither Congress nor the Administration has found the official methodology credible or compelling.[3]

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[2] Technically, the division would have followed career patterns, with the national structure covering two-grade interval work and the local structures covering one-grade interval work.

[3] Robert E. Moffit, "Federal Government Pay," *A Budget for America*, Heritage Foundation, Washington, DC, 2001, p. 339.

Three factors contribute to this "credibility gap." The first is rooted in FEPCA's definition of comparability, reflected in its statutory principle that "Federal pay rates be comparable with non-Federal pay rates for the same levels of work within the same local pay area."[4] In other words, FEPCA's conception of labor markets is two-dimensional, with the dimensions being grade (i.e., level of work) and locality.

This conception bears little resemblance to the reality of labor markets. For example, labor market shortages and excesses are described and analyzed in terms of occupations, skills, specialties, and locations, not grade level. When the Department of Commerce examined employment trends in the information technology (IT) workforce, it reported significant job growth and prospective shortages in specific occupations, such as database administrator, systems analyst, and computer engineer;[5] it did not report a shortage of undifferentiated GS-12s and GS-13s. The fourth Closer Look: *Labor Markets Are Not Supermarkets* (pages 48–52) discusses this issue for Federal compensation in more detail and illustrates what may be FEPCA's Achilles heel – its inability to reflect systematic pay differences among occupations at the same level of work.

Private sector employers tend to respond to labor markets in terms of occupations or specialized skill sets. For example, companies may raise salaries and starting offers for IT professionals with hard-to-find skills, but such actions do not automatically result in pay increases for their employees in other occupations. The Federal Government lacks this nimbleness, because its auxiliary mechanisms available under the General Schedule to recognize occupational differences are inadequate, as discussed in the fifth Closer Look: *The Problem With Special Salary Rates* (pages 53–54).

The second factor underlying FEPCA's credibility gap is that its methodology presumes an unrealistic level of precision and requires lengthy deliberation, both at the expense of relevance and strategic utility. Under FEPCA, general pay increases are based on changes in the Employment Cost Index (ECI). Locality payments, which are calculated to one one-hundredth of one percent, are based on surveys of salaries in each locality pay area.[6] Because these surveys are extensive and statistically rigorous, significant time lags occur between data

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[4] 5 U.S.C. §5301(3).

[5] U.S. Department of Commerce, Office of Technology Policy, "Update: The Digital Workforce," August 2000.

[6] A survey is also used to calculate locality payments for the "rest of U.S." locality pay area, generally referred to as RUS. RUS consists of all areas of the continental United States that are not part of another locality pay area.

gathering and pay-setting and implementation. After adding the time that the Federal budget planning and appropriation processes must necessarily entail, the result is a tenuous relationship between pay adjustments and current market conditions.

The third factor diminishing FEPCA's credibility is that its statutory language requires the calculation of a single average pay gap in each locality pay area. Even though sophisticated methods of weighting are used to take into account the actual presence and distribution of Federal work, the result nonetheless disguises and ignores substantial differences in the degree to which Federal and non-Federal salaries for particular occupations or grades differ. By its very nature an average is describing a set of values half of which are higher and half are lower than the summary statistic. In this instance, the average the law requires us to use in describing a "pay gap" is no Golden Mean, but more of a Great Muddle that describes nothing very meaningfully and masks the relevant differences across occupations and levels of work in each locality pay area, to the strategic detriment of the entire approach.

This is not to say that FEPCA should be rated a failure. It would be more accurate to say that FEPCA has been both a partial success and an unavoidable failure. Under FEPCA, the Federal Government has:

- Successfully implemented and administered a locality pay system;
- Gained a better understanding of labor markets;
- Developed experience in conducting and applying salary surveys;
- Introduced market-oriented tools such as recruitment bonuses and retention allowances; and
- Learned that defining and implementing comparability in simplified and overly broad terms would eventually and inevitably produce the effect of delivering actual comparability to relatively few while overpaying or underpaying others.

For many years, employee groups and others considering further changes to the Federal pay system have taken the position that FEPCA should be fully implemented before making more changes.[7] However, as the Federal budget once again faces deficits, the Administration has not requested and Congress may

[7] See *Strengthening the Link Between Pay and Performance.* The Report of the Pay-for-Performance Labor-Management Committee, Washington, DC, November 1991.

be unlikely to fund the $11 billion for locality adjustments and related benefits costs – which would subsequently be built into the budget base and increase outyear costs – that "full implementation" of FEPCA in 2003 would require. This reality is particularly compelling in light of that final "lesson learned" from FEPCA implementation – that ignoring occupational differences undermines the system's strategic utility. Rather, it may now be time to build on FEPCA's significant lessons and explore and develop alternative means and meanings for following the merit system principle to give "appropriate consideration to both national and local rates." The sixth Closer Look: *Whither Comparability?* (pages 55–56) discusses this issue in more detail. This much remains clear: the market sensitivity that our merit system contemplates is essential for a robust 21st century pay system.

If What We've Got Is Wrong, What Would Be Right?

Our white-collar pay system should be reexamined to identify and explore alternatives for addressing external or market equity and making more useful comparisons with non-Federal pay. External comparisons might better be made against segments of outside labor markets – not against the entire economy of non-Federal white-collar work – so that a nimble system can recognize and accommodate strategic occupational differences. The methodology for such comparisons may need to provide a better balance of cost, timeliness, and precision. And the system should perhaps recognize the limitations of any methodology used to give the merit system principle's "appropriate consideration of both national and local rates paid by [other] employers" and move beyond attempting to survey and measure rates precisely for specific positions in specific locations.

The System Is Performance Insensitive

In the current Federal white-collar pay system, performance does not matter very much. The way the Government delivers pay increases – and the relative value of those pay increases – reinforces the message that performance is secondary at best. In any given year, Federal employees receive more pay increases for remaining on the rolls than for meeting or exceeding performance expectations. The dominance of these performance-insensitive pay increases can make performance-oriented tools appear trivial. As recent events have shown all too clearly, Government performance is critically important, and system improvements may be needed so that agencies can recognize and value the competencies and contributions of their employees better. To be truly results-oriented, the Government would require a compensation system where performance truly makes a difference.

The Federal white-collar pay system sends and reinforces the message that performance does not matter. This message harms both mission accomplishment and recruiting effectiveness:

> [The] current system is weakening the public service it was designed to protect. It underwhelms at almost every task it undertakes. . . . Sad to say, when young Americans are asked to picture themselves in public service careers, they picture themselves in dead-end jobs where seniority, not performance, rules.[1]

This was not the intent of the framers of the system. The closing words of the very same merit system principle that charges us to consider external equity make it quite clear that performance *should* matter:

> . . . and appropriate incentives and recognition should be provided for excellence in performance.[2]

But the current system's structures and incentives were designed for a time when "performance" was so highly routinized that many employees simply had little means or opportunity to distinguish themselves from their coworkers.

Within the Federal Government, our understanding of "performance" has become much more sophisticated, particularly with the advent of the Government Performance and Results Act of 1993, which shifted our focus

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1 Paul C. Light, "Battle of the Bureaus," *The Washington Post*, March 11, 1999.
2 5 U.S.C. 2301(b)(3).

away from process and toward results and strategic outcomes. But our compensation system does not reflect that sophistication. (The *Glossary* of this paper offers a further discussion of this shift in conception of the term "performance" on page 74.)

At the organizational level, we now understand that performance is the organization's success in achieving its mission; it is not the arithmetic average of individual employees' performance ratings, nor is it the sum of the organization's outputs and activities. At the individual level, we now understand that performance is not limited to how reliably a position's tasks are executed (such as the quality and quantity of a typist's output). Instead, individual performance can be measured and recognized in several ways. For example, an organization can evaluate an employee on the significance of his or her work, in addition to its objective quality, with rewards contingent on both the employee's contributions and the organization's success. Or an organization can evaluate and reward an employee for acquiring the competencies that truly make a difference in achieving expected results. Private sector organizations have recognized such options and created supporting compensation practices such as results-driven variable pay and pay linked to strategic competencies. With some exceptions, the Federal Government has not done so to any meaningful extent.[3]

Worse yet, the Federal Government does not provide clear, strong incentives for excellent task execution, let alone individual contributions or organizational success. We do not even have a functioning merit pay system, the prevalent mainstay of private sector compensation systems designed for the kind of professional[4] white-collar knowledge work that now dominates the Federal Government. Some observers have noted a general interest coupled with a general hesitancy among public employers to adopt new models for pay design and delivery,[5] and the most recent attempt at a governmentwide pay-for-performance system, the Performance Management and Recognition System (PMRS) for Federal managers in grades GS–13 through GS–15, was abandoned nearly a decade ago. Unfortunately, that system was not replaced by another

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3 Demonstration projects have tested such practices. Examples include merit pay in the Department of Commerce and contribution-based pay in the Department of the Air Force. However, attempts to make these practices more broadly available have not been successful.

4 In the private sector, "professional" is a term of art that covers nonsupervisory work that is FLSA-exempt. The Federal counterpart is two-grade interval professional and administrative work, including occupations such as IT specialist, attorney, and budget analyst.

5 Howard Risher, "Are Public Employers Ready for a 'New Pay' Program?" *Public Personnel Management*, vol. 28, No. 3, International Personnel Management Association, Alexandria, VA, Fall 1999.

performance-oriented system that built on the "lessons learned" from PMRS.[6] Instead, it was replaced by the *status quo ante*, sending – unintentionally but inevitably – the message that excellence is of little consequence.

That message actually begins with the very structure of the General Schedule itself. OPM's research into non-Federal compensation practices shows that in private sector organizations carrying out similar kinds of work and recruiting similar talent, pay structures provide much more room for performance-based distinctions. The General Schedule uses a 30 percent range width (i.e., a GS grade's maximum rate equals 130 percent of its minimum rate). In contrast, our competitors' pay structures typically have range widths of at least 50 percent for professional positions, and ranges of 80 percent or more are common under paybanding systems.[7] In effect, a "pay band" in the Federal sector is simply a normal salary range in the private sector.

The General Schedule pay administration rules do have some pay-for-performance features. But these features do not make the current system a performance-oriented system. The Department of Energy's Deputy Assistant Secretary for Human Resources, Timothy M. Dirks, put it this way:

> Greater flexibility is needed in calibrating pay to individuals' skills, contributions, and value to the enterprise. The current system is too rigid and does not provide the range of mechanisms needed to make meaningful distinctions.

Indeed, the way Government delivers pay increases – and the relative value of those increases – reinforces the message that performance is secondary at best. Consider that:

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[6] Those lessons included a recognition that creating a statutory entitlement to a predetermined base pay increase on the basis of an assigned summary performance rating, in combination with a statutory ban on limiting the use of rating levels – all in the name of "fairness" compared with the treatment of non-managerial employees under the regular General Schedule – produced substantially increased costs with no demonstrable benefit to the taxpayer. The performance management programs the agencies designed and operated remained largely focused on process measurement and at the termination of the system in 1993, five out of six PMRS employees were rated above "Fully Successful." See also *Achieving Managerial Excellence: A Report on Improving the Performance Management and Recognition System.* Report of the Performance Management and Recognition System Review Committee, November 1991.

[7] A recent study of private sector companies with functions comparable to the Federal Government's, carried out for OPM by Booz Allen Hamilton, found that three out of four companies surveyed used ranges wider than 40 percent, with range-widths often falling between 50 and 80 percent. Only 5 percent of companies report using ranges of 20 to 30 percent. *Private Sector Compensation Practices,* Booz•Allen & Hamilton – Report to the U.S. Office of Personnel Management, Washington, DC, February 2000. *Broadbanding Design, Approaches and Practices*, American Compensation Association/Hewitt Associates, 1994.

- **The General Schedule system assigns more weight to position than to performance.** Promotion – placement in a position at a higher grade – results in an immediate pay increase and a substantial increase in long-term earnings, while outstanding performance at a particular level of work guarantees nothing.

- **The Federal Government's tools for managing base pay are limited.** Fundamentally, the pay system treats pay setting and pay adjustments as a series of binary decisions. Exceptions are permissible, but expected to be rare and may require higher level approval.

  Upon appointment, the pay system takes into account only the fact that the employee meets basic qualifications requirements – in our binary scheme, the employee is in a "go" status without further differentiation. Statute then specifies that the pay for a newly hired employee must be set at the minimum rate of the grade of the employee's position, unless the employee has unusually high or unique qualifications or the agency has a special need. An appointee with better than average qualifications still gets the minimum rate. Consequently, with rare exceptions, no differentiation can be made to relate starting pay to an incoming individual's performance capacity.

  After initial appointment, pay adjustments occur either within a grade's pay range, where the employee progresses further through the grade's fixed-step rates, or between ranges, when an employee is promoted to a higher grade. Here, too, the law establishes lock-step rules using "go"/"no go" judgments.

