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EFFECTIVENESS OF MERIT-PAY-POOL MANAGEMENT

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Abstract

A merit pay pool consists of individuals who are grouped together for the purpose of making merit pay computations. This paper investigates the consequences of variations in merit-pay-pool design and management for the linkage between performance and pay.

Introduction

With the adoption of the Civil Service Reform Act of 1978 (CSRA), federal managers became subject to several new "pay-for-performance" programs. Among these programs were \$10,000 and \$20,000 Presidential awards for senior executives whose performance was judged outstanding over a period of years. Senior executives also became eligible for annual bonuses of up to 20% of their salaries based upon performance appraisals. The pay-for-performance program involving the largest group of employees is merit pay, established for managers and supervisors in grades 13-15 of the general schedule. Unlike the new programs for senior executives, merit pay did not require an allocation of new monies, but was funded by changing the ways in which existing funds were allocated. Under the new system, funds equivalent to as much as one half the annual comparability adjustment and periodic step increases are now placed into a pool that is allocated based on performance ratings.

Merit pay is based on a familiar perspective on motivation: if individuals expect to receive a reward for high performance, they are more likely to strive for this level of performance than if there is no "payoff." This perspective has two components — the "value" of the reward itself and the expectation that the reward is contingent on some action. For merit pay to succeed, the pay increase must be considered to be both a valued reward *and* received for high performance rather than for other actions such as "avoiding risks," "empire building," or "always agreeing with the boss."

The CSRA requirement that the funds budgeted for merit pay not exceed the cost of the previous system places significant constraints on both the size of the rewards and the margin for error in performance appraisals. One constraint diminishes the probable value of a reward to an employee by setting an upper limit on the potential salary gain associated with outstanding performance. Since a fixed, rather than a variable, merit pay budget heightens the significance of allocational errors (for example, unnecessarily large payments to poorer performers) because one employee's gain is another employee's loss, it becomes more difficult to create expectations that rewards will be contingent on performance.

In a nutshell, if all managers and supervisors receive relatively uniform performance appraisals, the reward differentials among managers will be trivial and merit pay will have negligible motivational effects. Similarly, if performance appraisals are normally distributed across the ratings range, but are perceived as arbitrary or completely subjective, merit pay will be of little motivational consequence. The linkage between merit pay and performance appraisals — specifically, their accuracy and fairness — is then critical to the effectiveness of merit pay.

As one means for dealing with the critical dilemma that is inherent in the new system, a new control structure (called a merit pay pool) and a new, informal organizational role (termed merit-pay-pool manager) have been created. A merit pay pool consists of individuals who are grouped together for the purpose of determining each one's share of the merit pay funds.

The lack of prior experience and central guidance has led to uncertainty within agencies about appropriate pool design and management. Strategies of design and management vary not only from agency to agency, but within agencies as well. While it is still too early to assess the actual effects of variations in pool design and management, it is possible to speculate about some of their probable effects on merit pay effectiveness. The central question is: What pool designs and management approaches are likely to create the strongest linkages between appraised performance and pay?

This analysis is based upon our research in a diverse group of federal organizations: The Transportation and Public Utilities Service (TPUS) of the General Services Administration (Washington, DC), the Naval Ship Weapon Systems Engineering Station (NSWSES) in Port Hueneme, CA, NASA-Ames Research Center (Moffett Field, CA), 21 Social Security Administration (SSA) offices in the Southern California area, and both the National and California State offices of the Department of Agriculture Farmers Home Administration (FmHA) and Soil Conservation Service (SCS). Each has been visited at least six times during 1980-81 and extensive survey and archival information has been

collected at each site. The methodologies used in the research are described in detail in Perry and Porter (1981). Most of the information used here is drawn from documents and from semi-structured interviews with randomly selected employees and merit-pay-pool managers in each organization.

Characteristics and Design of the Pools

A merit pay pool is defined as the “amount of money from the agency merit pay fund targeted for merit pay purposes to be distributed to a defined group of employees within the organization” and is composed of “the non-automatic portion of comparability and the within-grade quality step increase money that would have been used to adjust pay under the General Schedule for employees in that pool” (U. S. Office of Personnel Management, 1981: 79). Thus, the term can refer to either the employees who make up the pool or the money that will be distributed among them. Each of the merit pay pools has a designated manager.

The manager may be assigned an array of responsibilities. Among the routine responsibilities of the pool manager are collecting completed appraisals from raters and distributing information about departmental policies. She or he may be called upon to review the quality and consistency of performance appraisals at the beginning of an appraisal period. At the end of the period, the manager can also be responsible for review and correction of inequities in payouts, and review of the fit between actual ratings and the theoretical ratings distribution that will create differentials between better and poorer performers.¹ The role of the pool manager is examined more closely in the next section.

