A Report by the Human Resources Management Panel of the
NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

Recommending Performance-Based Federal Pay

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A REPORT BY THE HUMAN RESOURCES MANAGEMENT PANEL

MAY 2004

Recommending Performance-Based Federal Pay

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FOREWORD

Pay and performance management systems have generated considerable debate in the federal community for many years. The Civil Service Reform Act of 1978 created opportunities for federal agencies to experiment with more modern and innovative ways to classify duties and stimulate employees to "be all they can be" and significantly improve organizational performance. After more than 25 years, those efforts have led to the development of new and comprehensive human resource systems in DOD, DHS, CIA and several other agencies. Pay and performance are key to these agencies' systems.

An Advisory Panel of the Academy's Human Resources Management Panel believes broader change is needed. It has completed the last of its three reports, *Recommending Performance-Based Federal Pay*. This report builds on the research, data and analysis contained in two earlier reports, *Broadband Pay Experience in the Private Sector* and *Broadband Pay Experience in the Public Sector*, issued last year.

The Advisory Panel suggests a government-wide broadbanding framework that has performance-based pay as its underlying key component. Within the framework and using that component, agencies can develop and implement systems that contribute flexibly and effectively to the accomplishment of their missions. Doing so will enhance agencies' ability to attract and retain the best people by meeting market supply and demand and rewarding the best performers with the most pay.

The Human Resources Management Consortium's leadership and funding made it possible for an Advisory Panel and the Academy's project team to accomplish this very timely work. I want to take this opportunity to offer my appreciation to them and to the Human Resources Management Panel for working tirelessly to produce this important report.

C. Morgan Kinghorn
President

EXECUTIVE SUMMARY

The federal government's General Schedule (GS) salary system no longer meets federal agency needs and should be replaced. Notwithstanding considerable debate on this issue, recent legislation—most notably authorizing the Department of Defense and Department of Homeland Security to reform their personnel systems—will result in a major portion of federal professional and administrative workers being paid under broadbanding systems. The Internal Revenue Service, General Accounting Office and Federal Aviation Administration all requested and received similar authorities. Each agency argued that the GS system created problems and impeded satisfactory performance. Indeed, Academy Panels previously recommended such change in Modernizing Federal Classification: An Opportunity for Excellence *(July 1991) and* Modernizing Federal Classification: Operational Broad-Banding Systems Alternatives *(August 1995).*

Broadbanding pay provides a well-established framework for salary systems, and serves as a major component of them. Federal agencies have enjoyed more than 20 years' experience with the approach, while several prominent national corporations adopted banded systems beginning more than 15 years ago. Broadbanding, which has been tested in a wide range of environments, has distinct advantages over the GS system. Defense and Homeland Security are working on specific plans, and several other agencies expect to shift to a new salary structure using broadbanding and salary increases based on pay-for-performance principles. The Academy Panel endorses the introduction of an integrated pay-for-performance system and recommends that a new government-wide system be created using broadbanding and market pay.

Open salary bands provide flexibility for agencies to manage salaries to support their human capital plans. At the same time, authorizing individual departments and agencies to develop and plan their own salary systems opens the door to problems that can be avoided. The broadbanding framework recommended in this report would provide greater assurance of pay equity across government occupations and better management control. It also would enable agencies to use pay more effectively to meet their workforce needs.

In the Academy's 1991 broadbanding report, the Panel recommended an architecture based on separate banded salary structures for ten broad occupation groups. For the most part, the groups conformed to the existing classification system. The use of separate banded occupational structures is consistent with the current salary schedules for engineers and law enforcement, as well as with many special rate schedules.

The occupation pay bands initially would be aligned with the GS grades, but be adjusted over time to reflect market pay trends for specialists in the occupations. This strategy is consistent with the influence of supply and demand on salaries and represents the best use of limited funds. It will also facilitate and support planning for other occupation-specific human resources systems, such as the performance management system. Human resources systems are more readily accepted when they are transparent and intuitively job-related.

The U.S. Office of Personnel Management (OPM) should support the new system by overseeing collection of adequate market data—which currently do not exist—and performance of labor market analyses. Salary increase budgets would be based on the market analyses, with the goal to pay federal employees salaries that are consistent with prevailing levels for their occupations. The U.S. Office of Management and Budget would work with agencies to develop salary increase accounts.

Each set of bands in the new system would be based on the career ladder for the job series within a specific occupation group. Accepted practice and research suggest that career ladders have three or four levels. Several job families have a limited number of world-class experts who are in high demand and can thus command salaries in the market well above GS levels. There should be a fourth or fifth band for these individuals based on a “dual career ladder” that would raise their salaries closer to market levels. There also is the need for a separate band for managers and supervisors; they should not be paid in the same band as their subordinates. Senior Executive Service salaries always will serve as the cap for middle managers and supervisors.

Agencies should have the authority to tailor their own performance management systems and be responsible for salary planning and management within the government-wide framework and their salary increase budgets. OPM should have an oversight role, with day-to-day responsibility for salary management being handled by agency managers. Agencies must support their managers in the development of needed skills.

The basis for managing individual salary increases should be pay-for-performance. This recommendation has been a constant theme in discussions for more than two decades and the principle in every demonstration project that tested new pay policies. The evidence from the projects confirms that pay-for-performance can be successful in federal agencies.

The switch to a pay-for-performance policy should be managed as an organizational change because it will alter each agency’s culture and contribute to improved performance. The performance management system is key. There must be clear "line-of-sight" understanding of how employee performance contributes to the achievement of agency goals. The system must recognize "star" performers, as well as employees who meet or fail to meet performance expectations. The Academy Panel believes that planning should begin by discussing system principles. Agreement will facilitate planning for system components.

Employee communications should be a central and ongoing element of the planning and implementation strategy. Both managers and employees need to understand what to expect, and they and their representatives must have input to the planning. At its core, effective performance management depends on managers and subordinates working together to define performance standards and having the shared understanding that the process was fair.

It is reasonable to require agencies to complete the rollout within five years, though they should have some flexibility to develop a strategy and schedule that fit their specific mission and culture. The agencies would continue the GS system until the rollout is complete.

The following pages provide a summary of the Panel's recommendations for a new federal salary system, along with the purpose and principles that underlie the system. The recommendations are discussed in greater detail later in the report.

Purpose, Recommendations, and Design Principles of a New Federal Salary System

Purpose

To contribute effectively to the accomplishment of agency missions and priorities by attracting and retaining the best people, and to do this by meeting market demands and rates and rewarding the best performers with the larger pay increases.

Recommendations for a New Federal Salary System

Using the merit system principles as a continuing foundation, the Panel recommends the following:

- The new federal salary system should be based on the concept of broadbanding, with salaries managed within bands and grounded in pay-for-performance principles.

- The system should be government-wide and apply to all white collar positions currently covered under Title V and the GS system.

- Each department and agency should be responsible for managing its employees' salaries within a government-wide framework.

- The system should have separate sets of bands, aligned with prevailing market pay rates, for several broad occupation groups.

- The Office of Personnel Management should be responsible for establishing the government-wide boundary framework, identifying the occupation groups, establishing the salary bands for each group, planning annual system adjustments, and monitoring agency salary practices.

- The Office of Personnel Management should be responsible for the development of a strategy to collect adequate labor market information, for its analyses and for using the data to align salary bands with prevailing market salary levels.

- There will be a continuing need for locality pay in some situations. However, locality differentials should be less prominent when salary bands are better aligned with market pay levels, making it possible to simplify the system.

- Salary bands should be aligned initially with the GS ranges to facilitate conversion and control costs. Annual adjustments then should be based on labor market analyses. Agencies should develop salary increase budgets using market data and guidance provided by OPM and OMB.

- The transition from the GS system to the banded structure should be completed within five years. Agencies should be allowed to develop their own schedule based on their human capital plans, budgets and performance management systems. Employees should receive credit toward their next within-grade increase and transfer to the bands at that pay level. No employee should lose pay with the conversion.

- Agencies should be accountable for planning and implementing performance management systems that identify outstanding performers, those who meet performance expectations, and employees who fail to meet expectations. The systems should demonstrate a clear linkage or "line of sight" to an agency's mission and operating goals.

- Each agency should define a new position to provide support to managers in implementing new performance systems and dealing with day-to-day pay and performance issues. Given OPM's proposal to create the senior performance official position, it makes sense to combine the responsibility for Senior Executive Service performance issues with the management of non-executive staff performance.

- Agencies should provide adequate performance management training to managers because managers are responsible for implementation. Pay-for-performance decisions should be based on salary budgets, performance ratings and agency policies.

- Both OPM and agencies should develop communication strategies, key to the success of the systems. The strategies should include delineation of the process used to develop policies and practices.

- The rollout of the new systems should be managed as organizational change. Managers and employees, the primary stakeholders, should be involved in the process.

Design Principles

- The system must be transparent and easy for managers and employees to understand.

- The system will identify the balance among the three aspects of equity: internal, external/market, and performance/contribution.

- Agency salary budgets will be set at levels necessary to fully fund the pay system, because high-quality human capital is critical to carry out the federal government's missions.

- Employee salaries will not be reduced during the transition to the new pay system.

- Employees and managers are the primary stakeholders. They and others will be involved in the design and implementation strategy for the new salary, performance management and position classification systems.

- The new pay system must be sufficiently flexible and responsive to changing market conditions to meet the needs of federal agencies for years to come.

- The system must support departments and agencies in achieving their missions, human capital management plans, and strategic goals and objectives.

- Salary management must be a manager's responsibility. Agencies will provide the leadership and training support to enable managers to develop required skills.

- The pay system will be based on prevailing market rates in the non-federal sectors.

- The new system must be acceptable to Congress and other stakeholders.

- The federal salary system will be implemented government-wide, but will be sufficiently flexible to enable departments and agencies to manage salaries to meet their mission needs.

- A streamlined band evaluation/classification system will be needed.

- Salary adjustments will be based on individual performance/contribution and prevailing changes in the non-federal sectors.

- Performance management systems that identify the "outstanding", "meets expectations", and "unacceptable" employees will serve as the foundation for the pay-for-performance component of the pay system.

- The system must be managed in a fair and equitable manner. Each department and agency will have a streamlined process to assure quick reviews of disputed band classification and performance rating decisions.

BACKGROUND

Introduced to the federal government by the Department of the Navy in 1980, broadbanding represented a radical departure from the General Schedule (GS) pay and classification systems. Since that time, it has enjoyed successes at every level of government, both here and abroad. Numerous prominent corporations now rely on banded salary systems across their global operations, as well. Further, broadbanding has been successful with jobs at every level, from executives to support positions. Academy Panels endorsed broadbanding in two previous reports: Modernizing Federal Classification: An Opportunity for Excellence *(July 1991) and* Modernizing Federal Classification: Operational Broad-Banding Systems Alternatives *(August 1995).*

Traditional salary systems have their origins in an era–effectively the 1930s and 1940s–when centralized control was an overriding consideration. Traditional systems in the public and private sectors since have been rigid and bureaucratic. As recruitment and retention have become increasingly important in today's public sector, pay has become a central tool in managing employee performance. In turn, flexibility and responsiveness are important attributes of an effective salary system.

Broadbanding makes it possible to satisfy agency needs because it is a simple framework for managing salaries. Bands define the upper and lower limits for salaries. When compared with traditional salary ranges, bands are broader (or wider) and fewer in number. For example, federal agencies that have authority to use a broadband system typically consolidate salaries into four bands, in contrast to the 15 GS grades.

The lack of overlap between bands is a second significant distinction with broadbanding.[1] The overlap and small differences among ranges in a traditional salary program, such as the GS, contribute to an environment where classification actions are contentious and time consuming. With its broad, open ranges, broadbanding reduces reclassification requests and facilitates job changes needed to respond to operating problems.

Even more important, employers commonly rely on pay-for-performance and respond to market trends when using banded systems. Such policies are common in the private sector, but not in the federal sector. When public employers adopt practices associated with broadbanding, the new pay system represents a very significant change in the way employees are compensated.

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[1] To illustrate this point, the difference between GS 7, step 1, and GS 8, step 1, is 11 percent. Regarding "overlap," GS 7, step 10, is $37,749, while GS 8, step 1, is $32,158. Thus, many GS 7 employees are paid more than some in GS 8 and 9. The relatively small difference in the "value" of jobs at each grade level and the imprecision of the classification process make those differences contentious.

Relatively few federal managers and employees have had more than superficial exposure to the concepts of a banded salary system and the day-to-day changes associated with transitioning to one. There is natural discomfort with change, especially when it affects employees directly. Their reactions are important and must be considered, but the overriding consideration should be the needs of federal agencies. The GS system is not meeting those needs.

Employers usually switch to broadbanding as an element of organizational change or a transformation strategy. The change significantly reduces administrative time and costs and facilitates changes in the way work is organized and managed. The effects of those anticipated changes often are the reason why employers encounter criticism and resistance to their broadbanding plans.

Change in Compensation Philosophy and Organization Culture

Broadbanding represents a major change in compensation philosophy and organizational culture because the public sector has not widely accepted its management principles. From an organizational standpoint, the change can be characterized as a move from an entitlement culture to a performance-earned culture. The Panel believes the reasons identified below demonstrate why employers shift to a banded system.