  – The primary means for adjusting an employee's relative position in a grade's pay range is the within-grade increase (WGI). The WGI is designed to reward experience and loyalty, not excellence, and is based on a judgment that the employee's work is of an "acceptable level of competence" – again, a binary decision. There is no way to make base pay distinctions between a very good – but not outstanding – employee and a moderately good one; their WGIs are identical. The quality step increase (QSI), which accelerates movement through the range by awarding the next higher fixed-step rate in advance of the normal waiting period, is also available, but is limited to outstanding employees, and less than 4 percent of all General Schedule employees receive them. In contrast, many private sector and demonstration project approaches to managing within-range movement are designed to affect employees' relative position in the range, and pay policies are often set to give only the best performers access to rates in the upper part of a range.[8]

– When an employee is promoted, statute again dictates the resulting pay adjustment. Promotions, particularly competitive promotions, are perhaps the strongest pay-for-performance linkage currently available. Nonetheless, the outcome is invariable and again of a binary character – the promoted employee is a "go" and given a predetermined payoff irrespective of relative performance or value to the agency.

- **Pay-for-performance tools coexist with structural and time-based pay increases.** This coexistence creates two problems.

  – First, it sends the message that pay will – and *should* – increase with the inflation that fuels wage increases – which drive structural adjustments – and with the passage of time. This message is reinforced by actual practice. In a typical year over the past decade, Federal employees received more and greater pay increases simply for remaining on the payroll than for meeting or exceeding performance expectations. The chart shown below illustrates this point.

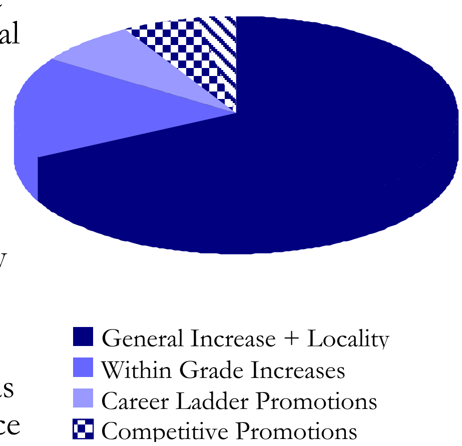
The Role of Performance in Pay

• Total increase in payroll as a result of increases to individual employees' pay: 7.1%

• Over threefourths of that increase in total payroll was insensitive to performance

• General increase and locality pay adjustments: 4.8%

• Over half of the remaining 2.3% total payroll increase was also insensitive to performance



Source: Central Personnel Data File – 2000

[8] See *Alternative Pay Progression Strategies: Broadbanding Applications*, U.S. Office of Personnel Management, Washington, DC, April 1996.

Of the total pay increases granted, those that are either completely automatic or essentially so – given their low threshold and predetermined size and distribution – are shown as the non-patterned wedges of this pie. They truly overwhelm the two forms of increase in the General Schedule system that provide some meaningful performance contingency: the competitive promotion and the QSI. Automatic and semi-automatic increases are artifacts of the fixed-step pay schedule: there is no way to *not* grant them when the President must issue pay tables with unique dollar amounts assigned to each grade and step. A General Schedule Federal employee's grade and step are known, rather than a precise annual salary. That latter value is derived through a look-up function tied to a published salary table, not through any considered judgment about the value of the employee's contributions or competencies.

This year, the Government will distribute 5 billion dollars on these performance-insensitive pay adjustments and related benefits costs. An employee needs to do little, if anything, to earn these increases; they are essentially entitlements.[9] In contrast, private sector companies take great pains to avoid creating pay entitlements and focus instead on the strategic leverage that pay delivery tools provide.

– Second, the dominance of performance-insensitive pay increases makes performance-oriented tools appear trivial. For most employees, their time-driven increases have much more value than any awards or raises they receive for outstanding performance. Furthermore, the limited extent and impact of performance-sensitive pay is strongly at odds with a strategic human capital management perspective. In light of the limitations that constraining statutory system features impose, many Federal leaders with a General Schedule workforce may well have felt some frustration as they applied the General Accounting Office's self-assessment checklist for evaluating the effectiveness of their human capital management and scored the following item:

> 4. **Compensation.** Does the agency's compensation system help it attract, motivate, retain, and reward the people it needs to pursue its shared vision?
>
> ***Look for:*** Indications that the agency has examined its compensation system and considered changes in light of its human capital needs,

[9] This characterization is not rhetorical: statute, appeal rights, and case law make it quite clear that employees do, in fact, have a property right in these increases.

> including skill-based compensation, and identified relevant constraints and flexibilities. Evidence that consideration has been given to making compensation packages more competitive. . . . Industry benchmarks on compensation and information . . . on average salary and projected demand for given occupations.[10]

In these various, cumulative ways, the General Schedule pay system sends the subtle but unmistakable message – overriding any management protestations to the contrary – that performance is a secondary consideration at best. This phenomenon is documented more specifically in the seventh Closer Look: *How the System Does – and Doesn't – Reward Performance* (pages 57–63), which examines the relative impact of performance alongside General Schedule system features like general increases, time, and position.

- **Agency efforts to strengthen the linkage between pay and performance are undermined by the *fiscal* dynamics of the compensation system.** One bright spot in the Federal compensation system is awards. When compared to other public sector employers, such as State governments, our awards system gives Federal agencies considerable flexibility to reward excellence through honorary recognition, cash, or time off. But few agencies offer the financial incentives commonly available in the private-sector, where employees may receive bonuses of several percent of salary or more.[11] This is not surprising, because, as the earlier chart illustrates, our system requires Federal agencies to deliver a substantial amount of money through pay increases that are essentially automatic. For example, in 2000, General Schedule employees received a pay adjustment of approximately 3.7 percent of base pay,[12] and more than one in every three General Schedule employees received a within-grade increase.[13] Such increases do not merely send the message that performance is secondary. By absorbing the lion's share of annual personnel funding, they may effectively prevent agencies from suggesting otherwise through performance-based increases and lump-sum

[10] *Human Capital: A Self-Assessment Checklist for Agency Leaders*, General Accounting Office (GAO/OCG-00-14G), Washington, DC, September 2000, p. 21.

[11] Jeremy Handel, "Variable Pay Highlights Year in Compensation," *Workspan*, vol. 44, No. 9, WorldatWork, Scottsdale, AZ, September 2001. This article, reporting highlights from a compensation survey, reports that FLSA-exempt employees in the south and east regions of the United States received variable pay worth approximately 10 percent of annual salary.

[12] This is the average General Schedule increase in 2001 for employees in the continental United States, comprising a 2.7 percent general increase in the basic pay rate and a 1 percent average locality pay adjustment. Individual increases varied, depending on factors including location and coverage by a special salary rate schedule.

[13] In FY 2000, approximately 38 percent of General Schedule employees received a within-grade increase. A within-grade increase raises the employee's pay by one step, or approximately 2.6 to 3.3 percent of base pay.

> awards. In addition, Congress has on occasion curtailed the limited agency spending on performance-driven lump-sum cash awards that does occur – few agencies spend more than 1 percent of their basic payroll on awards. Such congressional action – usually carried out through the appropriations process and affecting only a few agencies at a time – can have a severe chilling effect on other agencies' use of these flexibilities to link pay and performance.

This situation would need to change if the Government is to establish a meaningful performance culture. As recent events have shown all too clearly, Government performance is critically important, and we would be better served by a compensation system that reflects and reinforces this importance.

Of course, it is also important to remember that any compensation system changes that increase an emphasis on a performance linkage will only succeed to the extent that credible, reliable measures of that performance are readily available. A rigorous performance management system that employees trust to make appropriate performance distinctions is the *sine qua non* for stronger linkages, both for setting clear expectations and accountability and for establishing measures that can bear the burden of driving pay decisions. Our eighth Closer Look: *The Challenge of Performance Measurement* (pages 64–66) discusses this issue further. Past and present efforts aimed at improving financial management and information in the Federal Government will support efforts in this regard. The fact that Federal agencies do not have the luxury of refined accounting systems measuring a competitive bottom line or economic value added is finally fading as an excuse for not defining and measuring expected results. A results-focused, accountable Government operating effectively under the Government Performance and Results Act must know where it stands and how it has or has not improved.

If What We've Got Is Wrong, What Would Be Right?

The Federal pay system needs to include improved mechanisms for addressing individual equity so that it could allow agencies to recognize and value the competencies and contributions of their employees better. The current system's narrow pay ranges, time-based pay progression rules, and across-the-board delivery of annual increases impair the Government's ability to use pay, and particularly adjustments to base pay, to communicate important values and goals and to reward results. The Government's ability to establish and sustain a performance culture is essential. Such a culture requires clear expectations and robust measures that make meaningful distinctions across levels of performance and reinforce accountability. More importantly, however, that culture must be supported by a compensation system where those performance distinctions matter.

An Excess of Internal Equity

The Federal compensation system emphasizes internal equity at the expense of external equity and individual equity. The system does not permit Federal agencies to allow non-classification factors – such as the importance of the work to the employing agency, salaries paid by competing employers, and turnover rates – to influence base pay. The classification system's rigid quality defeats strategic human capital management and nimbleness. Most important, this internal equity emphasis limits the Government's ability to give external equity and individual equity their appropriate weight in compensation decisions.

The merit system principle governing Federal pay includes as its most familiar and most prominent precept that the Government should establish and maintain logical and equitable salary relationships inside the organization itself, stated as:

> Equal pay should be provided for work of equal value. . . .[1]

As noted earlier, this precept is known as internal equity. It is an indispensable element of fairness in the workplace and a core principle of every modern compensation system. But modern compensation systems balance this principle with two other principles, as discussed above: external equity (relating employee pay to external labor market rates) and individual equity (relating employee pay to the individual employee's contributions and results). The merit system principle clearly recognizes the need for balance, and its language contemplates all three forms of equity: internal, external, and individual.

Unfortunately, the Federal compensation system does not achieve this balance: it emphasizes internal equity at the expense of external and individual equity. This overemphasis is reflected in:

- A rigid linkage between a position's value – as determined by classification[2] – and its grade; and
- A rigid linkage between a position's grade and the employee's pay.

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[1] 5 U.S.C. §2301(b)(3).

[2] Here, "classification" refers to the Federal Government's job evaluation system, the General Schedule position classification system, which applies centralized criteria across all white-collar work to determine the proper occupational series, position title, and pay grade of each position.. This use of the term "classification" differs from private sector usage, where "classification" refers to a specific method of job evaluation.

In the Federal Government, job evaluation points = grade = base pay. Under this approach, job evaluation does not simply *inform* base pay; it *dictates* base pay. The system's architecture and guidelines do not permit Federal agencies to allow non-classification factors – such as the importance of the work to the employing agency, salaries paid by competing employers, turnover rates, and added value derived from employees acquiring additional competencies applicable to the same level of work – to influence base pay, other than by notable exception. OPM's research into public and private sector compensation systems suggests that this situation is extraordinary. Even organizations that place a high value on internal equity do not implement it in such a confining manner.[3] More important, the dominant rigidities of the classification system put strategic human capital management and nimbleness nearly beyond reach.

The Government's emphasis on and implementation of internal equity creates several problems.

- First, it rewards and perpetuates hierarchy. Modern communications technology and more enlightened, empowering management practices have rendered the command-and-control paradigm an irrelevant and inefficient allocation of scarce resources. Past and present executive branch leadership has consistently called for agencies to use organization structures that are much more flat, responsive, and adaptable:

  > To shrink the distance between citizens and Cabinet members, the Administration will flatten the Federal hierarchy, reduce the number of layers in the upper echelon of Government, and use work force planning to help agencies redistribute higher-level positions to front-line, service delivery positions that interact with citizens.[4]

  On the surface, this inconsistency is surprising because the principle of "equal pay for work of equal value" is egalitarian, and using classification to value work seems to provide effective controls to limit the potential for unfettered "empire building." But our job evaluation system values work in a way that insistently encourages developing and maintaining organizational layers. For

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[3] One example is the State of Minnesota. Although internal equity is a primary value of Minnesota's compensation system, job evaluation is not the sole determinant of a position's grade. Job evaluation produces a preliminary grade, which may be adjusted upward or downward one or two grades based on staffing, market, or other considerations. (See "State Employee Compensation," Office of the Legislative Auditor, State of Minnesota, St. Paul, MN, February 2000, p. 13.)