Although the formula for the computation of merit pay funds for each agency is uniform government-wide, the structure and management of the pools vary at the discretion of the agencies. In some agencies, membership in respective pools has been determined at the headquarters level. Other agencies (e.g., Navy and NASA) have permitted field units latitude to identify which employees will be grouped together. The final design in each case is usually specified in department or field unit regulations.

Experience at our research sites indicates that variations in the design and management of merit pay pools will systematically influence the validity and acceptance of performance appraisals and thereby the ultimate success of merit pay. Table 1 summarizes some of these variations at the research sites. The primary design variables include: the size of the merit pay pool (the number of employees in the pool), geographic coverage, occupational composition, and inclusion of the pool manager in the pool. Important management variables, which we discuss in the next section, are: the extent to which the pool management takes an active role in determining the ratings of pool members and the resulting appraisal distribution, and whether the pool is managed by an individual or board.

TABLE 1
Merit-Pay Pool Design and Management Variables by Research Site

Variables	NASA-Ames Research Center	Farmers Home Administration Headquarters	California	Naval Ship Weapon Systems Engineering State(NSWSES)	Soil Conservation Service Headquarters	California	Southern California SSA Offices	Transportation and Public Utilities Serv.
Design Size of Pools	11-14	40-94	40-54	21-103	16-47	13	34 & 90	70
Geographic coverage of pool(s)in this sample	within site	within site	nation-wide	within site	within site	state	San Francisco region	Site
Occupational or departmental composition of pool(s)	by department	by department	by occupation	by department	by department	by department	both types	by department
Inclusion of the pool manager in the pool	no	in some pools	no	yes	no	no	no	no
Management Extent to which ratings are actively managed	active	passive	passive	both	passive	passive	active	active
Individual manager (M) or review board (B)	M	M	M	B	M	M	M	M

Pool sizes vary enormously, from very small (one at Ames Research Center has 11 members) to very large. Size is likely to influence the distortion of appraisals by supervisors seeking to assure a “fair shake” for their subordinates. In a large pool, the manipulation of ratings is less likely to be discovered and dealt with effectively for at least two reasons: (1) the large volume of work associated with a review of appraisals for the pool, and (2) the pool manager’s probable lack of first-hand experience with the performance of ratees.

Pool size is not the only consideration in determining the number of pools in an organization. Among the trade-offs that must be considered when weighing many small pools against fewer large pools are administrative costs and equity. The larger the number, the greater the likelihood that ratings distributions and payout differentials across pools will become issues for management attention. However, assuring equity may be among the least difficult issues confronting managers because it can be dealt with centrally, such as by applying a general correction factor to each pool. For example, as a means of compensation for inequities created by skewed performance rating results, the Civil Aeronautics Board has devised a system in which the award points for a given performance rating vary accordingly to the average rating within each pay pool (Rappold, 1981).

The makeup of the pools is another important aspect of design. As shown in Table 1, a pool is composed of employees either from one location (such as at TPUS headquarters) or from a wide geographic area (the nationwide pool of FmHA State Directors is an example). It can be restricted to those with similar job responsibilities (such as the pools of FmHA State Chiefs) or it can include a wide variety of work responsibilities (e.g., at TPUS headquarters). The pool manager may be a member of the pool, although, as Table 1 indicates, most of the research sites have excluded the pool manager. Each of these facets may affect the acceptance of performance appraisals and merit pay outcomes among pool members. For example, field employees often expressed concerns about the equity of various pool-composition arrangements. Managers in the FmHA California State Office were concerned about being compared with their counterparts in other, smaller states. Their anxiety was heightened because goals tend to be uniform from state to state, even though they perceived their positions as involving greater difficulty.

The types of trade-offs agencies must confront when deciding about pool design are illustrated in the Soil Conservation Service (SCS). SCS originally opted for one large pool covering all 752 merit pay employees in the agency. A dry run comparing payouts under one large pool versus a series of smaller pools was conducted from April to August 1981. The results indicated that in one large pool those employees whose supervisors rated all their employees highly received higher payouts than employees whose supervisor rated all their employees lower. This penalized employees whose supervisors tended to be consistently low raters. By contrast, when employees were divided into smaller pools,

the employee with a high rating in a pool with a low average rating could get a bigger payout compared to the employee who was rated higher in the pool with a higher average rating. This outcome was deemed preferable and, therefore, the smaller pool system was adopted. There are now 60 pools, seven pools in the national office; one pool for each of four technical centers; and 49 state-level pools.