FIGURE 1
WHY EMPLOYERS SHIFT TO BROADBANDING

- *Supports organizational change.* Jobs can be redefined and work reorganized with little or no impact on band assignments. Employees do not have to worry about how the changes will affect their pay.
- *Introduces flexibility to respond to labor market trends.* Open bands make it possible to grant salary increases that reflect performance, as well as occupational and locality trends.
- *De-emphasizes hierarchical structure and formal reporting relationships.* Broadbanding de-emphasizes the job hierarchy and formal reporting relationships that create "silos" and impede quick decisionmaking. This enables organizations to be more responsive to developments and to encourage teamwork.
- *Encourages lateral career movement.* Broadbanding reduces the prospect for formal promotions based on incremental changes in job duties due to the reduction in pay grades and steps involved in a shift to broadbanding. Position descriptions become less important over time as employees look for challenging opportunities to use their current capabilities, develop new ones and expand their own roles.
- *Shifts the focus to individual development.* The diminished importance of position descriptions and changing job duties shifts the focus to the individual's contribution. Employers that have adopted banded systems often introduce new practices to encourage individual growth and development.
- *Reduces administrative costs.* Banded systems reduce the need to reclassify jobs, saving time and resources for line management and human resources staff alike. They also contribute to a culture that de-emphasizes centralized control, leading to reduced operating costs.
- *Changes the role of human resources staff.* Human resources specialists are expected to "police" salary actions in a traditional salary system. Broadbanding dramatically reduces that role, and the adversarial relationship associated with that role, and enables human resources to define a new role as a consultant to support managers.

Some argue that there is no reason for the federal government to make a "radical" change by shifting to broadbanding. They contend that the GS system has been managed similar to a banded system for more than 50 years, with virtually automatic promotions from GS 5 to 7 to the top of a career ladder. This argument, however, ignores the need to be market sensitive and minimizes performance concerns. It is unlikely that managers and employees will think differently about performance as long as the GS system is in place.

Making the Case for Modernizing the Pay System

The U.S. Office of Personnel Management (OPM) made a strong argument for a new federal pay system in its 2002 white paper, "A Fresh Start for Federal Pay: The Case for Modernization." OPM's stated purpose was "to open the conversation on the possibilities for a modernized federal pay system for the 21st Century." The paper did not provide recommendations, though it indicated a new direction in its discussion of the failings of the GS system.[2] OPM cited the following basic problems:

- "The Government asks its agency leaders to face new and unprecedented management challenges using an antiquated pay system."
- "The current pay system does not reflect market pay levels."
- "It has minimal ability to encourage and reward achievement and results."
- "Its structure suits the workforce of 1950, not today's knowledge workers."
- "Its prescribed procedures and practices effectively preclude agencies from tailoring pay programs to their specific missions and labor markets."
- "It is disintegrating with a growing number of separate systems."

OPM's comments, though valid, understate the impact of the problem. Federal agencies have experienced trouble recruiting well-qualified employees. In response to this impediment and periodic hiring freezes, agencies promoted people to professional and administrative "two-grade interval job series" who possess only minimal qualifications. Moreover, changes in how the Bureau of Labor Statistics compiles salary survey information have seriously undermined OPM's "pay gap" analyses. Data do not exist to determine with any precision how far federal salaries are behind market levels.

OPM also noted that federal agencies have been unable to develop effective performance management systems. There are several reasons for this, but perhaps the most important one is that managers and employees know that performance ratings have little practical significance. This undermines any real focus on performance management.

Persistent Problems with the GS System

Although difficult to document, federal agencies have been forced in many, often subtle ways to bend regulations and adopt practices that effectively circumvent or ignore the intent of Title V. One practice is to

[2] "A Fresh Start for Federal Pay: The Case for Modernization," Kay Coles James, Director, U.S. Office of Personnel Management, April 2002, p. i.

overstate a job's responsibilities in the position description, reclassify the job to a higher grade, and raise salaries closer to market levels. This practice results in what is often referred to as "grade creep," a pejorative phrase that has crept into the jargon and suggested a common practice.

Such problems are not new, but are becoming more commonplace. Key stakeholders appear to agree that Title V and the GS system have serious flaws; however, there has not been agreement on a framework for a new federal salary system. Recent legislation permitting the Department of Defense and Department of Homeland Security to replace the GS system with broadband systems has effectively reduced the debate. Another traditional GS-like structure, with grades and ranges defined with narrow differences, has not been suggested as an alternative. In contrast, the public and private sectors increasingly view broadbanding, coupled with pay-for-performance, as the alternative that meets the needs of today's organizations.

Job Evaluation and Broadbanding

OPM's report focused on the GS salary system. Traditional systems generally have faced criticism from public and private experts and practitioners, starting with Dr. Edward Lawler's Strategic Pay, published in 1990. Lawler argued that traditional job evaluation practices were bureaucratic and an impediment to change. His points were discussed in greater depth in the recent Academy report, *Broadband Pay Experience in the Private Sector.*[3] Lawler criticized traditional job evaluation practices on the grounds that they:

- Emphasize the importance of job hierarchy.
- Establish an impediment to organizational change and downsizing.
- Promote and perpetuate bureaucratic management style.
- Encourage "game playing" to get jobs upgraded and thus increase pay.
- Contribute to erosion of honesty and credibility.
- Inflate pay system operating costs due to the need for additional administrative staff.
- Overemphasize grade changes and promotions as the basis for salary increases.
- Inflate payroll costs.
- Establish implicit limits on the scope of job duties.

Private sector compensation practitioners generally accepted Lawler's points. His book, coupled with General Electric's shift to broadbanding, marked the beginning of an era of ongoing change in the way employee compensation is managed.

[3] Broadband Pay Experience in the Public Sector, National Academy of Public Administration, August 2003, p. 39.

The shift to broadbanding coincides with and is part of the dramatic ongoing changes in how work is organized and managed. The broad acceptance of "total quality management" (TQM) in the 1980s, followed by reengineering, led to a new work paradigm contrary to the narrow and somewhat rigid view of jobs and evaluation. Broadbanding is compatible with the new paradigm and overcomes or mitigates the problems cited by Lawler. As a result, salary programs outside the federal sector now are very different from the model of a decade ago.

THE CASE FOR A NEW FEDERAL SALARY SYSTEM

The first step in developing a human resources management system is to consider and develop agreement on its purpose. The Panel believes that the time is right to reshape the federal salary system around three overriding purposes: to help departments and agencies attract and retain quality employees, reward performance and respond rapidly to changes in mission and priorities. The current GS system falls short on all three purposes.

Assessing the Competitiveness of Federal Salaries

Valid job-specific data do not exist to assess the competitiveness of federal salaries. It has been several years since the Bureau of Labor Statistics last conducted a salary survey that generated data on prevailing pay levels for specific jobs. Meanwhile, commercial surveys are not considered to be viable alternatives because at this time they are not based on defensible stratified samples of employers.

Lacking a suitable survey base, annual adjustments to the GS are now based on changes in the employment cost index (ECI). OPM uses these data to estimate the pay gap in each locality area, but there are shortcomings to this methodology. For example, the ECI is a time series analysis that provides a measure of year-to-year salary increase trends; it provides no data relevant to assessing actual salary levels.

It is widely understood that new college graduates face lower starting salaries in the federal government than for comparable jobs in the private sector. When federal government occupations compete primarily with state and local governments (e.g., law enforcement, procurement, librarians), federal salaries may not be low. Meanwhile, corporate salaries are believed to exceed federal levels for senior administrative and professional positions, as well as for managerial positions, though the gap can vary with industry, company size, and geographic location. Data do not show a consistent gap for office support and technician positions; regional surveys actually indicate that many federal jobs pay competitively for these job series.

Adequate job-specific survey data are needed if the goal is to make the federal salary system more competitive. Despite ongoing rituals to adjust the GS, OPM's gap estimates are no longer based on job-specific market data. A credible database of market data is essential to planning a new salary system.

Figure 2 addresses several issues related to conducting salary surveys that satisfy federal requirements.

FIGURE 2
SALARY SURVEYS

Hundreds of wage and salary surveys are conducted annually across the nation. Many are private and available only to organizations that belong to industry associations. Some are available to employers in a specific urban area or region. Still others are conducted nationally by consulting firms. Public employers at all levels of government also conduct surveys that are used to adjust government salary systems.

A growing number of sources–newspapers, magazines, websites, etc.–make salary data available to anyone who is willing to pay a nominal price. These data often are compiled quickly and with little regard for data accuracy, but they can be seen by federal employees.

So many surveys are conducted now that it often is difficult to convince employers to participate in a new one. Completing questionnaires requires time and many human resources staff do not want to invest the time unless they are convinced that a survey will be valuable. In several industries, employers have agreed to share pay data by using a third-party firm to collect and report information; their rationale is that they want to be competitive within their industry.

Salary surveys are based on the concept of "job matching," where a survey instrument reports "benchmark" jobs with titles and brief descriptions. These benchmark jobs are selected because they are thought to be defined the same way in many organizations. Selecting benchmark jobs is a key consideration when planning a survey and using the data. The benchmarks should be a stratified sample of an organization's jobs. Yet this is particularly difficult for the federal government because the number of job families or series is much larger there than in most other organizations. Ideally, market data should be collected for a cross-section of the jobs in all Title V agencies.

Corporate compensation strategies assume there is a direct relationship between starting salaries and new hire qualifications. The better graduates are assumed to gravitate toward better paying jobs. To attract the best people, some companies pay above average salaries—75th percentile salaries (i.e., 75% of the competing employers pay lower salaries), for example—to attract above average employees. The same logic suggests that low salaries affect the quality of new federal hires.

Federal agency recruiting experiences confirm the seriousness of the problem, which has been exacerbated by hiring freezes that pressure agencies to fill vacancies from within their existing workforce. To fill administrative series vacancies, agencies have resorted too frequently to promoting employees from office support and technician occupations.

Staffing Strategy and Recent Hiring Experience

Human capital planning and skills gap identification should focus on job series where being competitive is critical. When the quality of hires is inadequate, some have argued, it provides justification for higher salaries to attract better candidates. Hiring experience has not been the same for every job family over time; that should be considered when planning a new salary system.

Low Federal Turnover

Some cite low federal turnover as evidence that federal salaries are competitive. That may be true generally for some job series and employees. However, the panel assumes most federal workers considered their salaries to be adequate when they accepted a job offer.

Starting salaries typically reflect an individual's credentials; the best qualified individuals receive offers with the highest salaries.

Rapid Promotions in the Early Stages of a Federal Career

Regular and significant salary increases given to recent hires are one reason for low turnover. In the GS career-ladder situation, promotions from grade 5 to 7 to 9 and to 11 and 12 take place almost annually for typical employees. Salary increases associated with moving to step 1 in the new grades exceed 20 percent when salary dollars reflect annual adjustment in the GS ranges. Federal employees remain relatively inexperienced when they reach the top of their career ladders, usually at grade 12. Their private sector counterparts may have started at higher salaries but they would not have been promoted as quickly and their promotion increases typically would have ranged from 8 to 10 percent annually.[4]

A 1997 Congressional Budget Office (CBO) study compared federal and private sector salaries. Taking work experience and qualifications

[4] To illustrate this pattern, the 2003 GS 5, step 1, salary in the Washington, DC area is $26,429. Assuming that ranges increase 4 percent annually and that a new hire is promoted annually for the first three years to GS 11, his/her salary would increase to $54,500, or 106 percent from the date of hire. Some employees are promoted to GS 12 and a salary of $67,934 after the fourth year. A new hire in the corporate world would likely have started at a higher salary—for illustration, $35,000. His/her merit increases might be 6 percent (with an average for all employees of 4.5 percent), with a 10 percent promotion (the individual would not have been eligible for a merit increase in the year following the promotion), raising his/her salary to $43,258 after three years, a 24 percent total increase.

into account, it concluded that federal employees are paid better upon reaching the top of their career ladders.[5] Federal starting salaries may be too low to attract better-qualified applicants and the problem is compounded when agencies pay employees better than they could expect at the same level in the business world once they reach the top of their career ladders. This helps to explain why federal turnover is low: Young employees are effectively locked into their careers partly because they are unable to find corporate jobs with comparable or higher salaries. The dynamic shifts by their mid to late 30s but they have too much federal experience then to move easily to another sector.

If starting salaries should be more market sensitive, it is important to reconsider promotion practices governing federal careers. Higher starting salaries combined with the current promotion practices would exacerbate the problem identified by the CBO. The goal should be to develop a career ladder model that aligns federal salaries with market levels at each stage of an individual's career.

The Goal of Reduced Bureaucracy

Reducing bureaucracy and increasing flexibility are standard goals for employers that adopt a broadband salary structure. Also important is replacing the steps with open salary bands that enable employers to respond to market trends and offer attractive starting salaries commensurate with an individual's qualifications. The same flexibility applies when an employee is promoted.

At the same time, reducing the pressure to re-evaluate and possibly upgrade jobs is even more important. Job differences at each band level are clear and easily understood when using a limited number of bands. It is very difficult to argue that a job has changed enough to warrant a higher band. As a result, managers and employees can spend less time being concerned with moving to a higher band. The role of the human resources function changes as well, as there no longer is reason to "police" the classification and job evaluation process. Reduced administrative burdens also mean that classification staff can be reduced or switched to other duties.

Bands no longer make important the claimed precision of point factor job evaluation systems, such as the factor evaluation system (FES). Employers have the ability to replace the system with a simpler classification system once they consider its reduced importance. For

[5] The Congressional Budget Office conducted two studies: *Comparing Federal Salaries with Those in the Private Sector* (July 1997) and *Measuring Differences between Federal and Private Pay* (November 2002). The former is based on a human capital analysis that takes employee education and experience into account.

example, IBM classifies its non-executive exempt positions into five bands based on three factors: skills and competencies, leadership contribution, and scope of responsibility. Its managers make the classification decisions.

Streamlined Position Classification System

In the traditional model, job evaluation decisions were based on an assessment of the position description. An added duty could justify a higher salary grade, and the semantics of language often were important to a decision (the interpretation of "direct" vs. "manage," for example). With broadbanding, however, jobs are classified by occupational band, and evaluation decisions are not used to determine levels in the traditional way. Nuances and minor job duties usually do not affect band classification actions, leading to shorter, more accurate work performance plans. This also means that very little time will be spent on preparing and classifying the job descriptions.