[4] *A Blueprint for New Beginnings*, Executive Office of the President of the United States of America, U.S. Government Printing Office, Washington, DC, 2001, p. 179.

example, the classification system rewards supervision, by requiring – with very few exceptions – supervisory positions to be evaluated at least one grade higher than subordinate positions.[5] And the three classification factors that carry the most weight in the classification of nonsupervisory jobs – knowledge required, supervisory controls, and guidelines – are all explicitly or implicitly related to a position's location in the organization's chain of command.[6]

- Second, the internal equity emphasis limits the Government's ability to give external equity and individual equity their due weight in pay decisions. This limitation has both cultural and technical aspects. The cultural aspect is a continuing – though decreasing – reluctance to make pay distinctions between employees based on factors other than job value as measured by classification, as illustrated by the history and implementation of the Federal Employees Pay Comparability Act. The technical aspect is that position carries more weight in Federal compensation than market pay or performance. Consequently, classification is more readily available – and much more powerful (in dollar terms) – than tools for making pay distinctions based on performance and labor market considerations. Congress has delegated to agencies the authority to classify positions. A manager can immediately increase an employee's pay substantially by getting the employee's position reclassified to a higher grade.[7] The additional funding that the higher grade requires, particularly in future years, has often been provided automatically through centralized agency budgeting processes – like "manna from heaven," as one manager put it. Providing an award or retention allowance of comparable value can prove much more difficult and may even require OPM approval.[8]

- Finally, limiting the potential for performance and labor market distinctions to influence base pay has actually undermined internal equity, because a lack of adequate market- and performance-oriented compensation tools creates a strong incentive to misclassify positions. This paradox is illustrated in the final Closer Look: *Classification – The Unintended Tool of Choice* (pages 67–68).

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[5] This oversimplifies the concept of "base level of work supervised," but is generally accurate.

[6] These are the three dominant factors used under the Factor Evaluation System (FES), a point-factor job evaluation system. FES classification standards do not cover all occupations, but even non-FES standards use conceptually similar factors.

[7] Depending on the employee's grade and step, reclassification to a higher grade will usually result in an immediate pay increase ranging from 5 to 20 percent.

[8] For example, most agencies continue to require multiple internal approvals for substantial payments like significant retention allowances and large cash awards. For most agencies outside the Department of Defense, OPM approval is required for most cash awards of more than $10,000.

The outcome of these problems is a classification system that lacks credibility and is perceived by many as superfluous at best, a hindrance at worst. A recent, precipitous decline in the number of Federal classification specialists reflects broader trends such as reductions in staff functions, the replacement of HR specialists with HR generalists, and increased efficiency through automation.[9] However, this decline – which shows no signs of reversal even as other human resources functions are being revitalized – can also be construed in part as a management commentary on the "value added" by classification. The recent OPM research on job evaluation suggests that many organizations are reassessing the costs and benefits of spending scarce resources to operate an elaborate job evaluation apparatus and drastically simplifying their processes.[10] [11] Another possible interpretation of the decline in Federal classifiers is that classification requires a decreasing degree of analysis and extent of expertise. This would certainly be true if classification has become, in many cases, a routinized exercise to justify a specific outcome (i.e., a desired grade and pay level) or – worse yet – a cynical "game" that is played by a few cagey and artful practitioners, instead of a careful analysis of work and a thorough, objective comparison of that work to established standards. These developments contribute to decreasing expertise and accuracy in classification – which will further erode the system's credibility and perceived value.

If What We've Got Is Wrong, What Would Be Right?

Equal valuation of *work* with similar characteristics within an organization maintains internal equity, which is an appropriate and important part of any sound compensation system. However, the apparatus used to ensure internal equity must be credible and cost effective and add value. Although internal equity may over-dominate the current system – crowding out the ability to make useful judgments about external market rates and to reward performance – retaining some internal equity structure, grounded in job evaluation, would be critical to support fairness to employees. Some governmentwide framework for job evaluation would also be valuable to ensure accountability and transparency, as

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9 *An Occupation in Transition*, "Part I: Federal Human Resources Employment Trends" U.S. Office of Personnel Management, Washington, DC, September 1999.

10 Robert L. Heneman, *Work Evaluation: Strategic Issues and Alternative Methods*, Human Resources Research Organization (HumRRO) – Report to the U.S. Office of Personnel Management, Alexandria, VA, June 2000.

11 Robert L. Heneman, *Work Evaluation: Leading Company Methods and Thought Leader Perspectives*, Human Resources Research Organization (HumRRO) – Report to the U.S. Office of Personnel Management, Alexandria, VA, January 2001.

well as compliance with the Equal Pay Act, and to support other compensation management functions, such as making pay comparisons with external markets to maintain external equity.

Conceptual Flaws, Tangible Problems

The Government's approach to compensation management rests on the outmoded idea of the single "correct" answer. Maintaining a "single employer" model for pay has required the Government to retain a level of central management that is increasingly at odds with the world we live in. At the same time, striving for the single "correct" answer has slowed the Government's decision making ability to the point where often even "correct" answers cannot be made in a timely manner. And deviating from the "correct" answer is difficult to achieve and takes too long to be effective.

The problems in Federal white-collar pay and job evaluation are not simply a product of ineffective practices; they are also the product of the Government's approach to compensation management. That approach is one of centrally-designed, uniform solutions based on thorough planning and analysis. It dates to the nationwide application of the General Schedule classification system, and it has persevered into the 21st century. Even as more pay flexibilities became available is the 1990s, the central system dominated and distributed the vast majority of payments employees received. This approach supplied and reinforced a powerful connotation to the phrase "Government as a single employer" – underscoring the idea that there is a single, demonstrably correct solution to human resources management problems which every Federal agency should use. In the modern era of strategic human capital management and particularly for many areas of compensation management, that conception may have outlived its usefulness – because a *single* correct solution probably does not exist and because the search for the *correct* solution may result in untimely action.

The limits of "single" solutions

Today few compensation problems are amenable to a "single" correct answer. In 1949, a "single employer" approach to pay system design and delivery made sense, for two reasons. First, the Federal Government was composed largely of clerical employees performing stable, routinized work. It had, if not a "single employee," a highly homogeneous workforce. Second, there were practical arguments for central management of pay. In a "Government of clerks," the expertise needed to design and administer a pay system was not widely distributed. The generally accepted models of personnel administration typically confined wage and salary administration to the comptroller's shop where labor economics models predicated on tenure as a surrogate for value cranked out annual salary budgets and controls. And uniform procedures and treatment reduced the possibility of administrative error and were more amenable to oversight and inspection. But now, neither reason holds true.

The Federal Government's work and workforce are highly complex. Agencies perform diverse missions, with diverse workforces, and increasingly compete in different labor markets. A single approach to pay and job evaluation that closely specifies how agencies will evaluate work, how agencies will set and adjust individual salaries, and how agencies will move employees through pay ranges cannot realistically hope to accommodate this diversity. Congress has, on occasion, acknowledged the inadequacies of a monolithic approach to pay by giving selected agencies the authority to design pay and job evaluation systems specific to their unique missions and workforces. But strategic management of human capital would call for pay design and delivery tailored to the agency, mission, and workforce to become the rule rather than the exception. This view is supported by ongoing agency efforts to be released from the strictures of the current compensation system. An increasing number of Federal agencies have demonstrated that they have the capacity to design and manage their own compensation systems.

Efforts have been made to address the problems of excessive centralization through delegation. This has worked well when the pay system and its tools are viable, as is seen increasingly with targeted recruitment and retention payments well planned and budgeted in advance. But delegation will be insufficient if the problem lies within the system itself; and, as noted above, our system with its myriad technical specifications is increasingly unable to accommodate Federal agencies' diverse demands.

The problem with searching for the "correct" solution

Federal pay practices are implicitly assumed to be "correct." Once established, agencies must implement them as written, often with no or little room for judgment. For example, agencies must classify jobs in accordance with published classification standards, must provide within-grade increases in the amount and at the time specified by regulation, and must provide the annual pay raises specified by governmentwide pay tables.

An agency that wishes to change these "correct" practices must prove the need to do so. And the burden of proof is high. For example, if an agency perceives a need to increase salaries for employees in a given occupation, that agency (and other agencies in the area) must prepare and submit a request for special salary rates.[1] This request must document, in detail, the need for the special salary rate, including factors such as vacancy and quit rates, the nature of the existing labor market, and the inadequacy of existing pay and non-pay solutions.[2] Similarly, to establish a personnel demonstration project,[3] the agency must develop and submit a project plan that describes, in detail, the project's intended outcome, methods, measurable objectives, costs, and benefits.[4] Then OPM must review and approve these submissions.

A high burden of proof makes it easier for the Government to defend those few deviations from standard pay and job evaluation practices that are allowed. But that same burden of proof also makes it costly and difficult to change such practices when necessary and even when they offer improved strategic value. The planning and consultation a demonstration project requires can consume 2 years or more. The result is that the pay system is not nimble; even if the Government's response to change is technically appropriate, it may well be untimely.

In its most recent annual report on locality pay, the President's Pay Agent raised questions about the process carried out under the Federal Employees Pay Comparability Act of 1990 (FEPCA), which in many respects is emblematic of the "single" and "correct" solution approach. The Pay Agent noted:

> . . . serious concerns about the utility of a process that focuses too much attention on locality payments and not enough attention on the differing labor markets for major occupational groups or the performance of individual employees.[5]

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1 Consensus among affected agencies is not required, but a lack of consensus may significantly reduce the likelihood that a special salary rate will be established.

2 Adapted from 5 CFR §530.303.

3 Under current law and regulation, a personnel demonstration project is the only way an agency can implement an alternative approach to classification and pay increases without separate agency-specific legislative authority.

4 These requirements reflect the research function of a demonstration project.

5 *Report on Locality-Based Comparability Payments for the General Schedule*, Annual Report of the President's Pay Agent (Secretary of Labor, Director of the Office of Management and Budget, Director of the Office of Personnel Management), Washington, DC, December 2001.

If What We've Got Is Wrong, What Would Be Right?

Of course pay systems and decisions should be grounded in facts and analysis. But the Federal Government's current paradigm makes the pay system very inflexible and quite unresponsive. Addressing this shortcoming would require the Federal Government to broaden its conception of "Government as a single employer." This likely would entail acknowledging the limitations of centrally-designed, uniform systems by establishing a more open framework – based on some core values and using some umbrella principles – and giving agencies greater flexibility to tailor pay systems and practices to their missions and strategic objectives. And that, in turn, would also require more openness to change – a greater willingness to adopt, modify, and discard pay systems and practices in the interest of effective strategic human capital management.

Final Thoughts About the Timelessness of Merit

Merit system principles, the foundation of the modern idea of a civil service, remain important today. Principles such as equity, procedural justice, and openness are essential to a sound public service. Agencies that have already moved outside the mainstream pay and job evaluation systems continue to use these principles effectively. As the Federal Government considers modernizing our compensation systems, merit system principles can remain our essential guides.

Even in a modernized pay system, the merit system principles, with their clear recognition of internal equity, external equity, and individual equity, can and should still serve as the fundamental drivers of Government action. These core – and remarkably timeless – principles sustain the vision that the Government remains a single employer in principle, if not in all areas of specific practice.

Some particularly important lessons in this regard emerged from the research into Federal agencies that use pay systems outside the general title 5 model, either through demonstration projects or through independent authority granted by Congress. The first lesson is that when one looks across the entire Government, a significant portion of the Federal Government has *already* left the centralized system,[1] so the notion that further change would disrupt a completely stabilized system is misplaced. Even more important, however, is the second lesson: when agencies operating under the merit system are free to do "anything," they generally do sensible things.[2] They own and adapt what makes sense for them and their missions. Managers are not given unfettered discretion to set and adjust pay, but operate within agency-specific rules and guidelines, including budget restrictions. And these agencies have in fact succeeded in using their pay and job evaluation systems to improve the strategic management of their human capital by aligning reward systems with strategic goals and mission accomplishment. Congress has recognized such successes by its actions to make permanent successful paybanding demonstration projects in the Navy and Commerce Departments.

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1 *HRM Policies and Practices in Title 5-Exempt Organizations*, U.S. Office of Personnel Management, Washington, DC, August 1998.

2 *Demonstration Projects and Alternative Personnel Systems: HR Flexibilities and Lessons Learned.*, U.S. Office of Personnel Management, Washington, DC, September 2001.

Aside from their specific directives related to pay, the merit system principles include other precepts that characterize our current systems. These constitute some extremely important elements that are "right" and that ought not to be jettisoned as "wrongs" are addressed. In particular, the merit system principles underscore important themes that compensation systems ignore at their peril.

One such theme is the principle of what has come to be called *procedural justice*, whether expressed generally as "all employees . . . should receive fair and equitable treatment" [3] or spelled out in specific prohibited personnel practices. A great deal of the dense, rigid administrative detail that characterizes our current pay and job evaluation systems originated in the interest of procedural justice. The time may have come to recognize that this principle might be equally well served by simpler, more flexible practices designed to fit a particular organization and workforce. Nonetheless, honoring the procedural justice principle is essential to establish and maintain trust among employees about any core human capital management system.