In general, our field observations and interviews with site management and merit-pay-pool managers indicate that small pools which maintain the integrity of geographic and programmatic subdivisions within an organization create the strongest incentives for achieving effective performance appraisal. While such homogeneous pools eliminate many problems, this design approach, which may result in a large number of pools, does require that agencies explicitly develop policies to provide equity across pools. The advantages of creating smaller homogeneous pools include a moderate workload for the pool manager, decentralized responsibility for accurate appraisals, and limited need for upper levels of management to modify ratings in order to achieve their desired ratings distribution.

Role of the Merit-Pay-Pool Manager

What does the agency expect of pool managers? Policy on the extent of management involvement varies from agency to agency. The role is explained in broad terms in the Office of Personnel Management Manual, *Merit Pay Systems Design: (1981)* the merit-pay-pool manager “must manage the linkage between the performance appraisal and the merit pay determination” and, therefore, “must be involved in both the performance appraisal and the merit pay process” (U. S. Office of Personnel Management, 1981:79). Managers are expected to change ratings only as necessary “based on specific information concerning the employee’s performance, or on the manager’s personal knowledge of and/or judgment about such performance.” Thus, in addition to variation in policy from agency to agency, managers themselves have some discretionary authority. Unfortunately, there is no assurance that the exercise of such managerial discretion will not be arbitrary and, more important, that employees will share a pool manager’s perception even when changes seem arguably appropriate. As reported by the U. S. General Accounting Office (1981b), some managements have changed performance appraisal ratings without sufficient or legal justification.

Thus, pool management at the research sites varies considerably along a continuum from passive to active control of the ratings distribution. In some cases, the performance ratings of merit-pay-pool members were not altered before the monetary distribution was calculated. The managers for these pools were essentially conduits for the performance appraisal paperwork (TPUS is an example). If the agency expects the managers to make some value judgments on the

ratings for those in their pools and to change some if they so decide, they become much more important to the process. At SSA, for example, raters were asked to change those ratings the pool manager felt were out-of-line.

The modification of appraisal ratings to achieve agency merit pay goals may have a number of undesirable consequences. A manager who requests changes in ratings (or personally changes them) can be viewed as manipulative by those in the pool and this may result in dissatisfaction with the appraisal used to compute pay awards. Changing a rating may not only create immediate dissatisfaction, but it may undercut the perceived validity of the entire performance appraisal system. A less problematic management strategy for dealing with inadequacies in performance ratings might involve devoting more effort to the early stages of the appraisal process. At NSWSES, for instance, an audit of performance appraisals by the management of one pool concluded that objectives were rarely related to position descriptions and that measurement standards were unclear, especially for “above target” ratings. Under these circumstances, any modification of ratings would clearly appear arbitrary and improvement of the validity and objectivity of appraisals would be a better management strategy.

Monitoring the ratings distribution is an important, but not the only, pool management issue. Another issue involves allocating the potentially large workload associated with management of the merit pay pools. Most of the research sites have opted to assign pool management responsibilities to an individual; but one, the Naval Ship Weapon Systems Engineering Station (NSWSES), has adopted review boards to perform pool management responsibilities. The review board arrangement has been useful for making the pool management workload more reasonable, by spreading it among several managers. On the other hand, this arrangement does not appear to be any more effective than individual managers for managing appraisal ratings. For example, the staff series pool at NSWSES consists of 21 employees. This pool is composed of all site employees who are not in the technical series at the site and includes personnel, finance, and computer operations. The review board during the dry-run considered the performance goals for these employees to be too varied to allow for any alterations to the ratings or comparisons of the pool members prior to the dry-run “payout.”

Conclusion

This paper has reviewed some of the options and issues in merit-pay-pool design and management. Our research suggests that some pool design and management strategies are likely to enhance the effectiveness of merit pay. Small, homogeneous pools that are designed to minimize the need for rating modifications would appear to have a number of advantages over larger or more heterogeneous pools. Overall, minimizing the modifications of ratings appears to be a useful agency goal for pool management. This can be facilitated by improving the validity and objectivity of the performance appraisal process.

While attention has been focused on payout schedules and performance appraisal systems, the area of merit-pay-pool management has been given less consideration. For example, the U. S. General Accounting Office (1981a) in its March interim evaluation report on merit pay did not address the issues of pool management raised here. In actuality, the management of merit pay pools is an important linkage between performance appraisal and payout schedules. It is a linkage that cannot be overlooked if the implementation of merit pay is to be successful.

NOTES

¹ According to OPM regulations (5 CFR 540.104d), "No merit pay determination may take into consideration any preestablished or forced distribution of levels of performance among Merit System employees." Agencies have, nevertheless, developed guidelines that identify preferred performance ratings distributions. The Department of Navy guidelines for FY 1980-1981, for example, indicate the desired percentage of employee ratings in each of six performance levels.

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