Broadbanding leads to the use of generic position descriptions and broader job family definitions. It also opens the door to more flexible job assignments and workforce management, including shifting personnel to new assignments to meet changing missions and priorities. The notion that, "It's not in my job description, so I don't have to do it," is minimized.

Pay-for-Performance

The Purpose

Pay is increasingly used to motivate employees to reach higher performance levels. Indeed, the pay-for-performance philosophy is deeply entrenched in American culture. From the time children enter first grade, their performance is evaluated and the best performers are recognized and rewarded. "Most valuable players" or best performers in specific situations are recognized in many organizations. The stars of the professional sports and entertainment industries are rewarded with what are considered by many to be extraordinary performance compensation packages.

Pay-for-performance is virtually universal among professional and administrative workers in the private sector and non-government organizations. In industry, pay-for-performance is not limited to merit salary increases. It also includes cash incentives and stock ownership opportunities for individuals who contribute to a company's financial success.

Even a superficial understanding of psychology supports pay-for-performance. Everyone may not be motivated by money, but people generally want their work and contribution recognized tangibly. Good behavior should be reinforced. In fact, many argue that ignoring good performance is an example of poor supervision. There also is the expectation that poor performers will be identified and action taken to correct the problem. The morale of other employees is adversely affected when that does not happen.

To be sure, there are notable challenges with federal management and culture, but demonstration projects confirm that pay-for-performance can be appropriate for federal agencies.[6] Research also conducted a decade ago by a National Academy of Sciences committee concluded that government would benefit from introducing merit pay policies.[7]

Readiness for Pay-for-Performance

Readiness is on the minds of managers and employees alike. They must be confident that their organization has taken the steps necessary to begin and complete the change successfully. A 1995 Academy study includes a model for determining organizational readiness and identifying issues that need attention. The model can be found in Appendix A of the 1995 study or online at http://www.napawash.org/pc_human_resources/publications/modern_class.pdf

In many agencies, annual performance appraisals have been inconsequential as supervisors all too easily inflate ratings to avoid problems with their employees even though there is well publicized pressure from OPM and the Congress to hold down ratings. Employees are cognizant that their salary increases will be unfair when linked to ratings that are not consistently honest.

The "psychological contract," discussed in business psychology literature, is an unwritten agreement between supervisors and their staff that governs behavior on the job. Pay-for-performance would represent a significant change in that contract for federal employees as it will require new behavior that takes time to work out. Employees must have confidence that they will be treated fairly.

To make pay increases an effective incentive, employees must understand what they are expected to accomplish and how their performance or contribution will be evaluated. They also must believe that policies will be managed across the organization consistent with agreed upon principles. Given that employees are aware that their supervisors are expected to take a more critical view of their work and make honest evaluations, they want to know that their organization has taken steps to help managers develop the skills needed for this new responsibility. It helps when employees understand the organization's

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[6] This has been documented in the second report in this series, Broadband Pay Experience in the Public Sector. It also has been mentioned in several OPM reports evaluating the success of demonstration projects.

[7] National Academy of Sciences, *Pay for Performance: Evaluating Performance Appraisal and Merit Pay*, 1991.

purpose and what it expects to accomplish. Employees are likely to accept the goal of enhancing performance agency-wide. It makes sense to employees, recognizes their importance, and establishes credible links to an agency's mission and goals.

Recently-announced changes to the SES compensation program will facilitate the replacement of the GS system. In December 2003, OPM Director Kay Coles James announced changes that would assure "a clear and direct linkage between SES performance and pay, a cornerstone of the President's Management Agenda." This is the most dramatic change in the SES program since its inception in 1979. Without the administration making its intention clear, it would have been difficult to convince managers and employees that they should accept pay-for-performance when executives were excluded.

Credibility of the performance management system and clear practices for the way performance is managed are the most important readiness issues. Stakeholders must perceive performance standards as reasonable and intuitively appropriate for the job. In addition, supervisors must have the ability and skills to carry out their role and to be fair and objective. These are key to an effective pay-for-performance policy.

Most federal agencies need a new performance system, if only because their existing systems and ratings are not seen as consistent across managers. To be credible, criteria used to evaluate performance must be specific to assigned duties. Supervisors must demonstrate they have developed the necessary skills to effectively manage a performance system, making adequate training all the more essential. In most cases, agencies will need at least two years to demonstrate that a new system is being managed effectively.

Experts believe that performance ratings should identify "star" performers, individuals whose performance is inadequate, and those who fully meet expectations. Each group warrants special treatment. Research shows that employees normally know and largely agree with who is in each group. The credibility of a performance-based system depends in part on having the right people in each group and taking appropriate action. System credibility depends on fair and honest appraisal and action. A particularly important point is that poor performers who meet or exceed expectations are recognized and paid accordingly, while action must be taken when employees fail to meet expectations. The focus must be on those who meet or exceed requirements.

Finally employees must understand that the new policy and performance system will be evaluated and modified to address any problems that may arise. Rolling out changes of this magnitude will not take place without a few bumps in the road. Employees must know that their concerns are heard and their input is considered and valued.

PRINCIPLE
The system must be transparent and easy for managers and employees to understand.

Integrating pay-for-performance into broadbanding is much for employees to absorb. Communications must have a much higher priority than has been the case in federal agencies. When large corporations launch new pay systems, they develop a multimedia strategy intended to promote the new system. Yet the situation is more challenging for federal agencies since a new government-wide salary system would be the first in more than 50 years. Moreover, federal employees will have to understand and accept several very different ideas like broadbanding and band-centered classification.

Employee Understanding

Employees must understand what they need to do to build a successful career and what they can expect from the salary system. Salary banding is markedly simpler in operation, and minimizes reliance on rules and has two major advantages. It provides an easier to understand, if initially uncomfortable, approach. Communications must be an overriding priority throughout the planning and implementation stages. OPM should adopt the same approach they used to plan for the Federal Employee Pay Comparability Act (FEPCA) with input from stakeholders across government. In that case, OPM created a task force during the planning stages that included agency personnel/human resources executives, employee representatives and senior compensation executives from industry. In addition, each agency must develop internal policies and practices for managing salaries and create committees or task forces to address those issues. Individuals involved in those meetings serve as credible and reliable sources of feedback on planning.

Salary management in a broadband environment is very different from management of the GS system. The former changes the culture and redefines the relationships between supervisors and staff. It necessitates relearning the basics and developing new managerial skills. When corporations plan and introduce a new salary system, they typically do so as an organization change initiative where employees know their concerns are heard and their input considered and respected. The same holds true for the federal government.

REDEFINING EQUITY

When discussing salary management, "equity" comes up as a central element. Despite its widespread use, the word is not well defined. Dictionaries actually define "equity" as "fairness."[8] Yet this definition does little to advance the discussion. Compensation specialists learn quickly that equity is in the eye of the beholder; what is fair and equitable to one may seem inequitable to others.

"Equity theory" refers to the primary theory of motivation as it relates to compensation. Employees provide labor and other inputs in exchange for a variety of returns, including pay. Conceptually, a ratio exists between the inputs and returns, and employees understand the returns that other employees receive for their labor. Employees thus manage or control their labor inputs to balance with the expected returns. Put another way, employees will work hard only if they believe it is commensurate with their compensation. They expect equitable treatment and their expectations affect their work efforts. They feel an equitable pay system contributes to their job satisfaction.

Equity theory also helps us understand employee behavior under the current GS system. Failing to recognize and reward employees who perform above expected levels sends the important message that good performance is not a priority. There are many tangible and intangible rewards available, but effectively using them is not currently a general management practice in the public sector. Predominantly automatic salary increases and promotions can negatively influence employee performance.

In contrast, federal agencies can use cash bonus awards to recognize quality performance. Budgets for those awards typically comprise less than 2 percent of total payroll, and there is no public evidence that a federal agency has studied the effectiveness of such payments.[9] Critics charge that the awards generally are subjective, after the fact, and not an effective, well-conceived reward policy. They also contend that the payments are intended to supplement low salaries rather than reward commendable performance.

Rethinking the Current Focus on Internal Equity

The GS system was intended to focus narrowly on jobs as described in a position description; the employee and his or her capabilities had little impact on salaries. Descriptions thus were the heart of the process by which jobs were assigned to salary grades. In the federal context, internal

[8] Webster's New World Dictionary and Thesaurus, McMillan General Reference Co, 1996, p.208.
[9] The General Services Administration is conducting an ongoing study of its reward practices.

equity meant assigning similar jobs to the same grade and treating those with similar jobs the same. The phrase internal equity has been widely used in salary management since the 1940s when the traditional public and private sector models were developed.

The federal government's factor evaluation system (FES) was developed three decades ago to facilitate decisions that determine a job's internal relative value and to ensure internal equity. Because neither individual performance nor market pay levels have significant impact on paying federal employees, the classification process is the central focus of salary administration and the basis for maintaining internal equity.

In government, internal equity has become the rallying cry for those opposing change in the way employees are compensated, much more so than in the corporate world. Such job evaluation systems as FES are designed to determine a job's position in the hierarchy. Job values are relative, narrowly defined, and based on comparisons against other jobs. Arguments for internal equity typically occur when someone contends a job should be evaluated higher and paid more after it is reclassified.

Market and Contribution Equity

To set the stage and facilitate the discussion of a new salary system, OPM has introduced "market equity" and "contribution/individual equity" to the federal government's lexicon. Market equity advocates paying employees the same as they would in other organizations. Contribution equity holds that employees who contribute or perform at higher levels deserve higher salaries. These phrases are not used in business communications because the ideas are well established, but they still are somewhat abstract in the context of federal compensation philosophy and supporting administrative policies and practices. The starting point is understanding how these concepts work in the private sector. A broader redefinition will require leadership at the highest levels of government and an effective communications campaign. These are prerequisites for the federal community to become comfortable with the new philosophy.

PRINCIPLE

The system will identify the balance among the three aspects of equity: internal, external/market, and performance/contribution.

The basic policy question for the federal government is how the three views of equity should be balanced. Many employers have shifted the current balance from internal equity and more toward market equity and individual performance or contribution equity.

The federal understanding of internal equity cannot be changed without new legislation. Internal equity was defined in 1949 when it was locked into the Classification Act, which defines job characteristics at each GS level. If two jobs were assigned to the same grade in 1949, both should be in the same grade today. Realistically, the focus on performance or contribution equity is limited under the GS system, reflecting the employee relations climate of 1949. At that time our current understanding of knowledge workers and appreciation for performance cultures was still four decades away.

Market adjustments to GS ranges reflect post-World War II industry thinking. General increases are virtually non-existent for professional and administrative workers, except in government, in today's labor markets. Pay increases vary by occupation, industry, company/organization economics, and geographic location. A general increase based on the average would be too high for roughly half the job families and too low for others. This is one reason why federal salaries in high demand fields are far below competitive levels.

Internal, market and contribution equity continue to affect salary planning and decision-making in non-government organizations. Businesses respond quickly to evidence that they are experiencing staffing problems. They also place more emphasis on performance than the federal government does. Internal equity is not always a formal consideration, but it is not forgotten. Employers in some fields, including health care and higher education, may have a somewhat different balance; but they rely on a similar philosophy. When business leaders become convinced that changes will benefit their organization, they generally do not ignore employee apprehension. They know continued employee commitment is important—and not a roadblock to change.

Future debate must focus on a better balance of the three equity factors for today's federal agencies. The GS system and the federal notion of internal equity have dominated the civil service for more than 50 years, so they are deeply entrenched. Yet the new discussion should concentrate on some core questions: How important is the market? Can federal agencies afford to pay competitive salaries? Should occupation differentials affect salary increases? How important is individual performance? What is the best way to accommodate the three equity factors? Is development of totally ad hoc agency systems effective or will it lead to chaos?

BALANCING EMPLOYEE REACTIONS AND THE NEED FOR IMPROVED PERFORMANCE

It is appropriate to consider employee concerns in the public sector. Nonetheless, it is important to keep in mind that a major reason to replace the GS system is the recognition that it is not meeting agency needs. Costly to administer properly, the GS system is widely seen as an impediment to change. Perhaps the most important consideration is that it is fundamentally unrelated to employee or agency performance.

Improving agency performance across government is an ongoing goal expressed in Presidential, OMB, congressional and General Accounting Office (GAO) reports. The phrase "results-oriented cultures" appears regularly and frequently on agency websites and in management conferences.[10] Many changes in management practice could contribute to achievement of this goal, but the most meaningful are shifting toward pay-for-performance policy and managing this culture change. In the private sector, entitlement cultures and across-the-board salary increases are dead. There are no guaranteed salary increases.

The private sector has focused on performance improvement, as well. Corporate experience confirms that significant improvement is possible with new management practices and financial rewards. There is a widely shared understanding that reward opportunities have been instrumental in the economic success of American industry. Many employers in other countries have adopted those practices, including the executive and/or civil service in Australia, Canada and the United Kingdom.

The most vivid difference between federal and private sector practices in the United States is the lack of financial rewards. When companies undertake new strategies, financial rewards commonly are part of the strategy. Companies complement this practice with non-financial rewards to celebrate group and individual accomplishments, something nearly unheard of in federal agencies.

Business experts argue that rewards should be an integral element of a performance improvement strategy. When such a strategy does not include a focus on rewards it is often because rewarding practices are taken for granted. When performance improvement is identified as a priority, it means that the basis for the rewards shifts to a new set of performance criteria. This is not to suggest that financial rewards alone

[10] One of the most recent is GAO-03-488, "Results-Oriented Cultures: Creating a Clear Linkage between Individual and Organizational Success," March 14, 2003.

trigger improved performance, or that salary increases or cash awards motivate everyone. However, pay-for-performance policies do communicate management priorities and reinforce the importance of good performance. The most effective rewards are planned as a component of an integrated performance planning, measurement, and management process.