Another theme the merit system underscores is *openness* supported by effective communication. However arcane the Federal pay system may appear to outsiders, most Federal employees understand its basic design and deployment. Organizations crafting new compensation approaches learn quickly that the key to success is constant and consistent communication. The idea that employees should have a clear understanding about what they can expect to happen and what will affect the outcomes that impact them is particularly relevant for the pay systems and other strategic rewards programs that not only put food on the table, but also may subsidize transportation costs and finance educational expenses. Any strategic human capital management improvements an agency might hope to achieve with a refined strategic rewards approach could be at substantial risk if employees are left to divine its contingencies and payoffs on their own.

It is appropriate to acknowledge and use the lodestone quality our merit system principles provide. Their core values and fundamental themes can serve well to keep the enormous diversity of Federal agencies, missions, and workforces on course, even as the Federal community sets out together to consider and explore possible system improvements.

[3] 5 U.S.C. §2302(b)(2).

Conclusion and Next Steps

This White Paper paints a "warts and all" portrait of the current Federal pay system. OPM expects – and indeed genuinely desires – its honesty to provoke an equally honest discussion of the disturbing issues it raises. We have an outdated pay system – built on the firm foundation of the merit principles but fundamentally out of step with today's work and workplace and workforce. Continuing to muddle through with an uneven set of "cans and cannots" across the spectrum of Federal agencies is not a meaningful answer for attracting, managing, developing, and retaining the quality workforce needed to produce the critical results that the American people expect from their Government.

Several valiant attempts have been made to "fix" specific problems – most recently the Federal Employees Pay Comparability Act of 1990 (FEPCA) – but these fixes ultimately fall short because they cannot overcome the underlying root problems. The question is not *whether* we can maintain the current system, the question is *should* we. As Sharon Barbee-Fletcher, Director of Personnel at the Pension Benefit Guaranty Corporation, put it: "The system has outlived the time in which it was an effective way to do business. It is time for a more flexible approach." So perhaps the hour has indeed come to start over, with a blank sheet of paper, and design a system that responds to 21st century organizational demands and makes sense for today's workers.

The next steps in this journey will involve all the stakeholders in the public service community. OPM will circulate this pre-decisional White Paper widely and provide specific opportunities for any and all who wish to comment or submit ideas. The intent is to trigger a broad conversation about the future of Federal pay and job evaluation. In the coming weeks and months, OPM will invite interested parties – including agencies, employee unions, and other stakeholders – to participate in discussions. OPM anticipates a wide range of views will be shared and looks forward to these exchanges and the opportunity to learn about and identify our agreements, disagreements, and concerns. Only through such discussion will the ideas emerge to modernize the way the Federal Government pays its employees to respond to contemporary market conditions and employee concerns. Ultimately, OPM hopes to build consensus on possible new answers for Federal pay and job evaluation for the 21st century.

Working together, guided by the merit system principles, OPM believes our shared goal can be to identify ways to improve the balance across internal, external, and individual equity to promote distributive justice while maintaining openness and procedural justice. By such means, we can ensure that the Federal compensation system will serve employees and agencies alike. The outcome can be a system that makes a significant contribution to achieving the strategic, results-driven Government that the Government Performance and Results Act envisions.

Let the conversation begin!

Closer Looks at Federal Pay

- A Framework for Strategic Rewards
- A Primer on the General Schedule
- Why Not Preserve the General Schedule?
- Labor Markets Are Not Supermarkets
- The Problem With Special Salary Rates
- Whither Comparability?
- How the System Does – and Doesn't – Reward Performance
- The Challenge of Performance Measurement
- Classification – The Unintended Tool of Choice

A Framework for Strategic Rewards

Reference: ***A System Whose Time Has Come – and Gone*** **(page 6)**

Over the past 10 years, as compensation theory and practice have secured their place within the human capital management arsenal in the war for talent, a related shift has occurred as practitioners recognize and leverage strategic value from a broader range of rewards than traditional pay and benefits. Simply put, "It's not just about money any more." Today's conception of reward systems has necessarily widened to include a spectrum of conditions that might be termed a "reward environment." The depth of this change in perspective was seen most clearly in May 2000 when the American Compensation Association reinvented itself as WorldatWork and adopted a "Total Rewards" approach.

In the 1980s and 1990s, employers increased their sophistication in analyzing and delivering what their employees – and potential employees – valued. In particular, employers looked for answers to the conundrum of fighting turnover when they were already paying salaries well above the market. Some of the most telling research revealed that even well-paid employees will leave when competing employers offer a better total rewards package. Such a package might include a commitment to skill development or a clear sense of mission and well-trained leaders who recognize results or an opportunity to balance work and family responsibilities better.

> Increasingly, it has become clear that the battle for talent involves much more than highly effective, strategically designed compensation and benefits programs. While these programs remain critical, the most successful companies have realized that they must take a much broader look at the factors involved in attraction, retention and motivation. And they must deploy all of the factors – including compensation and benefits – to their strategic advantage.[1]

Federal agencies are also rethinking how they offer talented and highly-skilled employees and applicants the rewards that will engage and focus them on meeting strategic objectives. OPM has developed a Strategic Rewards Framework to aid agencies in their analysis and investment in employee rewards. Strategic rewards embrace everything that employees value in the employment setting, and the term refers to the complete bundle of employee reward elements. The framework uses

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[1] "A Historical Snapshot," *What is Total Rewards?* WorldatWork, 2001, Online (URL: http://www.worldatwork.org/Content/About/aboutwaw-whatis-frame.html)

four quadrants that map the overall rewards environment agencies can manage and deliver, as depicted below:

Compensation
- Base Salary
- Variable Pay
- Other Payments
- Paid Time Off

Support Processes

Benefits
- Health Care
- Retirement
- Savings
- Other Insurance

Support Processes

Learning & Development
- Training
- Learning Experiences
- Career Paths

Support Processes

Work Environment
- Work/Life Balance
- Leadership
- Performance Culture
- Organizational Climate

Support Processes

The top two quadrants of the framework are sometimes called *transactional rewards* because they include the tangible results of the agreement between the employee and employer. In this agreement, or transaction, the employee provides time, labor, and competencies in return for salary and benefits. (NOTE: OPM includes paid time off, or leave, in the compensation [i.e., pay] quadrant simply because leave is so closely tied to hours of work and related pay entitlements.)

The framework's bottom two quadrants cover areas that are increasingly recognized as critical factors for employee satisfaction and retention. They are sometimes called *relational rewards* because they tend to represent the relationship (vs. the transaction) between employee and employer. Indeed, effective balanced scorecard measures of the employee perspective usually focus on these areas. And investing in relational rewards is not a matter of the employer being nice; it's a matter of being smart.

Each quadrant also refers to *support processes*. These include related activities and services such as performance management, job evaluation, workforce planning, competency modeling and assessment, leadership development, work/life program implementation, and employee surveys and analysis.

This conception is particularly noteworthy for the Federal Government because of the strengths and competitive edge we can achieve in the bottom quadrants. Agencies have flexible authorities to invest in learning and development, and the opportunities to develop and sustain a performance culture that also values work/life balance are strong assets for the Federal employer. Although many of these relational rewards compete for limited funds, there is little doubt about the payoff on that investment. The evidence is clear: people may join your organization for the pay, but they stay for the chances to develop and make meaningful contributions under strong leadership. Were the Government overnight to start paying at or above market salaries, we would still have to keep employees engaged through strategic investment in relational rewards.

OPM has labeled this framework "*Strategic* Rewards" (vs. the more commonly applied "Total Rewards") to underscore the role its elements play in an agency's overall strategic management of human capital. A reward is "strategic" when:

- it is valued by employees (or job candidates) that the agency must attract, retain, and manage because they make a difference for meeting the agency's strategic goals and objectives; and
- the agency can use it to communicate and focus on those strategic goals and objectives, and to enhance its capacity to achieve them (e.g., by building skills and rewarding results).

A Primer on the General Schedule

Reference: *A System Whose Time Has Come – and Gone* (page 9)

The term "General Schedule" denotes the major compensation structure for white-collar work in the Federal Government. The General Schedule covers more than 1.2 million Federal employees. The system has governmentwide rules and procedures for setting pay for newly hired employees, for increasing an employee's pay, for adjusting the overall pay structure based on comparison with outside pay levels, and for paying overtime and other sorts of premium pay (such as hazard pay).

At the heart of the General Schedule is a job evaluation (position classification) structure that sorts jobs into classes of positions across 15 grade levels and hundreds of occupations. The grade levels are differentiated by the difficulty and responsibility of the work.

The primary function of the job evaluation structure is to facilitate setting and adjusting pay, but this structure was designed to be useful in all aspects of human resources management, not just pay. For example, when Federal hiring was more centralized than it is now, the General Schedule job evaluation system helped channel applicants to agency jobs through a nationwide examining system. The General Schedule job evaluation system also serves as part of the framework for determining how employees are affected during lay-offs.

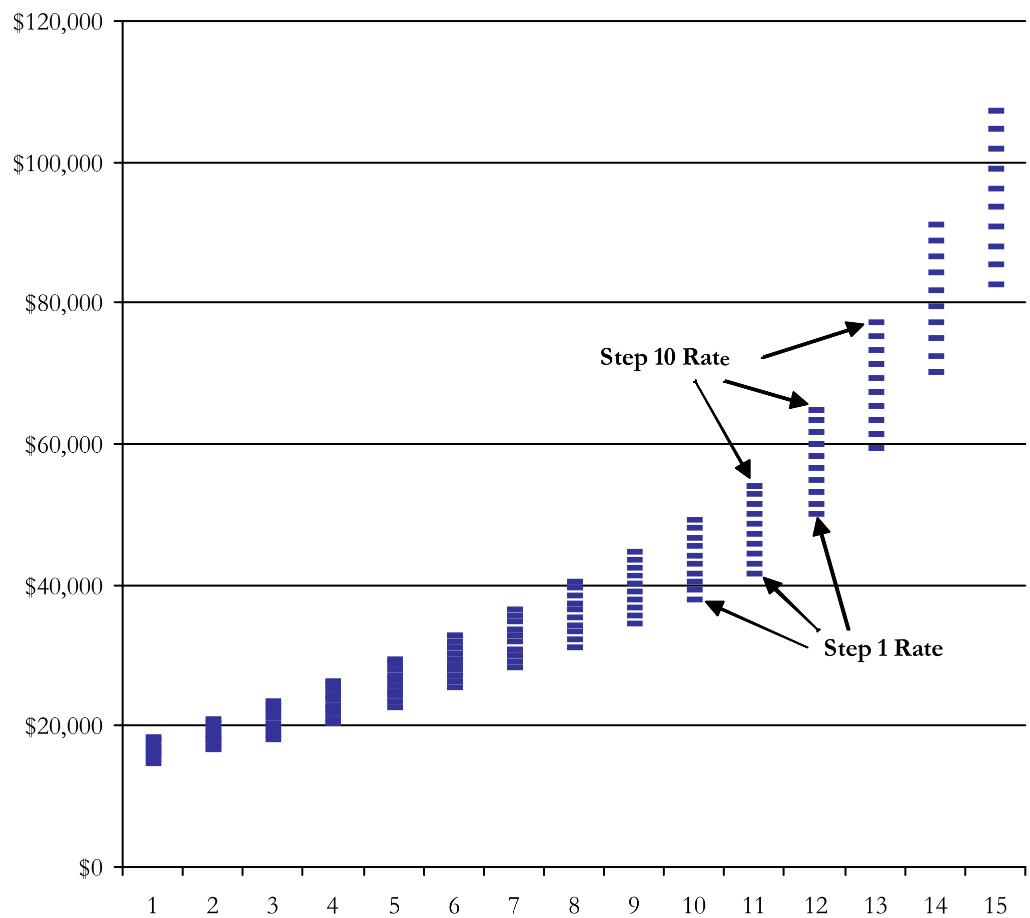
The General Schedule as a Pay Structure

The term "schedule" also refers to the schedule of pay rates that make up the salary structure for white-collar work. Each of the 15 grades has a pay range of about 30 percent. (The actual dollar values in the pay ranges for each grade vary from one locality to another.) The pay range for a given grade (in a given locality) is the same for all agencies and for all occupations, *except that* OPM may increase the value of the pay range by establishing special salary rates for occupations and grade levels for which there is serious difficulty in hiring and retaining staff at the regular pay levels.

Each pay range is divided into 10 specific rates of pay called "steps." An employee's pay generally has to be fixed at one of the steps. (There is an exception to this rule for managerial employees who were moved to the General

Schedule upon the termination of the Performance Management and Recognition System in 1993.)

An employee moves upward from step to step after serving a prescribed waiting period and on the condition that performance is at an "acceptable level of competence." Governmentwide regulations specify that that level is reflected through assignment of a summary performance appraisal rating at Level 3 or higher. Generally, agencies describe Level 3 as "Fully Successful." In appraisal programs that use only two summary levels, Level 3 is sometimes referred to as "Pass." The law sets waiting periods for moving from step to step at 1, 2, or 3 years, depending on an employee's position in the pay range. An agency may accelerate step movement for a high-performing employee by awarding a Quality Step Increase.



2002 General Schedule Grade Ranges and Pay Rates (without locality adjustments)

Why Not Preserve the General Schedule?

Reference: *A System Whose Time Has Come – and Gone* (page 9)

All the reform efforts of the last 50 years – including the Federal Salary Reform Act of 1962, the Civil Service Reform Act of 1978, and the Federal Employees Pay Comparability Act of 1990 – have left the General Schedule system intact. However, as the President and the Congress work to pursue good government policies and practices that improve management and accountability, OPM believes the time may have come for substantive reform that brings the era of the General Schedule to a close.

Legitimate arguments can be made for maintaining the current General Schedule system. These include stability, cost containment, and a lack of agency readiness or capacity to design and implement an alternative. OPM recognizes the need to maintain the General Schedule in the absence of an alternative and to provide an orderly and well-managed transition to any new system.

However, should the Government maintain the General Schedule simply because it is convenient? The Government Performance and Results Act – and, more broadly, the concept of performance-based government – holds Government programs and activities to a much higher test: they must "add value" by making a cost-effective contribution to mission accomplishment. For the reasons described below, the General Schedule system will not meet the "value added" test in the presence of a new framework for Federal compensation.

Culture

First, the Federal Government is shifting its emphasis from inputs and processes to performance and results. A "default" compensation system that communicates – however subtly – that position is more important than performance will not support the cultural change needed to effect and reinforce this shift. For some organizations – such as those where employees have limited scope of action to directly influence organizational results and therefore emphasize process improvement – it may still be sensible to have pay and job evaluation systems in which internal equity predominates. It is one thing to allow an agency to consciously and deliberately establish such a system as a strategic choice. It is quite another to imply *a priori* that such a system is appropriate by making it the "default."

Second, maintaining two systems – with the implicit prospect of returning to the old system if the new system is unsuccessful – conveys the message that cultural change is optional. This message would undermine the Government's ability to use compensation strategically. This is amply illustrated by the Federal Government's experiment with pay-for-performance under the Performance Management and Recognition System (PMRS) in the 1980s. PMRS, which based pay increases on performance ratings, existed side-by-side with the traditional General Schedule practice of increases keyed to longevity. The existence of parallel systems proved distracting and counterproductive. First, many employees focused on whether they were "better off" under the new system, devoting more attention to their pay than to their performance. Second, some employees perceived that they had "lost" pay because they no longer received full within-grade increases – even when they had, in fact, demonstrably gained pay by receiving partial increases in advance of the within-grade increase schedule. The result was that PMRS failed to establish a credible link between pay and performance,[1] and did not measurably improve Government performance.

Cost

Even if it were desirable to maintain the General Schedule, it would not be particularly cost effective or practicable. The resources and effort needed to maintain the General Schedule system – which include developing precisely defined locality pay areas and adjustments, establishing and administering special rates, developing and applying classification standards, and day-to-day pay administration – are substantial and presume considerable numbers of employees are still covered by the system. Given the extent to which agencies have already left the regular General Schedule ranks – some estimates are as high as 20 percent – and the prospect that progressive agencies would take advantage of the opportunity to design and implement more strategic pay systems, the dwindling numbers of employees remaining under the General Schedule would quickly become a new drain on the system's credibility.

Maintaining the General Schedule would not prove cost effective from another, broader perspective as well. This paper makes the case that the General Schedule system has limited capacity to provide strategic support to agency missions. The goal of the Government Performance and Results Act – and, more broadly, the

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[1] Problems in performance measurement and funding were also significant factors contributing to the failure of PMRS. Rigorous, credible performance measurement and management remain critically important to the success and credibility of any pay-for-performance approach.

concept of performance-based government – is to direct resources to programs and activities that add value for that purpose. The General Schedule no longer meets that value-added test.

Concerns about increased costs in the absence of the mechanical cost controls that the General Schedule's narrow pay ranges, fixed steps, and tightly scheduled within-range pay progression provide are not misplaced. However, the price of that control in the loss of strategic leverage discussed throughout this paper carries its own costs in human capital management terms. Experience from demonstration projects and other extra-title 5 systems indicates that the Government and its agencies can effectively use alternative cost control mechanisms such as salary increase budgets. In fact, such alternatives are better suited to supporting the integration of budget and performance that the Government Performance and Results Act envisions.

Labor Markets Are Not Supermarkets

Reference: *The System Is Market Insensitive* (page 14)

Venturing into a labor market is not like a trip to the grocery store. Valuing and acquiring talent in the labor market is much more complex than pricing and purchasing canned goods or packaged products. Nevertheless, all markets present the buyer with similar challenges: the need to be clear about what one is shopping for, the need to make intelligent comparisons among and between possible choices, the need to make decisions with incomplete price information, and the need to know when the price one is hoping to pay simply will not obtain the necessary level of quality. The processes the Federal Government is currently obliged to use to make pay decisions make it difficult to meet these challenges.

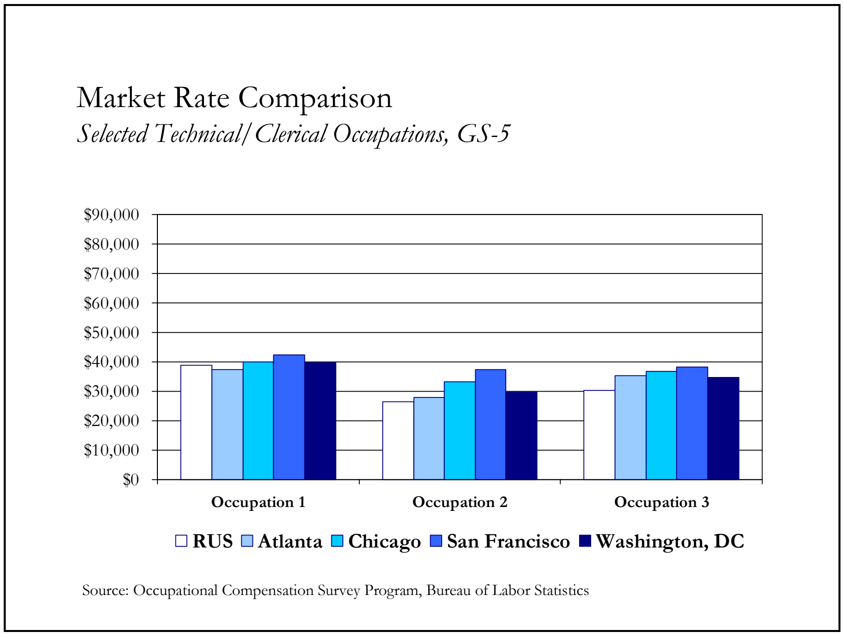
Labor market rates differ across occupations, not just grade and locality

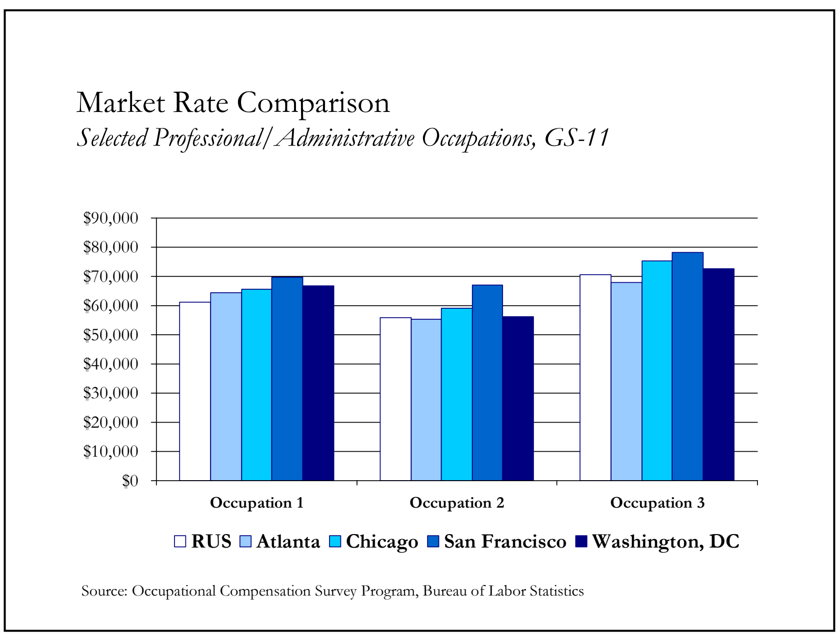
In the Federal system, grade is the major determinant of base pay. For example, all GS-12s are presumed equal: the Federal Government will pay GS-12 budget analysts, GS-12 attorneys, and GS-12 HR specialists the same amount of money unless agencies document the need to do otherwise. Most employers do not make this presumption, because they recognize that employees in different occupations are not interchangeable. For example, a GS-13 attorney is not a satisfactory substitute for a GS-13 biologist. Not surprisingly, labor markets reflect this reality: as shown in the charts on the next page, pay differences between occupations are often greater than pay differences between grades or localities.[1] For example, in Atlanta, market rates for Occupation 1 at the GS-5 level are 35 percent higher than the market rates for Occupation 2 at the GS-5 level.

However, the Federal process for determining whether and how much market prices have increased does not even price *occupations* in the labor market. It prices, instead, the Federal job classification system itself by superimposing the Government's internal equity structure onto the non-Federal jobs it looks at. Under current methods, when a non-Federal job is sampled, a determination is made about which of the 15 GS grades the sampled job would hold if it *were* a Federal job. Then the process rolls up the data for all the samples in a grade and

1 Locality remains important; some areas, such as San Francisco, appear to have uniformly higher labor costs. However, occupational differences are generally more significant than locality differences – particularly for professional and administrative work.

rolls up the grade data into one overall "price" increase. This result loses all clarity about what one is shopping for – a grocery shopper would not find such rolled-up price data (i.e., the average price of myriad items in the store) helpful in knowing what to pay for meat or milk or soap. Our pricing method does not arrive at accurate marketplace information for any one occupation or even a subset of occupations. Neither does it arrive at a number that Federal decision-makers find reliable for setting the pay of the entire General Schedule.





Labor market rates differ within an occupation

Occupation remains relevant in pricing the value of work, but it is no longer sufficient. In other words, not all IT specialists – or secretaries or nurses or engineers – are equal. Employees are not interchangeable; their skills, strengths, and performance vary. Labor markets recognize this fact. A professional recruiter, noting that job titles are less important than skills and performance, describes how this has changed his approach to interviewing – and valuing – job seekers:

> I used to look at the title. Now I just ask, "What exactly do you do?"[2]

The Federal Government has become more willing to acknowledge and act on skill- and knowledge-based distinctions. One example is the establishment of special salary rates for support employees with office automation skills. Another, more recent example is the establishment of special salary rates for attorneys and accountants performing work directly related to the securities industry.

This is a move in the right direction. But our system assumes that a given occupation or skill has a fixed, continuing value.[3] This assumption is problematic, for two reasons. First, skills may be valuable only in combination with other skills. Second, skills do not necessarily hold their value over time: they may lose their value if the employee does not maintain currency, if employers' needs change, or if technology changes. In such a situation, flexibility is required to adjust pay levels sensibly, e.g.., by adjusting the pay ranges for some occupations by a smaller percentage than for other occupations, while offering employees the opportunity to acquire more valuable skills. It could be useful to be able to go beyond narrow, predetermined categories like pay grade when necessary to make intelligent pay choices.

Labor market rates differ across individuals

Markets do not differentiate value based on skills alone. Increasingly, organizations recognize that high-performing employees are more valuable – to both the organization and to competitors – than average performers, and pay their employees accordingly. One corporation considers it a fundamental practice

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[2] Jennifer Mateyaschuk, "Salary Survey: Pay Up," *Information Week*, April 26, 1999.

[3] In theory, special salary rates (SSRs) are subject to ongoing reappraisal and adjustment. Pending enactment of the President's proposed Managerial Flexibility Act, regulations require annual review of SSRs, and there are strong disincentives for abolishing them. Consequently, SSR structures sometimes outlive the need for them.

to align and target pay differently depending on performance level; "distinguished" individual and organizational performance is pegged to what competitors pay at the 75th percentile and "achieved expectations" performance is pegged at the 50th percentile.[4]

As noted above, the Federal Government has become more willing (although imperfectly able) to establish pay differentials based on work-based distinctions that are finer than occupations. However, we lack the ability to create similar differentials based on performance, because our pay ranges are too narrow and our pay progression rules too restrictive. It could be useful to be able to make intelligent choices about paying within the market range for a set of skills *and* for the value added by high-performing employees.