The question for federal decision makers is: Can federal agencies expect to realize meaningful gains in performance if the GS system is not changed? Critics contend that the system has contributed to an entitlement culture. It was not conceived–nor was it administered–to support performance initiatives.

Philosophy, goals and policies governing the management of salaries present the core challenges for any new federal salary system. OPM has set the stage for a different approach.[11] Broadbanding itself is essentially neutral; bands make it possible to apply other salary management tools more effectively. Switching to bands will balance external, internal and contribution/performance equity, and will enable managers to be more responsive to pressures for improved performance.

[11] U.S. Office of Personnel Management, op cit.

PLANNING A BANDED SALARY SYSTEM

Banded salary systems are not new territory for the Academy. Modernizing Federal Classification: An Opportunity for Excellence, *issued by an Academy Panel in 1991, was one of the first reports on the subject.*[12] *It broke new ground given that only a handful of employers– public or private–had experience with the concept.* Modernizing Federal Classification: Operational Broad-Banding Systems Alternatives *followed in 1995.*[13] *Both reports, grounded in the views of a Panel of distinguished practitioners, recommended moving from the GS to a broadband salary structure. This current report, based on this previous work and updated to account for new research, renews that recommendation.*

The National Performance Review also recommended the switch to broadbanding in 1993, as did the National Commission on the Public Service in 2003. The latter concluded that there is a need for "more flexible personnel management systems," and specifically referred to abolishing the GS system and moving to a "broad-band salary system." [14] The Commission's report included a notable quote from OPM Director Kay Coles James, who said, "Continued reliance on this antiquated system (the GS system) is comparable to insisting that today's offices use carbon paper and manual typewriters." [15]

Because of the immensity and comprehensiveness of this change, federal agencies can expect to have any new salary system in place for at least a decade before it is imbedded in their cultures. It is important to plan a flexible system that can respond adequately to mission changes labor market conditions and workforce and management needs, present and future. It also is critically important to take into account and husband the internal dollar resources needed to maintain a new system.

Reasons for Recommending Broadbanding

In its 1995 report, the Academy panel cited the reasons for moving to a banded structure. They are listed below.

- Achieve program mission, vision, goals and strategic objectives.
- Streamline, such as reduced cost, layers and controls.
- Delegate more personnel authorities to managers.

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[12] National Academy of Public Administration, *Modernizing Federal Classification: An Opportunity for Excellence,* July 1991, p. 87.

[13] National Academy of Public Administration, *Modernizing Federal Classification: Operational Broad-Banding Systems Alternatives,* August 1995, p. 113.

[14] Report of the National Commission on the Public Service, *Urgent Business for America: Revitalizing the Federal Government for the 21st Century*, January 2003, p. 49.

[15] Ibid., p. 27.

- Facilitate multi-functional development of employees.
- Attract and retain high-quality employees.
- Make dual career tracks really work.
- Change the mindset of employees from vertical to horizontal mobility.
- Encourage Total Quality Management behaviors: teamwork, expansive behavior, versatility.
- Reduce or redeploy human resources staff and decrease time to fill vacancies.
- Achieve simplicity, flexibility, and understandability.

These reasons remain as relevant today as they were in 1995. If anything, the GS system is increasingly ineffective and out of sync with leading edge practices. At the same time, broadbanding will be more pronounced and far-reaching in federal agencies than in the private sector where companies rely on policies that maintain market-based salaries and pay-for-performance. By comparison, the GS is completely rigid.

Creating a Performance Culture

Reports on broadbanding experiences suggest that a new system will trigger significant cultural change and improved operational performance, but it is more accurate to attribute change to associated administrative practices. [16] The traditional focus on jobs and assigned duties is replaced over time with flexibility in how employees view their jobs. When the focus no longer is on narrowly defined jobs, employees are more willing to tackle new problems. There also is less concentration on internal job comparisons and greater focus on what the organization needs to accomplish. The most important change, however, is the shift from virtually automatic step increases to pay-for-performance.

The information on corporate banded programs confirms that banded structures can be very different, yet still satisfy organizational goals. In contrast, traditional salary structures almost are identical across organizations. There are dramatic differences in the size, organization and management of federal agencies, affecting their operational needs and human capital strategies. Those differences must be considered in depth before new banded structures can be planned.

It is particularly important to develop policies and practices that are “right” for federal agencies which have their own unique requirements and constraints. Corporate salary management practices should be

[16] If replacing a traditional salary structure with broadbands is the only change, it can be expected to reduce costs associated with the narrower job focus of GS and the tension between managers and human resources specialists related to reclassification requests.

considered, but often cannot be adopted successfully without modification. A new salary system also requires flexibility to accommodate the unique dynamics of each agency.[17]

The 1991 and 1995 Academy reports set forth recommendations that incorporated key features from the GS and classification systems. This report presents recommendations that build on the prior work with recommendations that take greater advantage of private sector trends and the experience with the federal demonstration projects.

Occupation Career Ladders

The 1995 report highlighted several possible banded configurations based on established career ladder concepts for federal job occupations.[18] The recommended options were intended to give federal agencies some latitude when selecting a configuration to best fit their needs. This Panel concurs that any new salary system must support the management of specialists in the full range of occupations.

The 1991 Academy report recommended defining bands around occupation career ladders. The recommended model "categorizes all 459 series into occupation families based on similarities in career progression, basic skills, recruitment, training, and performance management." [19] The report sets forth 10 occupation groups: [20]

- *Office services,* including the generic office support positions
- *General support*, including aides, assistants, certain technicians and trainees that are more occupation-specific than generic
- *Technical,* including specialists, certain technicians, paraprofessionals and sub-professionals that directly support professional disciplines
- *Administration,* including administration and management functions and processes in support of operations
- *Analysis,* including job series involved in review, analysis and evaluation of programs and processes
- *Engineering*, including series with a positive education requirement and professional engineering job duties
- *Sciences*, including physical, biological and related scientific occupations that have a positive education requirement
- *Health*, including medical and health sciences directly involved in medical/health care
- *Law enforcement and investigation*, including all traditional job series in these fields
- *Other*, including job series in the social sciences, mathematics, accounting, contracting and procurement

[17] National Academy of Public Administration, *Modernizing Federal Classification: Operational Broadbanding Systems Alternatives*, 1995, particularly chapter 4.
[18] Ibid.
[19] National Academy of Public Administration, *Modernizing Federal Classification: An Opportunity for Excellence*, 1991, p.44.
[20] Ibid, pp.47-48.

The federal workforce has changed a great deal since the 1991 report was released. Occupation groups have been redefined. For example, accounting and procurement now are considered to be much more mission critical. These series could be combined with the administrative series to create a "business management" occupation group. Information technology, another group receiving increased attention, was the subject of a recent Academy Panel study that recommended the creation of a separate salary system. It might make sense to develop a separate set of bands for lawyers and paralegals, as well. Several other groups are traditional and widely accepted; they should be retained in future human resources systems.

Occupation groups provide a simple and intuitively appealing way to organize and manage employees because the employees would have much in common, including their competency profiles, and would tend to share similar views of how they should be managed. Their salaries also would be affected similarly by supply and demand factors, and by performance criteria and competencies.

The federal classification system is organized around broad occupation groups, which are outlined in OPM's Handbook of Occupational Groups and Families and used regularly in classification actions. The occupational groups are broadly understood and widely accepted. Continued reliance on them should facilitate greater acceptance and buy-in.

The importance of grouping employees in related fields together is a key finding in private sector broadbanding analysis. Put differently, a salary system's credibility could be undermined if distinctly different jobs are in the same set of bands (e.g., health care and engineers). Occupation groups and the reasons for their creation should be transparent and logical. Grouping occupations from different labor markets and market pay rates also can be a management challenge.

The availability of powerful and flexible human resource information systems (HRIS), which facilitate management of human resources systems, is another important development that has taken place since the prior Academy reports. When employers rely on manual administration, the notion of ten separate systems is unthinkable. Related data problems now have been reduced.

The Career Framework

The career ladder is the framework for managing salaries when bands are defined for occupation groups. The 1991 Academy report used a simple ladder with three levels: developmental, full performance and senior/expert." The 1995 report modified the ladder to include a trainee level (GS 3/4) for employees who did not fully meet the qualifications for a two-grade interval job series. The 1995 study also removed the reference to "senior" and adopted "leader/expert."

Research confirms a similar career ladder for the private sector with four bands for professional job families and three for all others. The fourth band is reserved for experts and relatively few occupations have people with the knowledge and skills to justify this classification. Individuals decide to make the transition to a supervisory or managerial role at the second or full performance level.

Bands for Supervisors and Managers

There is the need for one or more bands for supervisors and managers. That presents a challenge for the federal system. SES salaries are constrained by political considerations and the link to Executive Level salaries, which mean that managerial salaries could be capped below the SES level. This may not be a problem for office support job series because supervisory salaries are lower than for professional occupations. For higher paying occupations, however, the band will be defined at the top by SES salaries and at the bottom by the full performance band.

Occupation Specific Market Data

Defining bands for occupation groups and aligning them with occupation-specific market data are a logical and understandable strategy. Doing so would provide the rationale for separate salary schedules for engineers and law enforcement specialists. It also would accommodate special rate schedules and ensure federal employees that they would be paid commensurate with their peers in non-federal organizations. This strategy would require occupation-specific survey data and new surveys to allow bands to "float" with the market and stay competitive. Some occupations would receive larger increases than others, which is the case with labor markets and occupations but is new for the federal environment.

Defining a fourth band for professional/technical career groups represents a simple but effective pay strategy for the few individuals who are recognized experts in their field. The relatively small group of professional/technical experts comprise a broad group of jobs paid significantly below market levels, notwithstanding the high demand for their skills. For this group, current GS-15 salaries are well below market levels. Corporations rely on a dual career ladder concept that enables experts to be paid as much as or more than their supervisors; the concept has been adopted on a limited basis in several federal agencies, including the Internal Revenue Service.

Managing Individual Salary Increases

Managing salaries within a broadband structure will require federal managers to become comfortable with and make pay decisions related to three new policy issues.

Starting salary policy. With a traditional salary system, it is common for new or promoted employees to start at or near the salary range minimum. This is not necessarily the case with broadbanding. The idea is to offer job candidates an attractive starting salary relative to alternatives. The market dictates starting salaries for each job family.

Annual contribution increase policy. Pay-for-performance is the heart of salary management in this system. Nearly all non-government employers rely on an increased budget plan to keep salaries aligned with market levels. Budgeted funds then are allocated across the organization and granted as salary increases based on individual performance.

The typical pay-for–performance salary increase policy is based loosely on the learning curve theory which holds that new employees learn their jobs rapidly and that their “value” or expected contribution increases as they acquire or enhance their job skills. As employees master their jobs, the incremental increase in value tapers off. Corporate salary policies typically follow the learning curve. Employees are paid competitively at market levels upon demonstrating their competence at their jobs. Only above average employees can expect to be paid above market salaries.

Promotion increase policies. In the traditional federal environment, each grade change is treated as a promotion with a salary increase. With broadbanding, moving from one band to the next is infrequent. It is possible that an employee may move from job to job within a band, which would be treated as a promotion. In fact, a trend has emerged to recognize within-band job changes with modest salary increases because it is common for employees to spend years in one band. For example, Marriott grants increases for all job changes as it assumes a change will make an individual more valuable, thus benefiting the organization.

PRINCIPLE

Agency salary budgets will be set at levels necessary to fully fund the pay system because high-quality human capital is critical to carry out the federal government’s missions.

Almost all federal and non-federal employers establish a separate annual budget item that includes salary increases. Every employer must track expenditures during a fiscal year and make certain that expenditures are within budgeted limits. Professional associations and consulting firms often conduct surveys of merit increase budgets during the third quarter of the calendar year. They focus on a simple question: "How much are you budgeting for salary increases for the next fiscal year?" Results typically are reported by industry and geographic area.

Planning a salary system is key to remaining competitive, so it is important to maintain the planned alignment with market pay levels. As competitor salaries increase over the fiscal year, an employer establishes a salary increase budget to provide the funds needed to maintain the planned alignment. Private sector salary increase budgets typically range from 4 to 4.5 percent, though it varies by industry and by occupation level. Budgeted increases for executives tend to be somewhat higher and increases for non-exempt employees somewhat lower. Recent surveys show that budgets fell to the 3 to 4 percent range given the economic downturn.[21]

OPM has relied on a more sophisticated approach to plan federal salary increases for the following fiscal year. FEPCA's target is to pay federal employees 5 percent below levels paid by non-federal employers. The process begins with BLS survey data and an understanding of market pay levels. Staff then determine how much in the aggregate federal salaries should be increased to reach target levels; the information is used to determine the funds to be budgeted. A problem with this federal approach is that the survey data have been approximately two years old. The Bureau of Labor Statistics requires time to collect and report the information, a challenge when salaries are escalating rapidly and salary increase budgets are falling. Federal salary increases appear to be out of sync with labor market trends in such circumstances.

Budgeted amounts generally are allocated throughout an organization so that managers have funds available to determine pay increases for their employees, a practice consistent with the "pool" concept that federal agencies occasionally use. The importance of adequate salary increase budgeting is key to a broadbanding system.

[21] WorldatWork, the professional association, conducts one of the most widely used surveys.

PRINCIPLE
Employee salaries will not be reduced during the transition to the new pay system.