Labor markets can change rapidly

Market rates are the product of supply and demand. Supply and demand are, in turn, influenced by factors including economic conditions, business opportunities, and technological changes. The result is that labor markets are dynamic. Market rates do not necessarily move in the steady, predictable manner suggested by broad indices such as the Employment Cost Index. This dynamism is amply illustrated by two "reports from the front" in the information technology (IT) industry:

> IT professionals of all ranks are having another big year. The median annual salary increase across the board was a hefty 8.9%. . . .[5] [April 1999]

> If you're a job-seeking Microsoft certified systems engineer, better brush up on your negotiating skills. The average base salary for MCSEs is down 7% over last year, dropping from $67,000 to $63,400.[6] [July 2001]

Replacing the Federal Employees Pay Comparability Act of 1990 (FEPCA) mechanisms with "new and improved" versions that simply use the same approach, with more variables, so that every employee's salary follows the gyrations of the labor market would not appear to be a meaningful development. It is not feasible to precisely value every individual employee. Nonetheless, it could be useful to be able to apply a better approach that acknowledges Federal employees and potential employees – with their individual talents – are not lining the shelves of the Nation's labor markets like so many cans of cling peaches, but

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[4] Maggie Gagliardi, "When Paying for Performance Simply Isn't Enough," *Workspan*, vol.44, No. 9, WorldatWork, Scottsdale, AZ, September 2001, p. 38.

[5] Jennifer Mateyaschuk, op. cit.

[6] Sandra Swanson, "Survey Says MCSE Base Salaries Dropping," *Information Week*, July 24, 2001.

are part of a dynamic labor marketplace that challenges all employers to make the intelligent pay decisions necessary to use resources efficiently and get the mission accomplished.

The Problem With Special Salary Rates

Reference: *The System Is Market Insensitive* (page 14)

The special salary rate authority is the Federal compensation system's primary solution to pay-related recruitment and retention problems. It is the tool Congress has provided to address external equity anomalies. Through special salary rates, OPM can take steps to ensure that Federal rates are competitive enough in the labor market to ensure adequate staffing. OPM can target special salary rates to a particular group of employees defined by occupation, location, grade, and other appropriate factors. Performance is not a factor in establishing special salary rates, since the underlying General Schedule pay system is not designed to address the performance of individual employees through scheduled pay adjustments.

The current special salary rate authority, however, is limited in its usefulness – primarily because special salary rates still operate within the General Schedule system. Special salary rate employees are still subject to General Schedule pay-setting and pay progression rules. They are classified in a GS grade, and their pay is set at a fixed GS step. Movement through the rate range is still largely driven by time in grade, with performance (individual equity) having little influence. When a special salary rate schedule is approved, all covered employees at a given grade receive the same pay increase regardless of their performance. In contrast, private sector employers typically have an open pay range instead of fixed longevity-based steps. Thus, an increase in the pay range (i.e., increases in the range's minimum rate and maximum rate) to respond to labor market demands does not necessarily translate into pay increases for all current employees in that pay range. Private sector employers can adjust individual pay rates by taking into account individual performance, skills, or contributions. Mediocre performers may receive no increase at all, as their value in the labor market may not warrant a pay increase.

In recent years, OPM has acted to make special salary rates in the General Schedule system more focused and responsive. OPM has sought to accelerate the approval process and has provided agencies with greater levels of assistance. Nevertheless, special salary rates remain challenging to administer and difficult to terminate, as documented in a previous OPM study of special salary rates.[1]

[1] *The Use of Special Salary Rates in Federal Agencies*, U.S. Office of Personnel Management, March 1996.

Although legislation has been proposed as part of the President's Managerial Flexibility Act to correct many shortcomings of the current special salary rates program, this proposal cannot address problems that are rooted in the General Schedule pay system itself. It could be useful for the Federal Government to have a more competitive and flexible pay structure that can address external and individual equity more effectively.

If the Federal employee pay system were to be redesigned to place more emphasis on both external and individual equity, there might be less need for "special" solutions. Market-based adjustments could be part of the normal pay-setting process. Individual performance, skills, and contributions could play a stronger role in adjusting an employee's pay. There might, therefore, be less need for special rates. If, however, a subset of jobs still experienced severe recruitment or retention problems, those jobs could be placed in a separate category or covered by a special salary range or pay supplement.

Whither Comparability?

Reference: *The System Is Market Insensitive* (page 16)

Although this report documents numerous problems with the General Schedule structure and the existing pay comparability system, the idea of comparability should not be abandoned. The Federal Government cannot recruit, manage, and retain the talent needed to perform its missions and functions unless it can provide an attractive employment package, which includes a competitive salary.

Our system's current approach to comparability promises much. The statute governing pay comparability states that "any existing pay disparities between Federal and non-Federal employees should be completely eliminated."[1] This statement has no qualifiers; it does not say that we will eliminate some disparities, for some employees, on some occasions. Thus, "comparability" appears to be a promise from the Federal Government to the *individual* employee. The difficulty is that the Federal Government defines and implements comparability in a *collective* manner. An individual employee's market value – and thus any gap between his or her current pay and that value – is the product of many variables, including level of work, locality, occupation, credentials, skills, and accomplishments. But the locality pay system accounts for only two variables – level of work and locality. Consequently it does not – and cannot – precisely determine what individual occupations, specialties, or employees should be paid.

The result is that the Federal Government does not deliver on the promise of comparability under the current white-collar pay system, because it cannot reliably make market comparisons that are meaningful for the purpose of setting and adjusting the pay of actual jobs. Agencies – convinced they cannot offer employees "fair market rates" for their occupations – have sought authority to leave the General Schedule.[2] Therefore, new approaches to comparability probably should be explored.

The merit system principle about pay says only to take into consideration other national and local rates of pay. The precise form of that consideration is left undefined. The statutory language of the Federal Employees Pay Comparability

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1 5 U.S.C. §5301(4).

2 This occurred most recently when Public Law 107-123 was enacted allowing the Securities and Exchange Commission to develop its own pay system consistent with related Federal agencies subject to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

Act (FEPCA) offers only one operationalization of such consideration or comparison – namely, the calculated disparity between General Schedule and non-Federal white-collar pay rates. Others are certainly possible and worth examining. The lessons of FEPCA include much that has been learned about the resources that extensive salary surveys require to calculate gaps that leave many users and observers still dissatisfied with the results.

Possible alternative approaches to addressing the issue of comparability and establishing competitive pay approaches might include:

- At the governmentwide level, a commitment to providing a competitive pay structure – one that enables agencies to set employee pay at competitive levels without resorting to extraordinary measures; and

- At the agency level, a commitment to monitoring market rates and employee compensation levels – and making appropriate pay adjustments – so that employees can be fairly and competitively compensated.

How the System Does – and Doesn't – Reward Performance

Reference: *The System Is Performance Insensitive* (page 23)

To recruit and retain the talent it needs, the Federal Government points with pride to its merit system principles and their promise that excellence will be rewarded. The reality for employees, however, is somewhat different, and it does not take a new employee long to discover that time and uniform treatment dominate the pay system. For some employees, the prospect of reliable – if not immediate – rewards for steady – if not stellar – performance is a completely acceptable employment relationship. Unfortunately, these systemic properties put the Government at a disadvantage when trying to attract and retain top-flight employees who may expect more timely recognition of their achievements and who keep a careful eye on whether and how the agency also rewards their colleagues who may contribute less to meeting the agency's goals and objectives.

The pay system's limitations and counterintuitive dynamics can have perverse effects on employees. System properties that may have been sensible for a homogeneous workforce of clerks with little latitude to make different performance contributions now have serious unintended consequences for present and prospective employees. Characteristics that may have been established in the interests of precluding administrative error (e.g., fixed-step pay rates) leave employee and employer unable to move beyond rigidities that prevent pay distributions that properly reflect differences in performance. The following examples illustrate how these systemic features affect employees, undermine the promise to reward merit, and send conflicting messages instead.

Ø *The Distant Relationship Between Pay and Performance*

The General Schedule system does not permit an agency to send strong messages about performance through base pay. The outcome is that even mediocre employees can prosper, and a better performer will not necessarily get better pay. In fact, as shown below, the system, even when applied properly, can pay an indifferent employee more than a good one. The *only* way that an agency could avoid this outcome would be to abandon rewarding outstanding performance through base pay – which would also be unsatisfactory and inconsistent with the general pay-related merit principle.

Assumptions

- Both employees were rated under a 5-level system, with 5 being the highest possible rating.
- The agency made full use of performance-based salary tools; it granted a quality step increase (QSI) when possible and denied a within-grade increase (WGI) when possible.
- At the start of the 5-year period, both employees occupied grade 12 General Schedule positions and were paid at GS-12, step 4. The employees remained in these positions throughout the 5-year period.
- Both employees were located in Washington, DC.
- Pay changes took effect at the end of the year. Thus, Employee A's QSI affected the Year 2 salary, but not the Year 1 salary.

	Employee A	**Employee B**
Begin	**Salary: $48,906**	**Salary: $48,906**
Year 1	• Rating: 5 • Employee receives QSI	• Rating: 4
Year 2	• Rating: 3	• Rating: 4 • Employee receives WGI
Year 3	• Rating: 3 • Employee receives WGI	• Rating: 4
Year 4	• Rating: 2	• Rating: 4 • Employee receives WGI
Year 5	• Rating: 2 • WGI denied	• Rating: 4
End	**Average rating: 3.0** **Salary: $62,013** **Cumulative salary: $270,982**	**Average rating: 4.0** **Salary: $62,013** **Cumulative salary: $267,824**

The employee whose performance actually deteriorated during this period "earned" more pay than the employee who maintained a record of good performance. We expect good performers to sustain their efforts even when less effective colleagues keep pace and can occasionally move relatively higher in the pay range through time-driven WGIs. The system almost seems predicated on employee inertia that will keep the better employees in place even during those periods when their base pay may lag somewhat.

Ù *How Time Trumps Performance*

The following observation about needed changes in Federal civil service systems suggests that our pay system should adopt an increased performance orientation:

> [Civil service] reforms should include placing greater emphasis on skills, knowledge, and performance in connection with federal employment and compensation decisions, rather than the passage of time and the rate of inflation, as is often the case today.[1]

It is not apparent why time and inflation should overshadow skills, knowledge and performance: the merit system principles governing Federal human resources management do not state that the Federal Government should or must compensate employees for years on the job or changes in either the cost of living or the cost of labor. But this is, in fact, the current reality. As shown on the next page, base pay increases are driven primarily by changes in the pay structure and the employee's time on the job. Performance plays almost no role in pay increases for the average performer and only a limited role in pay increases for the exceptionally good performer.

Assumptions

- Both employees were rated under a 5-level system, with 5 being the highest possible rating.
- The agency made full use of performance-based salary tools, and granted a quality step increase (QSI) when possible. If it was possible to grant both a WGI and a QSI, the agency did so.
- At the start of the 5-year period, both employees occupied grade 11 General Schedule positions and were paid at GS-11, step 2.
- Both employees were located in Washington, DC.

[1] David Walker, Comptroller General of the United States, testimony before the Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Committee on Governmental Affairs, U.S. Senate, July 17, 2001.

	Employee A	Employee B
Begin	**Salary: $38,330**	**Salary: $38,330**
Year 1	• Rating: 3 • Employee receives WGI and general increase.	• Rating: 5 • Employee receives WGI, QSI, and general increase.
Year 2	• Rating: 3 • Employee receives WGI and general increase.	• Rating: 4 • Employee receives general increase.
Year 3	• Rating: 3 • Employee receives general increase.	• Rating: 5 • Employee receives WGI, QSI, and general increase.
Year 4	• Rating: 3 • Employee receives WGI and general increase.	• Rating: 4 • Employee receives general increase.
Year 5	• Rating: 3 • Employee receives general increase.	• Rating: 4 • Employee receives WGI and general increase.
End	**Average rating: 3.0** **Increase in salary: +$11,935** **% of increase resulting from:** • **General increases: 66%** • **Longevity (WGI): 34%** • **Performance (QSI): 0%**	**Average rating: 4.4** **Increase in salary: +$14,891** **% of increase resulting from:** • **General increases: 55%** • **Longevity (WGI): 27%** • **Performance (QSI): 18%**

How did this phenomenon come about? The situation has its roots in efforts to make Federal pay more rational and objective, which produced two hallmarks of the Federal white-collar pay system: the periodic within-grade increase (WGI) and across-the-board pay increases.