Initial Alignment with the GS Pay Schedule

For most all occupation groups, the initial set of bands should be aligned with current GS grades and ranges. Increasing salaries to market levels will not occur in this first step; yet the absence of reliable job-specific survey data makes it impractical to move immediately to market sensitive band ranges. Under the recommended system, employees would convert first from the GS system to bands related to the current GS-1 through GS-15 salaries at their current salary levels plus pro-rated salary additions for time earned toward their next within-grade increases. The individual employee would not lose money while the conversion costs to the government will be neutral since salaries are moved to the new bands with pro-rated, already earned partial within-grade increases. For example, an individual who has completed two years of a three year within-grade waiting period would be transferred at a salary that equals his or her current salary plus two-thirds of the next within-grade increase.

When market data becomes available, it will be used to help define new band limits. The bottom of each band will capture the lowest entry-level salary the government employer is willing to pay for someone hired to or promoted to a job within the band. The top of each band will capture the highest salary the government employer is willing to pay for the specialists in that band. As an example some employers define the top and bottom based on the 25th and the 75th percentile of reported salaries in the market survey. At this stage covered employees would move from the GS-1 to 15 band system to the market sensitive bands at the current salary levels.

When market data are limited to similar jobs common to an occupation group, the salary ranges at each career level normally are limited. Early broadband systems typically were based on 100 percent bands--from the lowest to highest salary—but the width can be significantly less with occupation-specific bands.

Following practice that is virtually universal in the non-government sectors, band limits should be adjusted annually to reflect market pay level increases for respective occupation groups. These levels generally increase more slowly than average salary increases. Turnover holds down averages as new hires generally start at lower salaries than the losses they replace.

GAINING ACCEPTANCE OF A NEW SALARY SYSTEM

At one level, salary systems are a series of numbers–grades, minimums, survey data, job evaluation points and budgeted increases–that can be analyzed in the abstract. Given the focus on numbers, design alternatives are addressed in technical terms, such as the percentage "spread" from the minimum to the maximum of a salary range. Numbers determine the cost and establish constraints.

At another level, salary systems trigger emotional responses and affect employee work behavior, life choices and relationships with others. Anticipated emotional reactions, the "softer issues," combine with cost concerns to make employers reluctant to change the way salaries are managed. When evaluating salary systems and potential adjustments, the focus is on employee reaction (e.g., impact on recruiting and retention). Technical design issues are secondary.

PRINCIPLE

Employees and managers are the primary stakeholders. They and others will be involved in the design and implementation strategy for the new salary, performance management and position classification systems.

The switch from the GS to any new salary system will be followed by a period of anxiety and apprehension that is largely unrelated to system design. This is true in any organization. Employees must understand what to expect and what the organization will expect of them. Managers must understand how the new system will affect them and how their roles will change, and must become proficient with new skills. Both groups also must understand why the changes are necessary and how they will benefit the organization. Involving managers and employees or their representatives throughout design and implementation is critical to acceptance.

Managing Banded Pay as an Organization Culture Change

The implementation of a banded pay system, particularly one grounded in pay-for-performance principles, is best managed as an organization culture change initiative. In a recent report, GAO outlined a series of critical steps associated with successful change initiatives. Gaining acceptance of the new pay system is the immediate goal upon completion of the rollout. The longer-term goal is to change the organization: to introduce more flexibility, reduce bureaucracy and improve performance.[22] There may be no more complex change for a government agency. And, there certainly is no change that triggers more employee concern.

Change is not always easy to accept, especially among employees whose work patterns are well established. Some in the federal workforce will oppose any change, regardless of its impact. Others may know change is needed but do not trust agency leaders. Experience tells us they may be vocal critics of plans to change the system and work to undermine the prospect for success. Their comments will influence many of their colleagues.

Nonetheless, employees often are the best witnesses when a pay system is "broken," and they are bothered if the disrepair is allowed to continue. They want their organization to be well managed and their leaders to be on top of the problems. They are anxious to know how changes in policy or practice will affect them, but they are more likely to accept those changes if they trust their leaders, believe the changes are fair, and know that they have the opportunity to expand their opportunities. This is especially true for quality performers who want their value recognized and rewarded, a group that is important to an agency. A major goal should be to strengthen these individuals' commitments to the organization because they are most likely to be recruited by other employers.

A major difference between the public and private sectors is that pay-for-performance generally is perceived positively in the latter. There, the focus is on recognizing star performers and providing added rewards for good performance. In government, the focus too often is on poor performers and decisions to deny increases. Poor performers certainly exist in private companies, too, but they are out of the spotlight and rarely become an issue. The emphasis on the positive makes it more likely that employees will work to reach higher performance levels.

[22] U.S. General Accounting Office, "Results-Oriented Cultures: Implementation Steps to Assist Mergers and Organizational Transformation" GAO-03-669, July 2003. The steps include: ensure top management leadership; establish a coherent mission and integrated strategic goals to guide the initiative; focus on a key set of principles and priorities at the outset of the initiative; set implementation goals and a timeline to build momentum and show progress; dedicate an implementation team to manage the initiative; establish a communication strategy to create shared expectations and report progress; and involve employees to obtain their help and gain ownership.

This difference reinforces the importance of the steps outlined by GAO to plan change initiatives. Leadership is vital. Goals and timelines are important. Effective employee communication is essential. It also is advantageous to create a design and implementation team, a component that emerged from experience with reengineering initiatives, as well as to seek input and involvement from managers, employees and employee representatives.

These steps suggest that agencies should have some latitude to develop or modify pay practices to meet their specific needs. In its white paper, OPM has cited tailoring pay systems to meet agency needs as a critical issue, and the agency can prescribe steps in the planning process and develop a set of required parameters. However, OPM should not mandate acceptance; that has to happen at the agency level. The changes are consequential and the involvement of people will enhance the prospect for system acceptance and ownership.

Process Concerns Are Critical

“Process” concerns are at least as important as technical design issues when planning a new pay system. In designing a broadband salary structure, the decisions appear to be simple: How many bands? How broad? The difficult issues are those related to gaining acceptance for the new system. The process considerations such as how to facilitate employee input will determine if a new system helps or hinders an organization’s human capital management strategy.

During planning for FEPCA, the OPM Director established a high-level steering committee that included representatives of labor, larger occupation groups, experts on government, and private sector compensation experts. A prominent consulting firm conducted a study to guide the committee, while the Director sought the opinions of many stakeholders. Additionally, a broad spectrum of organizations was represented in public meetings. Although discussions assumed some issues were management prerogatives, Congress readily accepted the FEPCA legislation, notwithstanding its sensitivity and costliness, partly due to the rigorous consultative process.

The federal white-collar salary payroll now exceeds $100 billion. Planning for the key system changes that broadbanding entails requires management by individuals who are accountable to the President and Congress. A new salary system can be expected to affect federal agencies and their performance more than any other change in management practice. The impact on performance makes this much more than a routine new human resources system. Broadbanding must be manager-led.

RECOMMENDED FRAMEWORK FOR A NEW FEDERAL SALARY SYSTEM

The salary management problem facing the federal government is far more complex and difficult than in any other organization. In fact, there are order-of-magnitude differences when compared with even the largest corporations and state governments. The number of locations, occupations and stakeholders all are significantly larger in the federal government as are the differences in missions, customers served and performance expectations.

At its core, salary management is not a difficult problem. Several million employers across the nation must develop practical ways of handling wage and salary issues. The basic questions are similar: “How much should we pay employees to perform assigned job duties?” “How should we manage their pay to maintain their commitment or ‘engagement’?” “What is the best way to manage pay to enhance our organization’s prospects for success?” Every employer must develop policies, practices, and management systems to answer those questions.

Government, more than almost any other employer, depends on its people and their performance. In other sectors, new products or technologies—and access to them—provides an employer a competitive short-term advantage. Public employers certainly use technology too, but employees always are central to the services provided. Human capital management is listed first on the President’s list of government-wide initiatives because public employees are integral to solving societal problems and providing services to the public. The salary system is key to managing the federal government’s diverse workforce.

For the most part, federal human resources practices are one year or more behind private sector trends. An idea rarely surfaces first in government and then migrates to the business world; ironically, an exception is broadbanding. There is some value in delaying the adoption of new ideas as federal agencies can accept those that are proven and minimize hassles that commonly occur as new ideas are tested and refined. The ideas considered when formulating the recommendations in this report reflect the best thinking in the business world. Yet they have been modified to be consistent with federal realities.

There is no inherent reason that federal agencies cannot develop effective salary systems. The China Lake demonstration project was the first of several new systems in the federal government that provide evidence of success. One theme running through the demonstration projects, as well as through the growing list of agencies authorized to move to new pay systems, is that the policies and practices were mostly developed locally. This strategy provides for individuals at all levels to play a planning role, thus creating a sense of ownership and understanding. The changes must have a clear business reason, as they did at China Lake, along with reasonable expectations.

Agencies have real differences but also share many similarities. They operate under the same budget limitations and civil service regulations, and they work to meet the expectations of Congress and the President's Management Agenda. The values that guide their human resources management tend to be very similar. Throughout history, the similarities across agencies have been paramount when considering proposed changes. The merit system principles, for example, have consistently guided personnel management in all federal agencies.

Salary Management Principles

Given similar conditions it would be appropriate to base a new federal salary system on a common set of principles and framework and then provide an agency some latitude to develop local salary management practices consistent with them. It is important to agree upon the principles to prompt executives and managers to approach compensation issues with a shared perspective. The Academy Panel's system design recommendations follow from the principles, which are listed throughout this report.

PRINCIPLE

The new pay system must be sufficiently flexible and responsive to changing market conditions to meet the needs of federal agencies for years to come.

The GS system has limped along for more than 50 years despite widely acknowledged problems. Whatever changes are adopted should be designed to meet agency needs for an equally long period, yet it is unlikely that another rigid one-size-fits-all system would even last a decade, much less half a century. The need for a salary management system to "fit" the organization and support its operating plans is a compelling reason to allow agencies considerable latitude to develop policies and practices that reflect their human capital strategies and work environment.

Change has become the constant. It is very difficult to anticipate change in organizations and the way people are managed, both of which make flexibility essential for any management system. For long-term success, the system must be able to accommodate organizational changes and adapt to labor market developments. It also should take advantage of proven new ideas, not those already dated.

Salary management is a dynamic practice, as employers continuously compete to recruit and retain quality people. Broadly publicized workforce demographics show clearly and inevitably that federal agencies must find ways to replace the many people who will retire over the next five to ten years. The demographics of the U.S. workforce demonstrate that labor shortages will occur as baby boomers retire. The next cohort of workers, age 25 to 44, actually will decline over the next few years. The challenge is exacerbated by the increased importance of knowledge workers; new federal workers will have to meet a higher standard for education and training than prior generations. This leads to the conclusion that the federal government must become more competitive now than in the past if it is to continue meeting public expectations. A pay system based on performance is central.

PRINCIPLE

The system must support departments and agencies in achieving their missions, human capital management plans, and strategic goals and objectives.

The federal government is the ultimate conglomerate with diverse missions, resulting in very different staffing strategies and cultures. To respond to the President's Management Agenda, each agency is working to develop a human capital management strategy that will provide an understanding of the steps necessary to ensure it has the staff and competencies to achieve its mission. Each agency also is working to determine the needed knowledge, skills and abilities that will be the basis for a staffing strategy.

Focusing on mission and people capabilities demonstrates the importance of recruiting and competing in the labor market. Salaries are central to that strategy. Agencies need a salary system that gives them flexibility to offer adequate salaries to individuals with mission-critical knowledge, skills and abilities. In this new environment, the GS system is a dinosaur that does not meet the challenge.

PRINCIPLE

Salary management must be a manager's responsibility. Agencies will provide the leadership and training support to enable managers to develop required skills.

Day-to-day decision making and effective people management are the heart of salary management. Agencies and their managers are best positioned to make and be responsible for such decisions, while Congress is responsible for funding the salary system and prescribing the philosophy and core principles that govern it. OPM should take the lead in operationalizing the principles, planning a broad basic boundary framework, assuring that adequate salary surveys are conducted and providing guidance on salary management. This delineation of responsibility is similar to the way that corporations manage their salary systems. Additionally, each agency must develop policies and procedures to manage employee salaries consistent with the principles listed in this report and merit principles within the framework developed by OPM and OMB. Agencies will be responsible for preparing managers for this new responsibility.

No major private corporation delegates complete responsibility for salary management to its operating units. For companies that operate in several industries, salary systems may reflect differences in industry practices but headquarters human resources staffs maintain centralized oversight. In the federal context, OPM must monitor and oversee how well agencies manage salaries.

Great Britain's experiences with evolution of salary management seems to echo this. The following appears in a recent article in a UK journal.

> Over the past year the Treasury has obviously listened to some critics of its previous views on localization. And last summer the chancellor changed policy by saying that local variation should occur within national frameworks.
>
> In new guidance in January, the Treasury demonstrated growing awareness of the pitfalls of localization. In practice, extremely devolved practices are not desirable. There are the risks of workers being treated differently for no good reason other than subjective variation in judgment or local affordability.There could be dangers of leapfrogging and parts of the public sector competing with each other for the best staff. [23]

Human Resources Must Lead and Support Salary Management

The recommended system for classification, performance management and salary management requires a new set of skills not presently available in the federal human resources community. OPM must take the lead in identifying the skills set for compensation managers and providing the recruiting guidance and training necessary to build compensation

[23] "What's Next for Local Pay?" Alastair Hatchett, People Management Magazine, February 12, 2004, p.14.

management capabilities in the human resources workforce. This function will have a major impact on the performance of the organization and on payroll, one of the largest budget items.

In the private sector, the director of compensation position is commonly defined and staffed. In contrast, no similar position or role exists across the federal government. OPM recently has suggested that each agency create a senior performance official post to be responsible for SES performance management systems. The position could be expanded to handle performance management for all employees and be titled, "compensation and performance manager", as each agency would need to monitor the program and provide coaching and advice to managers. If defined similarly to such positions in the private sector, the manager would be responsible for the salary system, including classification in the bands, salary decision monitoring and performance management.

PRINCIPLE

The pay system will be based on prevailing market rates in the non-federal sectors.

This Panel agrees with OPM that that a salary system should be more sensitive to labor market trends. It may be that paying every employee at market levels would be prohibitive but agencies should be more competitive for mission-critical occupations. The Panel also recognizes that the entitlement culture undermines, or at least is inconsistent with, efforts to improve agency performance. Shifting to a pay-for-performance philosophy is in the best interest of the federal government.

Each agency should establish its own market alignment priorities. For example, every job series is not equally important to each agency's mission within the government-wide boundary parameters that would be defined by OPM. Within OPM parameters agencies should have the authority to increase the pay for selected jobs if the approach is consistent with their human capital strategy. They are best positioned to develop their own systems to identify and reward their best performers. In addition, they will need to maintain salaries that make continued federal employment attractive to their best employees.

PRINCIPLE
The new system must be acceptable to Congress and other stakeholders.

The new salary system also must be acceptable to stakeholders and elected officials. The history of the GS system cannot be ignored. Nor can the cost of transitioning to a new system. Title V must be changed and authorizing legislation must ensure a "clean slate." Congress and the White House must know that the salary system is consistent with their directives and that employee compensation is fair and reasonable.

Uniform Government–Wide Boundary Parameters

The Panel is aware of the interest in allowing agencies to develop their own salary systems. Congress already has authorized several agencies to do just that. However, the Panel believes that allowing every federal agency to develop an independent salary system would result in unnecessary fragmentation and trigger over time more problems than benefits. This includes the new Department of Homeland Security and Department of Defense systems. A banded salary structure with broad and flexible parameters can provide agencies wide latitude to manage salaries to satisfy organizational requirements. As such, the Panel believes there is a compelling argument for a broad unified federal salary system framework.

OPM should have a lead role with agencies in planning the new system's architecture and framework. OMB also should participate given the system's emphasis on salary management by managers. The Panel believes Congress is unlikely to authorize a new salary system until its Members understand the proposed changes in compensation philosophy and principles, the estimated costs and implementation plans and the authorities delegated to agencies. To ensure development of a system that meets agency and government-wide needs, OPM and OMB should create a task force similar to the one created by OPM to consider changes authorized by FEPCA. Agency chief financial officers (CFO), who must embrace and fund the new system, also should be represented.

Once implementation begins, OPM will be responsible for determining annual adjustments to the bands to maintain planned market alignments, monitoring salaries and increases at the government-wide level, and periodically evaluating the effectiveness of agency practices. There also will be the occasional need for new government-wide policies for things like making exceptions to normal band limits.

Within government-wide parameters, each agency should be responsible for assessing how salaries affect recruiting and retention, planning salaries, and defining policies and practices to manage employee salaries. The agency also should be responsible for developing effective performance management systems by developing policies, training programs and administrative systems. There will be the need to work closely with OPM and OMB to identify issues for study and to request supplemental market data. An interagency salary council should be created to address development of the government-wide framework and other shared needs.

Labor Market Issues

Two basic labor market issues must be addressed in the new system: locality differentials and occupation differentials. Both are essential to the system's acceptance and long-term viability.

Locality Differentials

OPM tackled the locality issue in 1989 following severe staffing problems in three cities: New York, Los Angeles and San Francisco. The original focus also was on job series where separate, local salary systems were common in the business world, primarily the office support and technician series.

An OPM-sponsored survey showed that the largest companies, almost without exception, rely on a national salary structure for exempt, professional and administrative jobs, and on local salary structures for clerical and other non-exempt employees. The emerging FEPCA locality system essentially provided a political answer, extending local salary increases to professional and administrative workers in 27 additional cities. [24]

The FEPCA locality system must be modified, but it is premature to speculate how the occupation-based bands will align with local salary differentials, which exist in every metropolitan area. A banded market-sensitive system will be more responsive and not require separate locality adjustments, except possibly for a few locations such as New York City, Los Angeles and San Francisco where differentials may be quite large and well above the national norm.

The survey methodology used by the Bureau of Labor Statistics for the locality system under FEPCA requires periodic local salary surveys. Because the methodology has been considered to be flawed, OPM originally used the surveys as precise measures of the differentials when

[24] Since FEPCA's enaction, other cities periodically have worked to secure approval as a locality area. Today, that is seen as an effective strategy to gain salary increases.

they actually were based on samples that have a natural error factor that affects the reported averages. In planning the new salary system, it will be essential to rely on market data that satisfy stakeholders, but the interpretation of the data will vary depending on how they are used.

An alternative is to recognize that survey data are not precise. Based on current estimates of the gaps determined by OPM, the following five groups depicted below would simplify the system. For the most part, metropolitan areas are within a narrow percentage range of what is best understood as the national average. Washington, DC salaries generally were close to the national norm for most occupations when the Bureau of Labor Statistics last collected job-specific data. This illustration depicts a tentative grouping of cities based on the deviations from salary levels in the Washington-Baltimore corridor.

These groupings maintain the current differentials but simplify the cumbersome structure and eliminate the need for frequent local area surveys. Based on experience with salary surveys, cities will not move from one group to another very often. The differentials will need to be determined again with new salary surveys; it has been several years since it was done. It is important to note that the differentials shown are considerably smaller than the percentages often cited in discussions. The percentages here are the differences when an area is compared with DC-area salaries used as the base. The salaries in most locality areas are within several percentage points of DC-area salaries (the error factors in the surveys are at least that large). At the same time, these percentages should not be interpreted as necessary to be competitive.

FIGURE 3
PERCENTAGE DIFFERENCE FROM WASHINGTON, DC "NORM"

-7.5%	**-5.0%**	**+/- 2.5%**	**+7.5%**	**+15.0%**
Indianapolis	Cincinnati	Washington	Hartford	San Francisco
Kansas City	Cleveland	Atlanta	Houston	
Orlando	Columbus	Boston	Los Angeles	
Rest of U.S.	Dayton	Chicago	New York	
	Huntsville	Dallas		
	Milwaukee	Denver		
	Pittsburgh	Detroit		
	Richmond	Miami		
		Minneapolis		
		Philadelphia		
		Portland		
		Sacramento		
		San Diego		
		Seattle		

Occupation Differentials

Occupation differentials are as important as locality differentials, if not more so. Currently only law enforcement specialists, engineers, medical officers and certain information technology specialists have separate salary schedules. However, the jobs and locations for which OPM has approved special salary rates entail 440 pages of documentation. Jobs as diverse as park rangers, nurses, computer operators, messengers, security guards and firefighters are on special rates at approved agency locations across the nation.

From a related perspective, a growing number of agencies are not covered by Title V or the GS. Congress several times authorized separate salary systems for what has become 53 percent of the federal workforce. This growing trend began when such financial agencies as the Federal Deposit Insurance Corporation were authorized to create new salary systems.[25] The Department of Homeland Security, Securities and Exchange Commission, and Department of Defense are the most recent agencies to receive similar authority. The Federal Aviation Administration and Internal Revenue Service previously were authorized to develop salary systems.[26] These congressional actions demonstrate that the GS system did not meet agency needs.

[25] Financial Institutions Reform, Recovery and Enforcement Act of 1989.

[26] The current total white-collar workforce in the agencies covered by Title V prior to the Act, is roughly 1.3 million. The agencies now authorized to adopt separate salary systems employ 694,000, or 53 percent, of the total.

A number of jobs should not be covered under this salary structure. Park rangers and security guards are the types of job series that would be paid under a separate salary system in other organizations, given their specialized requirements.

Multiplicity of Federal Salary Systems

A single salary structure no longer is a viable alternative. Given the current multiple schedules and special rates, it is apparent that the notion of the federal pay system as a single salary schedule has been a myth. It has proved to be impossible to pay federal employees across diverse occupation groups under a single schedule. The mishmash of separate structures and locality areas is symptomatic of a salary system that no longer works. Such decentralization is something that corporations would be unlikely to permit. The problems with the GS system make separate systems appear advantageous, but the evidence suggests separate systems that lack a common framework create significant problems, as well.

PRINCIPLE

The federal salary system will be implemented government-wide, but will be sufficiently flexible to enable departments and agencies to manage salaries to meet their mission needs.

The 1991 Academy report recommended a government-wide banded salary system based on 10 occupation groups, a recommendation endorsed here as a critical element of a federal salary system. Each occupation group has distinct labor market issues, making it important to have occupation-specific human resources systems. The specific ten groups should be reconsidered, but the rationale remains valid. For example, the information technology series was not identified as a separate group, but the market subsequently made that an obvious oversight.

Separate occupation groups will facilitate better control and management of limited funds. The most expensive way to manage salaries is an across-the-board or general increase. The increase inevitably will be too high for some occupations and too low for others. In other sectors, salaries are regularly assessed and adjusted relative to market levels and individual performance. Theses sectors aggressively avoid practices that provide increases not warranted by individual contribution or market pressures. Yet they also are willing to adjust salaries to respond to market trends or retain valued contributors. Occupation salary structures make it possible to manage salary adjustments more in accordance with an agency's human capital strategy.

Focusing on occupation groups will accomplish several objectives. First, groups will make it much easier to adjust the structures to maintain intended alignment with market pay trends. Second, this grouping will bring together people whose careers are affected by the same factors, such as new technology, and over time will facilitate the development of other occupation-specific human resources systems. Third, it will simplify salary management and ideally eliminate the need for special rates. Just a decade ago, separate structures would have made system management more difficult, but this will not be a problem with information systems available today. Separate salary structures represent a practical solution to a complex problem.

As stated previously, it would be advantageous to create occupational salary councils to plan and guide each separate salary system. Senior specialists and managers are best positioned to understand how pay should be planned and managed to meet federal needs. They could assume responsibility for planning salary surveys, defining career paths, developing performance management systems and assessing recruiting and turnover experience. This approach will affect how employees perceive the salary system as it will provide for consistent salary management among people in related occupations. Some employees may argue that their group is not treated fairly when the annual adjustments are determined, thus underlining the need to redefine the understanding of equity. Separate structures correspond with the market equity concept and provide for internal equity within the occupation groups.

In reality, the recommended occupation structures actually will tend to shift the focus some from internal equity to market equity, an important policy change. Internal equity will still be a basic consideration within the occupation groups, though employers must be responsive to market trends.

With occupation bands, people in the same job series and career level will be paid similarly within the band. An agency may decide to pay specialists more within the band to attract higher caliber people for mission-related reasons, but salaries and salary increase budgets will be developed using equivalent criteria. This is consistent with the principles of Title V. Creating this government-wide framework will enable the White House and Congress to retain control of the federal payroll and the basic principles of compensation management. The concept of management prerogatives is important to any management system. At the same time, agencies need the flexibility to identify their critical jobs and manage salaries so they can compete more effectively in national labor markets.

An agency may not be ready to shift to a banded structure for its entire white-collar workforce. Since the shift is accompanied by pay-for-performance, it should not occur until the agency is comfortable with how it handles performance management. Thus, the agency should defer the shift from the GS system and implement broadbanding on a scheduled basis over a period of years. The panel recommends that time limitation, of five years, be adopted to move the entire agency to the banded structure.

Broadbanding and pay-for-performance may not be seen as viable alternatives for a particular occupation group. One such group is law enforcement since few public employers have adopted a policy for these positions. At the same time, outstanding performers and poor performers alike serve in these occupations. It is worthwhile to assess the competencies and behaviors associated with high performance and use that understanding to help people improve their performance. Yet decisions related to one occupation group should not influence compensation for others.

On a related issue, some have argued that the switch to broadbanding is not warranted for lower level employees in the office support and technician job series. These arguments focus largely on the difficulty of developing and assessing performance measures for these workers that relate to an organization's goals. The Panel believes this omission would send the wrong message that coverage "would be more trouble than it's worth." The counterargument is that employees must understand that their performance is important. To conclude that any occupation should stay under the current GS system could send the message that the performance of employees in the occupation is not sufficiently important to push for change.

Broadband Experience in the Private Sector, the first report in this series, addressed the growing use of career ladders to define salary bands, with a separate band for each stage or level in the career ladder. This is consistent with the recommendations offered in the 1991 and the 1995 Academy reports. It is a simple, intuitively logical and credible basis for defining salary bands and managing salaries. As employees develop or expand their knowledge, skills and abilities and demonstrate they can perform at higher levels, this progress should be recognized with salary increases.

The previous Academy Panels offered recommendations that focused on career ladders with three levels and were confined to the GS' 15 grades. In a 2002 Academy review of the SES system, a Panel recommended creation of a dual career ladder, with a separate but equal track for the world-class experts that are found in a number of fields.[27] Doing so would add a fourth career stage and make pay for those individuals more competitive according to national labor markets. This Panel recommends

[27] *Strengthening the Senior Leadership in the U.S. Government.* National Academy of Public Administration, December 2002.

defining career ladders with four levels for selected professional and administrative job families, with a separate salary band for each level. Career ladders would have three levels for other job families.

Several job series–high demand information technology specialties, for example—have some world-class experts who command salaries that are well above GS pay levels. For job series that command premium salaries, the highest band should recognize the concept of a dual career ladder that makes it possible for the experts to be paid at the same level as their managers. This change will require overlap between this high level band and pay levels now reserved for the SES. Promoting individuals to this level must be managed closely.

PRINCIPLE

A streamlined band evaluation/classification system will be needed.