The WGI was designed to reward employees for increasing their value to the organization. The WGI is based on the theory of the "learning curve" – the idea that an employee will become more productive (and thus more valuable) as he or she learns the organization's subject matter and work processes. But WGIs are not based on a rigorous measurement of employee productivity. Instead, the WGI uses a "waiting period" as a proxy for increased value. Unfortunately, the assumptions underlying this practice – that value always increases with experience and that the increase does not vary across employees – are questionable. So it is no longer clear that WGIs reflect or reward increased performance, but it remains very clear that they reflect the passage of time.

Across-the-board pay increases are intended to establish and maintain fair and competitive pay levels. The Federal Employees Pay Comparability Act of 1990

(FEPCA) established two types of increase:[2] the general increase and locality adjustments. These increases are delivered automatically and uniformly[3] to General Schedule employees. In effect, the Federal Government uses changes in the Employment Cost Index and changes in salaries in large, geographic areas as a proxy for changes in an individual employee's "market value." As with WGIs, the assumption underlying this practice – that an employee's "market value" is independent of occupation, skills, and level of performance – is questionable. So it is not clear that an employee's structural pay increases reflect changes in his or her actual "market value" – but it is clear that they reflect the historical rate of labor market inflation.

The result, from both a financial and employee perspective, is that time carries more weight in pay decisions than does performance. The history of the Federal pay system makes this understandable, but it does not make it appropriate or acceptable for today's performance-oriented government.

Ú *The Relative Rewards of Better Performance vs. Better Position*

For the employee who defines "advancement" solely in terms of increased financial rewards, the path to that advancement is clear: the pay system will not reward improving performance to meet outstanding standards, irrespective of its relevance to the agency's strategic objectives, as much as it will reward merely acceptable performance at the next higher level of work. Even allowing for the fact that the higher level work requires greater skill or has more responsibility that merits greater pay, the agency must still grapple with the challenge of keeping and motivating top performers at the other work level on the front line, where more direct impact on desirable results may be achieved. The illustration that follows shows why this is so. Even using unrealistic "best case" assumptions to make performance as rewarding as possible,[4] performance remains much less lucrative than promotion. Moreover, when OPM analyzed how performance and schedule adjustments contribute to pay increases, performance finished – at best – in a

[2] Technically, these changes are adjustments rather than increases. In theory, they can be negative; in practice, they are not.

[3] There are some exceptions. For example, employees on pay retention and employees covered by a special salary rate may receive a lesser increase.

[4] It is uncommon for a Federal employee – even an outstanding one – to receive both a within-grade increase and a quality step increase in the same year. It is highly unlikely that this would happen twice, or that an employee would receive QSIs 5 years in a row. (It is much more probable that the outstanding employee would simply receive within-grade increases – in which case the employee's salary would increase no faster than that of his or her merely satisfactory peers.)

dead heat with schedule adjustments. Why does this happen? First, because the pay structure and pay-setting rules make position (raises through promotion) more valuable than performance (raises due to high performance). Second, because structural increases are independent of performance and are delivered across-the-board. Finally, because the current system limits performance-based pay increases to an annual level that will rarely exceed the annual structural increase.

Thus, the pay system strongly encourages employees to seek promotion. This is not illogical: in theory, incentives for promotion support efficient use of human capital by channeling the best employees into higher graded positions which will, presumably, put their abilities to better use than less demanding, lower graded positions. And this system has often served the Government and its employees very well. The Federal Government has many employees who have "worked their way up" to high-level positions, where they serve with distinction.

But our system's overwhelming incentive to seek promotion appears increasingly problematic. First, restructuring agencies and shifting resources to front-line work will, over time, reduce the number of available managerial and quasi-managerial[5] positions – traditionally the highest-graded positions in the General Schedule. Retaining a strongly promotion-oriented pay system in this context will, at best, generate frustration when employees who aspire to promotion face a lack of opportunities. At worst, it will discourage the reengineering and delayering needed to achieve the leaner, flatter structures that increasingly characterize modern, more strategically shaped organizations. Second, it is difficult to argue that a system that so strongly encourages an employee to devote substantial attention to "the next job" – at the possible expense of the job at hand – is truly performance- or results-oriented.

[5] "Quasi-managerial" positions include positions in policy, internal coordination and control, and administrative functions such as budget and human resources.

Assumptions

- Both employees were rated under a 5-level system, with 5 being the highest possible rating.
- The agency made full use of performance-based salary tools, and granted a quality step increase (QSI) when possible. If it was possible to grant both a WGI and a QSI, it did so.
- At the start of the 5-year period, both employees occupied grade 12 General Schedule positions and were paid at GS-12, step 1.
- Both employees were located in Washington, DC.

	Employee A	**Employee B**
Begin	**Salary: $44,458**	**Salary: $44,458**
Year 1	• Rating: 4 • Employee competes and is promoted to grade GS-13, step 1	• Rating: 5 • Employee receives WGI • Employee receives QSI
Year 2	• Rating: 3 • Employee receives WGI	• Rating: 5 • Employee receives WGI • Employee receives QSI
Year 3	• Rating: 3 • Employee receives WGI	• Rating: 5 • Employee receives QSI
Year 4	• Rating: 3 • Employee receives WGI	• Rating: 5 • Employee receives QSI
Year 5	• Rating: 3 • (Employee not eligible for WGI till next year)	• Rating: 5 • Employee receives QSI
End	**Average rating: 3.2** **Salary: $69,534** **Cumulative salary: $285,796**	**Average rating: 5.0** **Salary: $65,556** **Cumulative salary: $265,177**

These three examples illustrate some of the undesirable effects produced by the apparatus that keeps the General Schedule running. Its predictability and control as positives are starting to be heavily outweighed by the strong negative of denying employee performance its relevant place in determining pay. The message is clear – when all is said and done, your performance as a Federal employee has little impact on your base pay.

The Challenge of Performance Measurement

Reference: *The System Is Performance Insensitive* (page 24)

The success of a performance-oriented compensation system depends heavily on the quality of the underlying performance management system. A universal challenge in performance management is establishing and communicating credible and reliable measures of performance, whether at the organizational, work unit, or individual level. Informed observers of Government agree that the rigor and quality of Federal agency performance management – and performance measurement in particular – is uneven at best.

Nevertheless, OPM believes it may be time to establish a governmentwide framework for making pay distinctions based on performance – whether or not agencies are fully prepared to use this framework. Such a framework could be critical to making Government more performance- and results-oriented, as envisioned in the Government Performance and Results Act (GPRA), for two reasons.

First, the Government needs to convey to its employees an unequivocal message that performance matters. For this message to be credited as more than rhetoric, however, the compensation system would need to reinforce it. To that end, basing all pay increases on performance may need to become the rule rather than the exception. But this approach could well fail unless the Government makes rigorous performance standards and measures a precondition for any performance-driven system.

Second, linking pay to performance will focus agency and employee attention on performance management. This could create a strong and much-needed incentive for agencies to improve how they measure and manage performance, as some have noted:

> The new President and Congress should reconsider the issue of pay for performance within the federal government. For a performance appraisal system to have real meaning, there must be real consequences. Tying pay to performance by a management that is committed to performance makes the system real.[1]

[1] Angela M. Antonelli and Peter B. Sperry, editors, *A Budget for America*, Heritage Foundation, Washington, DC, 2000, p. 341.

This is also the perspective of the private sector, which links pay to performance as a matter of principle.[2] At an absolute minimum, nearly all private sector firms have a merit pay program for their professional[3] and managerial employees that links base pay increases to performance ratings.[4] Our approach – across-the-board general increases and time-based increases – is almost unheard of.[5] This is not to say that merit pay is always appropriate or effective. Ineffective merit pay systems can produce the same muted pay distinctions and lack of credibility that afflict our current system. But they do, at least, send the message that pay depends on performance, although the reality may fall short of the ideal.

High-performing organizations emphasize the need to differentiate levels of performance and to take actions based on those differences. The Federal Government's practices in this area, while perhaps understandable in some respects, are impossible to defend. Many agencies have basically drained all meaning from the label "Outstanding" by applying it to such large proportions of their workforce that no connotation of "standing out" remains. Performance rated as better than fully successful starts as low as the 20th percentile in many agencies. The dynamics that contribute to rating inflation are well known, particularly the perceived, although not substantiated, impact on retention standing in a reduction-in-force and the desire not to disadvantage employees when "everyone else is doing it" (i.e., inflating ratings).

Perhaps a more daunting and insidious cultural dynamic that mitigates against effective differentiation comes from the rigidities of our pay system with its predefined and undifferentiated payouts from general increases, within-grade increases, and career ladder promotions. Managers who might be inclined initially to differentiate levels of performance among their employees get little or no payoff. As noted elsewhere in this paper, they are extremely limited in their ability

2 Some organizations have adopted a total quality management approach and do not link pay to individual performance. These are few, and are concentrated in manufacturing and other process-centered industries.

3 In this context, "professional" refers to salaried employees whose work involves the application of specialized knowledge. "Professional" includes, but is not limited to, employees in occupations with a positive educational requirement. The Federal counterpart is employees in two-grade interval positions.

4 Research indicates that merit pay can be problematic. Criticisms include cost, a lack of credibility in supporting performance measures and evaluations, and limited pay differentiation between high and average performers, particularly in times of low inflation. Yet merit pay remains prevalent: private sector organizations link pay to performance as a matter of principle to communicate and reinforce performance as a core value, even if the mechanism is flawed. And few organizations that discontinue merit pay programs abandon the idea of linking pay to performance. Instead, they take steps to strengthen the linkage. The trend is to make *more* pay contingent on organizational and individual performance, not less.

5 *Private Sector Compensation Practices,* Booz•Allen & Hamilton – Report to the U.S. Office of Personnel Management, Washington, DC, February 2000.

to deliver differentiated pay increases as rewards, and most agencies still use only modest cash awards budgets as a means of distributing differentiated cash incentives. Indeed, many agencies appear to operate under the principle that the awards amounts are so small that the prudent course is to distribute them widely and evenly and thereby avoid disputes.

OPM's hopes in this arena rest with the continued implementation of the Government Performance and Results Act of 1993 throughout Government and its integration with the strategic management of human capital. As organizational performance measurement improves, OPM is confident that agencies will continue to improve employee performance measurement as well. There can be no turning back from the shift to measuring results. Agencies increasingly are paying attention to these issues and looking to improve the ways they plan and measure employee results as well as program results. These efforts can be expected to continue, and OPM is committed to supporting them.[6] Performance-oriented pay that communicates and reinforces what is important and provides the "appropriate incentives and recognition . . . for excellence in performance"[7] that the merit system contemplates can work effectively only when trusted, credible measures of that performance are available.

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[6] See *A Handbook for Measuring Employee Performance: Aligning Employee Performance Plans with Organizational Goals*, U.S. Office of Personnel Management, Washington, DC, September 2001.

[7] 5 U.S.C. §2301(b)(3).

Classification – The Unintended Tool of Choice

Reference: *An Excess of Internal Equity* (page 28)

The need for a more strategic approach to compensation – and a broader range of pay and job evaluation tools – is widespread:

> A set of tools should be created that is appropriate for the environment and allows managers to do the right thing in each unique situation. Historically, managers have been given only one tool to deal with a variety of situations across the bulk of populations – merit pay. This is akin to the master carpenter giving an apprentice a hammer and then trying to teach him to build something: Everything the apprentice looks at appears to be a nail.[1]

Although the compensation consultant quoted above was discussing the private sector, his remarks are equally applicable to the Federal Government, with one important difference: substitute "classification" for "merit pay." The example below illustrates why classification is the "hammer" of the Federal pay system.

Suppose an agency has two employees in a work unit who occupy the same position. As is typical in the Federal Government, both were hired at the first step of the grade level. One employee is a recent hire but an excellent performer; the other employee has been on the rolls for many years, but is an average, although still acceptable, performer. Consequently, the senior employee is paid considerably more than the junior employee. Using the terms of the merit system principle, their work is not of equal value to the organization. What can the agency do about the disconnect between these employees' salary levels and their levels of performance and contribution? Very little, with existing pay-for-performance provisions.[2]

Promoting the first employee through reclassification appears much more promising. First, there is a manifest difference in the two employees' work. Second, promoting the better performer will help bring the employees' compensation in line with their relative contributions by placing the better performer in a higher graded – and thus better paying and higher status – position. But a problem lurks: as every classifier knows, matters such as

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[1] Todd M. Manas, CCP, "The Compensation Carpenter," *Workspan*, vol. 44, No. 9, WorldatWork, Scottsdale, AZ, September 2001, p. 8.