This principle carries with it the continuing need to group jobs by pay band. The process is dramatically simplified under this structure; classifying a job into one of four bands based on the level in a career ladder is straightforward. Jobs must be classified by job family, though there is a trend to define broader, more generic families. This principle makes it possible to use and promotes more generic position descriptions. The Panel believes it is reasonable and recommends using band descriptions as the classification focus. Broadbanding should also dramatically reduce the time spent on classification decisions because of its simplicity. [28]

There will be the need for separate bands for managers and supervisors in each occupation structure. Team leaders can be in the same band with their co-workers. There also are many employees who have titles that suggest managerial responsibility but who do not supervise subordinates. These titles should be changed to reflect the true nature of the work performed. More importantly, their salaries should reflect the true level of their jobs.

The Need for Occupation-Specific Survey Data

Once survey data are available, OPM should lead an initiative to determine how the bands are adjusted to reduce identifiable pay gaps,

[28] The Factor Evaluation System (FES) will no longer be needed.

which means that available funds will be allocated to strategically important occupation groups. When the gaps are understood, the cost to move salaries closer to market pay levels may be determined and a funding strategy may be developed.

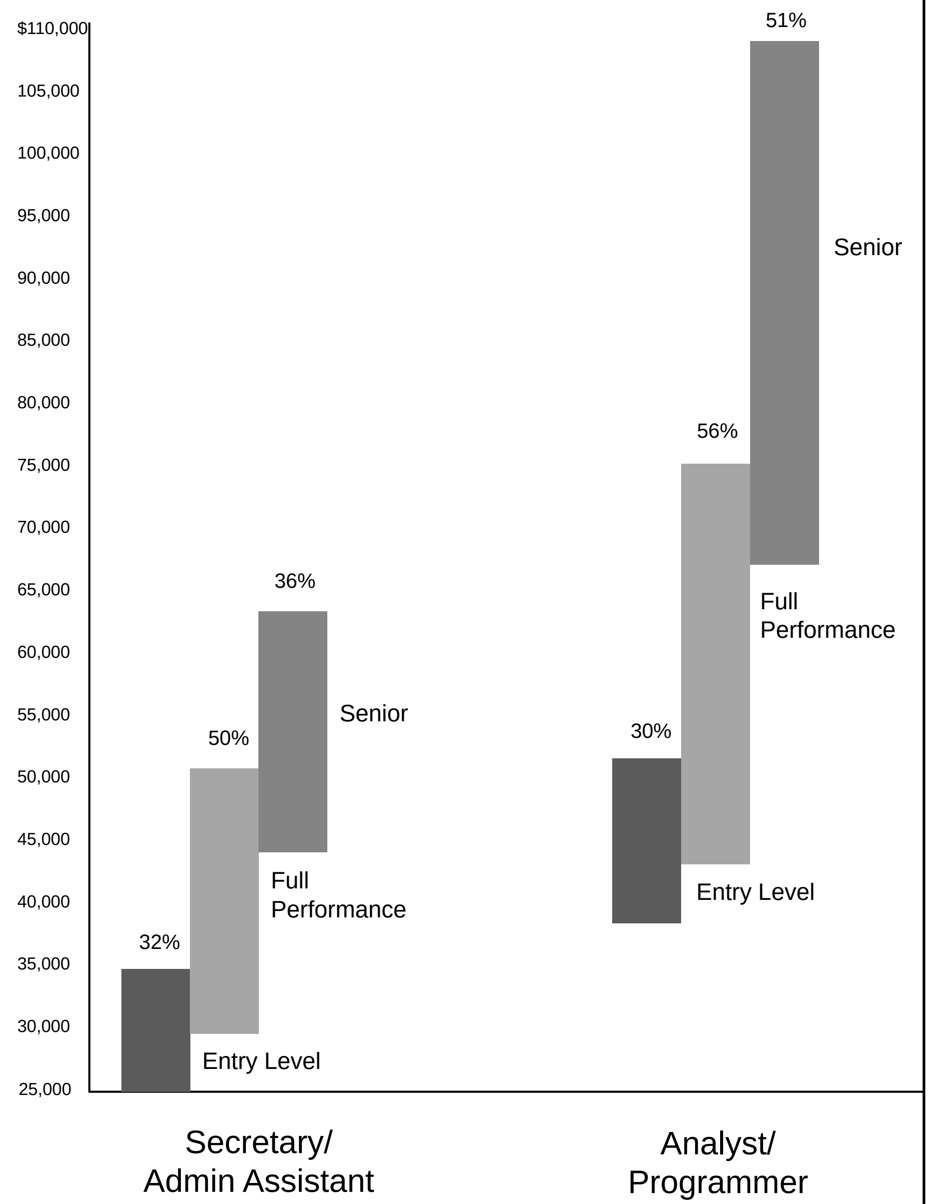
Based on the 2002 Pay Agent's report, the remaining gaps ranged from 15 percent to as much as 30 percent in San Francisco. The gap for Washington was estimated at 21 percent. In concept, these average gaps are based on the assumption that they are the same for all job series and levels. At the very least, this is the understanding implicit in the annual communication related to the gap. These assumptions result in an estimated cost of $8.8 billion to raise salaries to the levels originally planned under FEPCA.[29] In reality, some occupations are probably over-compensated, some adequately compensated, and others under-compensated.

Data needed to develop valid cost estimates do not currently exist, though the largest and most widely used survey for the Washington-Baltimore corridor provides a different snapshot of how federal salaries compare. This survey includes salary data for a broad cross-section of private and public employers. The data show clearly that some federal jobs are paid competitive salaries and that there is no justification for increasing salaries across the board. The data for selected benchmark jobs are included as Appendix A. There is a need for similar surveys in other cities.

[29] Locality Based Comparability: Annual Report of the President's Pay Agent, www.opm.gov

The following figure illustrates the band concept for two common job families based on market data.

FIGURE 4
ILLUSTRATIVE SALARY BANDS BASED ON MARKET PAY LEVELS IN THE WASHINGTON, DC AREA



Source: 2003 Survey conducted by the Human Resource Association of the National Capital Area

THE MANAGEMENT OF SALARIES WITHIN BANDS

PRINCIPLE

Salary adjustments will be based on individual performance/contribution and prevailing increases in the non-federal sectors.

Pay-for-performance is virtually universal for professional and administrative workers in the private sector. Conceptually, funds available for merit increases are determined separately for each occupation group based on current salaries and the amount needed to increase pay to market levels. The funds then are allocated across an organization based on payroll and set aside in a salary increase budget for each manager's use. Salary increase budgets are the focus of several annual surveys typically conducted in the fall for use in planning operating budgets for the following fiscal year.

In the recommended framework for the federal government, agencies would budget and manage salaries in a manner that is similar to business sector practices. Bands would be adjusted annually to reflect fluctuations in market pay levels; but generally this would be a lower percentage than the average increase in market pay levels. The reason is that some employees–poor performers, new hires or newly promoted employees in their first year and those at or close to the band maximum–would not receive increases, thus holding down the overall increase.

The amount budgeted for increases should be determined using market surveys. The increases would vary according to the occupation group with budgeted amounts planned to align with prevailing market rates. The business media regularly report on increase trends for high demand occupations, such as information technology and health care.

The pressure for occupation differentials led OPM to develop its structure of special rates. This pressure will increase over time as workforce demographics and projected agency retirements make recruiting an even higher priority. Mushrooming special rates, even with locality pay, are indicative of the problems of staying with a single salary structure. Separate occupation salary systems are one of few strategies that can accommodate market trend projections.

The Panel anticipates that salary surveys will show that certain federal job series are paid at or above market rates in some locations. Once the salary bands are based on surveys, the data will confirm that specific jobs are paid above market. Figure A.1 is an example. Those jobs should not be eligible for a full salary increase, but be limited to a maximum annual increase of 2 percent until the bands are raised above the individual's salary. So long as the gap for essential occupations is large, there is no justification for misallocating limited payroll dollars to less important occupations.

It will be important to develop occupation salary budgets consistently across government. Any variation by occupation would violate the government-wide pay system philosophy because agencies that influenced or controlled the salary budget could create a "have" and "have not" scenario as agencies would work to convince Congress to grant them increases.

While the panel supports creation of government wide boundaries for pay, it does not appear practical or sound to mandate a government-wide formula for granting performance increases. There are differences in how to handle salary increases among common occupations. For example, merit increase practices are rarely used with law enforcement specialists. Moreover, agencies should be able to develop their own performance management systems and define how to link performance to pay. Each agency can determine how the increases will support its goals and needs if the funds for increases are budgeted consistently.

This budget would pay merit salary increases for eligible employees, a zero sum game where higher increases for some will mean lower increases for others. The basis for an increase is the employee's annual performance rating. Overall, the typical increase must be close to the budgeted amount.

PRINCIPLE

Performance management systems that identify the "outstanding", "meets expectations", and "unacceptable" employees will serve as the foundation for the pay-for-performance component of the pay system.

Given OPM's intent to certify performance management systems, agency rating systems should be based on best practice thinking with employees rated on performance (or results) and competence. The ratings should differentiate among performance levels and identify "star" performers, those who meet expectations, and those few individuals who do not meet expectations. All three groups warrant special management consideration, which suggests that performance-rating scales have at least three levels. Agencies should be free to adopt their own rating scales with three being the practical minimum. These are system planning decisions that agencies must make. The only common characteristic is that a worker rated "meets expectations" for his or her occupation group as based on the annual survey should expect close to an average increase.

Until the recent recession, private sector merit increase budgets ranged from 4 to 4.5 percent of payroll. Excluding new hires, recently promoted staff and poor performers, who would not be eligible for increases, the average increase might be closer to 5% of payroll. The best performers typically would receive an increase of perhaps 8 percent.

HUMAN CAPITAL PERFORMANCE FUND

OPM's Human Capital Performance Fund, approved by the 2004 Defense Authorization Act for government-wide application, suggests that an agency's highest-level performance category should be limited to 15 percent of its workforce. This amount is consistent with research findings and generally consistent with the number of private sector workers rated as outstanding. The Act's intent is to provide an incentive for agencies to be more discriminating in identifying and rewarding the highest performers and the Fund is related to OPM's plan to certify SES performance systems. Yet with a government wide performance-based pay system, a government-wide fund would be superfluous.

The Panel recommends that each agency establish its own performance fund. Management would set aside approximately 0.5 percent of payroll for awards to star performers. Dedicating this amount in a separate fund would make supervisors' decisions somewhat easier as it would alleviate the zero-sum dilemma. The supervisor no longer would be obligated to find the funds to reward these performers which would, in turn, hold down the increases themselves. If star performers were limited to 15 or 20 percent of the workforce, the added increase would be 3.3 or 2.5 percent, depending on how many employees earned the money. If the average increase, for example, were 4.0% then the star performers would earn 7.3% or 6.5%. As the number of recipients increases, the size of each award decreases, a pattern consistent with typical industry differentiation.

Several prominent companies, such as GE and 3M, have recently adopted a forced distribution policy to differentiate performance ratings. The distribution may not be a normal or bell-shaped curve, but it is designed to limit the number of high ratings and require that a percentage of employees be rated as unacceptable. The intent is clear: Reinforce the importance of good performance.

PRINCIPLE

The system must be managed in a fair and equitable manner. Each department and agency will have a streamlined process to assure quick reviews of disputed band classification and performance rating decisions.

Managers and employees will determine the success of a pay-for-performance policy, and they must consider it to be a top management priority, not merely "another HR initiative." They also must believe that top management wants employees to be treated fairly. Further, the performance management system and performance criteria must be reasonable and credible. Employees are more likely to accept the change if they consider it to be a well-conceived policy expected to benefit the organization. Success stories across the federal community demonstrate that pay-for-performance can be effective.

The panel believes that employees are more likely to accept salary increase decisions if there has been “procedural equity,” meaning that the procedures used to determine salaries and increases are fair. That has been a central issue in resistance to merit pay and a new federal salary system. Nonetheless, it can be tackled directly when an agency plans a new system, policies and practices.

Performance management and pay-for-performance are more effective when they affect everyone the same way. In most corporations, senior executive compensation is determined by company performance and the performance of those who contribute to achieving function-specific goals. Focusing on performance goals cascades through the organization, and serves as the basis for managing performance. Employees who understand how their work contributes to organization performance are more inclined to accept performance goals. Financial rewards, linked in part to organization performance, contribute to a culture where people focus on planned results.

Performance Management Champions

The probability of success for this policy change will be much greater if agencies have one or more executives who are committed to making it happen. To support these leaders, agencies should identify someone who is responsible for managing the performance management system, championing the change, and working aggressively to ensure that managers and supervisors understand their responsibilities and have the support they need. Everyone across the organization should have training and other techniques to advance the effective implementation of this culture change.

OPM has proposed the creation of the senior performance official to play this role. Its initial responsibility will be limited to the SES changes but there is an even more compelling argument for a much larger role in coordinating and championing the shift to pay-for-performance. This role, regardless of title, is absolutely critical.

Internal Agency Review and Resolution Process Needed

Agencies must ensure that broadbanding and pay-for-performance operate fairly. First, they should provide for timely internal reviews of disputed performance ratings as part of their performance management plans. Second, they should establish processes for expediting reviews of employee challenges on assignments to occupation groups and bands. Third, they should regularly monitor the aggregate results of performance ratings and pay increases to determine if any group is adversely impacted, and take any appropriate action.

The change to a pay-for-performance policy is a "chicken-and-egg" problem in some respects. The federal track record shows clearly that supervisors find it all too easy to inflate ratings to satisfy their people when performance ratings have little impact. Those patterns cannot continue. Managers must change their behavior and employees must change their expectations. OPM's proposal to certify performance systems is a useful first step. Federal agencies have not yet shown that they are uniformly capable of developing effective performance systems on their own. Making "new" funding available to agencies that demonstrates an effective system would be a powerful incentive. Managers and employees need a reason to make any new system a success.