[2] A quality step increase will not erase the disparity, although it could reduce it. Retention allowances may not be granted solely on the basis of performance.

workload, quality of work, and results are not classification factors under our statutory system.[3] So the problem is not simply that the only tool available is classification; the problem is that the only tool available is *mis*classification. And the incentives to misuse classification are not only financial; they are also cultural and include the following:

- **Ease of budgeting.** Although changes are developing in this regard, the fact remains that under an FTE-based system, the budget process tends to focus on the number of employees. If an FTE is approved, the associated salary may be fully funded, or at least is not subjected to intense scrutiny. Awards and retention allowances, on the other hand, have often been viewed as incremental and nonessential expenses.

- **Ease of justification.** Rewarding excellence through a cash award or a quality step increase is discretionary. Thus, the agency must decide to reward the employee, document the performance, and justify the expenditure. In contrast, to promote an employee through classification, the agency must simply document the existence of a sufficient amount of higher level work. If that work exists, payment is automatically justified by the principle of "equal pay for equal work" and the associated requirement to classify positions accurately and pay employees accordingly.

- **Acceptability.** Our compensation system places a high value on fairness and internal equity. This has created an organizational culture where pay distinctions based on "objective" factors such as classification are less controversial than pay distinctions based on "subjective" factors such as managers' assessments of employee performance. Consequently, misclassification – although inappropriate – may be much less controversial than openly making and rewarding performance distinctions.

The point is not that agencies may be abusing the current classification system. The point is that agencies should not be forced to choose between complying with law and merit principles and managing their workforce effectively.

[3] The classification factor of "scope and effect" is conceptually related to results. However, it has relatively little weight, and is evaluated in the abstract.

Glossary

ACROSS-THE-BOARD INCREASE An equal flat rate (dollars and cents) or percentage increase in salary given to every eligible employee. Also known as a **general increase**.

AWARD Something given (e.g., cash or a certificate) or an action taken (e.g., granting time off with pay or holding a ceremony) to provide an incentive or recognition for individual or group achievements that contribute to meeting organizational goals or improving the efficiency, effectiveness, or economy of the Government. Examples of specific types of awards include: honorary award, informal recognition, time off award, performance award, special act or service award, on-the-spot award, group incentive, suggestion award, referral bonus, and travel savings incentive.

BASE PAY The basic cash compensation that an employer pays for the work performed, typically expressed as an annual salary. Also referred to as **basic pay**, which generally means an employee's regular and recurring base pay excluding irregular payments such as overtime pay. In some contexts, "basic pay" has different definitions for different purposes. When pay is used as the basis for computing another payment or benefit, it is basic pay for that purpose.

CLASS In statute, a class (of positions) contains all positions that are so similar in their type and level of work that they can be treated similarly for all human resources purposes. Essentially, a "class" includes all jobs in the same grade and the same occupation. (The word "class" is not used often by Federal HR workers.) The Office of Personnel Management produces standards and guidance agencies must use in placing positions in their correct classes.

CLASSIFICATION

A hierarchical structure of jobs, usually arranged into classes or pay grades according to some form of job evaluation. Also the term generally used to describe the Federal Government's job evaluation system.

COMPENSATION

Generally, all forms of financial returns and services employees receive as part of an employment relationship. Historically the term included benefits such as insurance and retirement income plans like annuities. More commonly today, practitioners refer to benefits design and administration separately and use "compensation" to denote only the various forms of **pay**, including equity pay, the employer may offer as part of a broader strategic or total rewards design.

Under the Federal compensation statutes, the results of position classification are so rigidly tied to employee pay that the term "compensation" is sometimes construed to cover both pay and job evaluation.

EMPLOYMENT COST INDEX (ECI)

A number of statistical measures published quarterly by the Bureau of Labor Statistics to measure changes in specified non-Federal compensation. ECIs for different quarters are used to adjust the General Schedule and the Executive Schedule.

EQUITY

A general term denoting fairness and the means and criteria established to ensure fairness. Equity is properly distinguished from equality, which more often connotes uniformity.

> NOTE: In compensation practice, the term **equity pay** applies to forms of compensation that publicly traded private sector corporations offer as financial rewards – usually stock options (i.e., equity in the company) provided to executives and managers and increasingly to other employees as well – to promote risk sharing and engage employee commitment.

EXTERNAL EQUITY

A fairness criterion that directs an employer to set pay levels based on comparisons with rates prevailing in external markets for an occupation.

INDIVIDUAL EQUITY

A fairness criterion that provides a guideline for employers to set salary rates for individual employees (people on the same job, in the simplest case) according to individual variation in merit. Also sometimes referred to as **contribution equity.**

INTERNAL EQUITY

A fairness criterion that directs an employer to set pay rates that correspond to each job's relative value to the organization.

FEDERAL EMPLOYEES PAY COMPARABILITY ACT OF 1990 (FEPCA)

The pay reform legislation that made several changes in the way pay is set for the white-collar Federal workforce covering a broad range of compensation issues, including locality pay, pay for administrative law judges and Boards of Contract Appeals, a new aggregate limitation on pay, higher pay for critical positions, interim geographic adjustments for New York, Los Angeles, and San Francisco, law enforcement officer special pay entitlements, recruitment and relocation bonuses and retention allowances, senior level pay, expanded special rate authority, supervisory differentials, time off as an incentive award, payment for academic degree training, travel and transportation expenses for interviewees and new appointments, and higher uniform allowances.

GENERAL SCHEDULE (GS)

The classification and pay system for most white-collar employees in the Federal Government. The pay structure for the General Schedule has 15 grade levels, with 10 salary steps at each grade. Positions are classified using governmentwide standards to determine their proper occupational series, title, and grade within the General Schedule.

GRADE

Each of the 15 grades in the General Schedule represents a unique band of difficulty and responsibility and is defined in statute at 5 U.S.C. §5104.. Grades are the same across different occupations, so that a GS-7 secretary, a GS-7 engineer, and a GS-7 photographer are in positions of equivalent difficulty and responsibility. Each of the 15 grades is defined in statute (the definitions were written in 1949). In the General Schedule system, grade also is used to mean level of work.

GRADE INTERVAL

"TWO-GRADE INTERVAL"

"ONE-GRADE INTERVAL"

The terms "two-grade interval" and "one-grade interval" refer to the differing patterns of career advancement through a sequence of General Schedule grades. The two basic patterns reflect a basic distinction between the two general kinds of white-collar work covered by the General Schedule. Two-grade interval work generally comprises jobs in the professional and administrative occupational categories, and promotions are granted in two-grade increments from grades GS-5 through 11 and in one-grade increments at GS 12 and beyond. One-grade interval work generally comprises jobs in the clerical and technical occupational categories, and promotions are granted in one-grade increments.

These two labels perform roughly the same function that "exempt" and "non-exempt" tend to have in the private sector as a short-hand way to distinguish higher level "professional" work and lower-level clerical and technical work. The Fair Labor Standards Act (FLSA) did not apply to the Federal Government when the General Schedule was established. Therefore, the FLSA categories do not serve, in the Federal compensation environment, as a basic distinction upon which the pay structure is built.

JOB EVALUATION

A formal process by which management determines the relative value to be placed on various jobs within the organization. The end result of job evaluation consists of an assignment of jobs to a hierarchy of grades or some other hierarchical index of job value. Job evaluation is most closely associated with the criterion of internal equity.

Job evaluation methods can focus on the position being evaluated, irrespective of any information about its market value, or determine the market price of that work among other employers, or use some combination. The Federal Government's job evaluation system relies on the first method in its **position classification** system.

LOCALITY PAY

Supplemental locality-based payments in addition to the rate of basic pay that apply in the 48 contiguous States in areas where non-Federal pay exceeds Federal pay by more than 5 percent. Most Federal employees – including GS, SES, and Senior-Level employees, but excluding blue-collar employees and officials paid under the Executive Schedule – are eligible for locality pay.

A **locality pay area** is a geographic area that serves as the basis for setting pay and is established by the President's Pay Agent for General Schedule employees in the 48 contiguous States and Washington, DC. The Pay Agent has established 32 GS locality pay areas, including the Rest of U.S. locality pay area.

PAYBANDING

A salary structure divided into fewer, broader pay ranges than traditional grades. Broad grades reduce the number of traditional grades, widen them, and generally retain traditional salary administration. Career bands are fewer and broader than broad grades and involve alternative salary administration. Also commonly called **broadbanding**.

PAY PROGRESSION

The positive movement of salary within a pay range. For example, pay progression is approximately 1% if salary increases by 4% while the pay range increases by 3%. An organization's policies for managing position-in-range are implemented through the pay system's pay progression method (e.g., the conditions an employee must meet to advance in the range or to be paid the top rates in a pay range).

PERFORMANCE

1. The act of going through or executing in the proper, customary, or established manner.
2. The manner in which or the efficiency with which something reacts or fulfills its intended purpose.

NOTE: These two complementary, but distinct, definitions of performance reflect the fundamental evolution in conception that occurred throughout the public sector in the late years of the 20th century as expectations and accountability shifted from processes (definition 1) to results (definition 2). Further, the connotation of "results" has increasingly expanded to entail constant **improvement**. Given continually evolving technologies and expected improvements in human capital and financial management, performance goals typically describe increases in terms of results (e.g., customer satisfaction index targeted to improve from 85 to 90, unit cost decreased by 8 percent) rather than in terms of process.

PERFORMANCE MANAGEMENT

In the context of **employee performance**, an integrated set of managerial processes that consists of:

- **planning** performance – both by translating organizational goals and objectives to specific results employees and units are expected to achieve and by establishing the measures that will be used to assess such achievement and maintain accountability,
- **monitoring** performance – through ongoing observation and feedback, including taking steps to address and resolve poor performance,
- **developing** the capacity to perform – both by increasing needed employee competencies through learning management and by improving business processes,
- **appraising** performance – including formally measuring and reporting individual, group, and organizational achievements and periodically summarizing performance in an employee's formal rating of record, and
- **rewarding** performance – both informally using ongoing recognition and formally using financial rewards such as variable pay based on organizational, group, or individual achievements and adjustments to individual rates of pay.

(continued)

PERFORMANCE MANAGEMENT (continued)

In the context of **program performance**, an integrated set of managerial processes to establish and assess organizational goals and accountability for results, such as those carried out in the Federal Government under the requirements of the Government Performance and Results Act of 1993.

POSITION-IN-RANGE

The position of a pay rate relative to all pay rates in a range. Position-in-range is normally expressed as a percentile, but may be expressed relative to control points or range zones.

QUALITY STEP INCREASE (QSI)

The increase of a General Schedule employee's pay from one step rate to the next higher rate for that same grade in advance of completion of the applicable waiting period.

RANGE

A range of pay rates, from minimum to maximum.

SALARY STRUCTURE

A hierarchical structure of pay ranges. The salary structure may be expressed in terms of job grades, job-evaluation points, or policy lines. An organization may use different salary structures for different categories of employees.

SERIES

Derived from the statutory phrase "series of classes," this term is synonymous with occupation for almost all purposes.

SPECIAL SALARY RATES

Rates of basic pay that are higher than the normal GS rates. OPM may establish special rates for a group or category of GS positions in one or more geographic areas to address existing or likely significant handicaps in recruiting or retaining well-qualified employees. Special salary rates address staffing problems caused by pay disparities, undesirable working conditions, remoteness, or any other circumstance considered appropriate.

STEPS

The 10 specific rates of pay within the pay range of a given grade at which pay can be set.

STRATEGIC REWARDS

Everything valued by employees that an organization provides for the purpose of recruiting, retaining, developing, or aligning them in support of strategic organizational goals. Strategic rewards refer to the bundle of all employee reward elements, including compensation, benefits, development and learning, and the work environment. Strategic rewards mix traditional with non-traditional rewards and make the employment relationship more meaningful and satisfying to the employee.

STRUCTURAL ADJUSTMENT

An equal flat rate (dollars and cents) or percentage increase of the pay rates that define a pay structure, including pay range minimums, maximums, steps, and control points, if applicable. In non-Federal organizations, the increase is often not reflected in employee paychecks (see across-the-board increase). Non-Federal organizations often increase employee pay at approximately the same time as a structural adjustment, but use other mechanisms to do so, such as merit increases, which for most employees might closely track the adjustment in amount. In such circumstances, pay progression occurs to the extent employee increases exceed structural adjustments.

VARIABLE PAY

Lump sum pay that is not guaranteed; variable pay is usually dependent on employee or organizational performance, or both.

WITHIN-GRADE INCREASE (WGI)

The increase of a General Schedule employee's pay from one step rate to the next higher rate for that same grade at the completion of the applicable waiting period.

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We want to make clear that the views expressed in this paper are those of OPM and not necessarily of any of the individuals or organizations who have helped us in our endeavor to understand the strengths and the challenges of the Federal white-collar pay system.

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