Despite the negative perception of merit pay across the federal community, there are several success stories shown by the panel in Report 2 of this series. In the private sector, pay-for-performance is deeply entrenched and is an important tool to recognize and reward valued employees. As a prominent global trend, it supports the pressure in government to make people accountable and focus on results.

Periodic Program Evaluation

Agencies should conduct manager and employee surveys annually to assess how well the new salary and performance systems are working. It will take several years for them to gain acceptance and work as planned. Ideally, the initial surveys should show improved perceptions and indicate where corrective action may be needed. Multi-year comparisons of agency performance would be useful to track so that the impact of the new systems can be evaluated.

OMB and OPM have a joint responsibility to periodically confirm that the changes achieve the Administration's management goals. They should review and evaluate the new systems. This should assure effective operation of the systems and discover the need for policy changes.

OVERVIEW OF ACADEMY PANEL RECOMMENDATIONS

- **The new federal salary system should be based on the concept of broadbanding, with salaries managed within the bands and grounded in pay-for-performance principles.**
  - Several federal agencies have successful salary systems that are consistent with the recommended principles. Broadbanding and pay-for-performance have been the program model of choice whenever an agency has proposed a new salary system. It is a simple concept that is less bureaucratic and more responsive to market trends and organization needs.

- **The system should be government-wide and apply to all white collar positions currently covered under the GS system.**
  - Broadbanding provides sufficient management flexibility to satisfy agency requirements. A government wide broadbanding framework is consistent with the history of federal human capital practices and satisfies some of the concerns with equity and fairness. The Panel appreciates the differences in agency missions and workforce requirements, but it is certain that the recommended strategy for defining salary bands will meet each agency's needs.

- **Each department and agency should be responsible for managing its employees' salaries within a government-wide framework.**
  - Salary management is a basic element of human capital management and a central consideration in recruiting and retaining qualified employees. Within the government wide framework agencies need the authority to set salaries and use available salary budget dollars consistent with their staffing plans. They also need to develop performance management systems that support their values and operating plans. Salary bands will provide the flexibility that agencies need and ensure basic equity across government.

- **The system should have separate sets of bands, aligned with prevailing market pay rates, for several broad occupation groups.**
  - Salary management will be most effective over time when pay practices can be modified to reflect market trends for specific occupations and job families. Although it is premature to recommend the job series for specific occupation groups, the concept is consistent with the structure and rationale of the federal classification system. Thus, it should be familiar and transparent to all employees and stakeholders. It also will support occupation-specific performance systems and related human capital policies. Perhaps more important, it will group employees who share career expectations and values, and ensure equal opportunity for people in similar jobs.

- **The Office of Personnel Management should be responsible for establishing the government-wide boundary framework, identifying the occupation groups, establishing the salary bands for each group, planning annual system adjustments, and monitoring agency salary practices.**
  - This role is essentially the same as a corporate holding company staff in a large, diversified company. There is a need to periodically evaluate system effectiveness.

- **The Office of Personnel Management should be responsible for the development of a strategy to collect adequate labor market information, for its analyses and for using the data to align salary bands with prevailing market salary levels.**
  - Job-specific market data have not been available for several years. There is evidence that "pay gaps" are not as large as once estimated. Nonetheless, market data are essential for sound salary management if the goal is to pay employees competitively. The need to be more responsive to market trends is one reason to focus on occupations.

- **There will be a continuing need for locality pay in some situations. However, locality differentials should be less prominent when salary bands are better aligned with market pay levels, making it possible to simplify the system.**
  - Initial locality pay thinking focused on a small number of high pay areas. That is consistent with the practices in large, multi-location companies. Salary bands provide considerable flexibility to respond to local market trends with individual adjustments.

- **Salary bands should be aligned initially with the GS ranges to facilitate conversion and control costs. Annual adjustments then should be based on labor market analyses. Agencies should develop salary increase budgets using market data and guidance provided by OPM and OMB.**
  - Salary increase budgets are an important reason for government-wide planning. This recommendation is consistent with practices in large corporations.

- **The transition from the GS system to the banded structure should be completed within five years. Agencies should be allowed to develop their own schedule based on their human capital plans, budgets and performance management systems. Employees should receive credit toward their next within-grade increase and transfer to the bands at that pay level. No employee should lose pay with the conversion.**
  - One advantage of broadbanding is that the impact on payroll at the point of conversion can be controlled. The initial conversion should be cost neutral.

- **Agencies should be accountable for planning and implementing performance management systems that identify outstanding performers, those who meet performance expectations, and employees who fail to meet expectations. The systems should demonstrate a clear linkage or "line of sight" to the agency's mission and operating goals.**
  - Non-government sector experience suggests that performance systems are more credible and readily accepted when standards are occupation and job specific. There is compelling evidence

that involving employees in planning and defining performance measures will enhance "buy-in" and acceptance.

- **Each agency should define a new position to provide support to managers in implementing new performance systems and dealing with day-to-day pay and performance issues. Given OPM's proposal to create the senior performance official position, it makes sense to combine the responsibility for Senior Executive Service performance issues with the management of non-executive staff performance.**
  - This position must be high profile and have the solid support of agency officials and credibility to provide leadership during this difficult transition. The individual will not be responsible for making the new practices a success—this function remains a line management responsibility—but this official must be a catalyst and champion for change.

- **Agencies should provide adequate performance management training to managers because managers are responsible for implementation. Pay-for-performance decisions should be based on salary budgets, performance ratings and agency policies.**
  - Managers must know that performance management is a priority that has solid agency support.

- **Both OPM and agencies should develop communication strategies, key to the success of the systems. The strategies should include delineation of the process used to develop policies and practices.**

- **The rollout of the new systems should be managed as organizational change. Managers and employees, the primary stakeholders, should be involved in the process.**

APPENDIX A
LABOR MARKETS AND SALARY SURVEYS

The balance between supply and demand for specific knowledge and skills determines pay levels in labor markets, which themselves are defined by geographic area and the mix of employers in that area. For example, Houston has many energy companies, so its occupation mix and pay patterns are much different from Philadelphia, where health care and education are dominant employers.

For lower level, clerical and manual jobs, the labor market often is limited to the few miles that surround an office or plant. Those workers tend to live only a short distance from their workplace. For executive and management level jobs where industry-specific knowledge is important, the market usually is nationwide in order to find the best talent. For many professional and administrative jobs, markets sometimes are defined as regional, though web-based recruiting results in employers receiving applications from across the nation. Top companies traditionally recruit nationally for the best college graduates.

Public and private sector labor markets have important differences. Some jobs are fairly unique to the private sector; companies must concentrate on tax management, marketing and stockholder relations. Public employers must concentrate on national defense, law enforcement and education. Other occupations are common to both sectors, such as budget management and human resource management. Even for these occupations, however, it can be difficult to move from one sector to the other.

Employers must understand their labor markets and their near-term demand for talent. Aligning salary levels with prevailing market levels is important to the development of their human capital management strategy. Salary may not be the only reason why people accept job offers, but pay levels clearly affect an employer's ability to recruit and retain qualified employees. For this reason, ongoing analyses of market pay levels are key to managing salary systems.

Understanding labor markets provides the rationale for using salary survey data. Prior to pay reform, OPM relied on a national salary survey conducted by the Bureau of Labor Statistics to adjust the GS. Yet the strategy ignored pay differences across the country. Enactment of FEPCA introduced the concept of making local metropolitan area adjustments so that GS ranges would be more competitive in high pay areas. The legislation anticipated that survey data would be aggregated separately in each area to determine a weighted average salary for workers in selected occupations. That number then would be compared with the weighted average for federal workers in the same occupations.

This approach would allow for the identification of gaps, which is the basis for determining the increase needed to move GS salary ranges to market levels. The analyses changed when the Bureau stopped surveys based on benchmark jobs. Once the survey methodology was changed, the employment cost index was used to adjust GS ranges. OPM no longer has the survey data to determine pay gaps for specific jobs or occupations.

Recognizing differences in local area pay levels was an important and politically difficult step, but it was accepted that these differentials did not fully address the GS system's market deficiencies. In its white paper, OPM noted that economic forces also can cause differences and rapid changes in labor market rates across occupations, pay grades and individuals, and within an occupation.

Businesses are ready to compete for talent and competition drives up salaries. They recognize the importance of their human capital and the knowledge and skills needed to compete in product or service markets. Trends clearly show that people in high-demand occupations like information technology enjoy more rapid salary increases than those where demand has waned. This dynamic would dampen pay increases for data entry operators or file clerks, but would drive up pay rates for health care and information technology specialists. Hard knowledge occupations such as engineering have benefited from an imbalance of supply and demand for several decades. As technical developments emerge, individuals who demonstrate an understanding of them would enjoy above average increases.

Supply and demand considerations also dictate that better qualified employees can command higher pay rates. Fresh graduates from highly regarded colleges and universities generally start at higher salaries than those from less prominent institutions. Individual capabilities are difficult to assess during the recruiting phase, but credentials are always important.

Analyses of salary survey data show a clear distribution, with a range of salaries for those in similar jobs. Surveys tend to focus on average salaries but some job incumbents are paid much more, and others less, than the average. Most employers pay average salaries but some pay at the 75th percentile level under the assumption that doing so will enable them to recruit above average people. An appreciation for how pay levels affect the quality of applicants is basic to salary planning.

Figure A.1 provides salary data for selected benchmark jobs and illustrates the labor market challenge. These data are from a 2003 local survey, the largest one focusing on the Washington-Baltimore area featuring data from several hundred private and public employers. The results are far from consistent. The average gap for this limited group is 7.2 percent. Of the 36 jobs shown, the average federal salary for 12 of them actually is higher than the non-federal average. In the 2002 pay agent's report using Bureau of Labor Statistics date, the gap for the DC area, was 21.3 percent. Yet the survey data depicted here show only three jobs where the gap exceeds 20 percent. It is important to note that the survey does not have benchmark jobs that are unique to the public sector.

FIGURE A.1
COMPARISON OF FEDERAL AND NON-FEDERAL SALARIES IN WASHINGTON-BALTIMORE CORRIDOR

	Federal Salaries		DC Area Survey Salaries			
	Average	% Gap	Average	10th%	90th%	
Incumbents						
Accountant I	$35.4	-17.8%	$41.7	$34.6	$49.8	473
Accountant II	40.4	-16.8%	47.2	38.4	57.0	753
Accountant III	53.3	-7.5%	57.3	46.1	69.6	618
Budget Analyst	42.5	-18.4%	50.3	39.8	64.8	137
Sr. Budget Analyst	69.3	9.20%	62.5	48.2	83.6	204
Internal Auditor	45.9	-25.5%	57.6	45.5	67.8	89
Benefits Specialist	36.3	-19.3%	43.3	34.3	52.0	167
Sr. Benefits Specialist	61.5	6.2%	57.7	45.0	72.0	107
Sr. HR Generalist/HR Manager	84.7	14.0%	72.9	52.5	102.8	235
Analyst/Programmer I	41.7	-23.3%	51.4	40.0	62.0	866
Analyst/Programmer III	50.6	-38.5%	70.1	56.7	82.6	1,634
Analyst/Programmer IV	68.9	-17.7%	81.1	68.1	95.0	1,286
Analyst/Programmer V	84.7	-12.1%	91.7	78.2	107.0	753
Network Analyst I	50.6	6.6%	47.3	37.2	58.2	139
Network Analyst II	57.6	-3.3%	59.5	47.7	74.1	328
Network Analyst III	76.4	12.3%	67.0	54.1	81.6	267
Network Systems Engineer	66.5	3.2%	64.4	53.0	78.9	55
Sr. Computer Systems Admin	66.5	-5.0%	69.8	55.0	84.9	247
Sr. Database Administrator	76.4	-14.4%	87.2	66.7	105.0	282
Applications Development Mgr	86.8	-13.7%	98.7	77.2	120.5	166
IT Project Manager	86.8	-7.7%	93.5	70.5	122.0	452
Systems/Electronics Engineer IV	83.4	-5.6%	88.1	72.8	103.1	743
Systems/Electronics Engineer V	97.6	-5.4%	102.9	84.2	123.3	853
Systems/Electronics Engineer VI	115.6	3.0%	112.2	91.4	140.5	297
Mail Clerk	27.2	1.1%	26.9	21.3	34.3	402
Admin Assistant/Secretary I	25.3	-19.0%	30.1	24.3	36.9	1,181
Admin Assistant/Secretary II	31.0	-14.8%	35.6	28.1	44.3	3,234
Admin Assistant/Secretary III	34.8	-18.6%	41.4	32.4	51.5	3,205
Executive Assistant/Secretary	41.6	-15.9%	48.2	37.4	58.8	1,594
Sr. Staff Nurse	68.1	-1.9%	69.1	58.3	79.3	804
Medical Technologist	50.1	11.6%	44.3	36.2	51.8	834
Staff Pharmacist	69.9	-12.7%	78.8	71.7	85.1	381
Purchasing Assistant	34.9	2.9%	33.9	25.4	43.8	107
Sr. Buyer/Planner	61.9	5.2%	58.7	43.4	75.9	84
Economist	88.2	-13.2%	99.8	82.6	110.6	187

Source: Survey conducted by the Human Resource Association of the National Capital Area, 2003.

The rates in Figure A.1 illustrate a key point: The gaps cover a broad range, from plus 14 percent for the Human Resources manager to minus 38.5 percent for the Analyst/Programmer III. Clearly an across the board increase of 21.3 percent is not warranted as the HR managers will be overpaid and the Analyst/Programmer underpaid.

The data show that the gaps tend to be larger toward the bottom of the career ladders. For example, the gap for Accountant I is 17.8 percent while it is 7.5 percent for Accountant III. This supports the contention that starting salaries are quite low but that rapid early promotions raise salaries for employees at GS 12-13 to more competitive levels. Comparable data for other metropolitan areas generally are not available, though most cities have such surveys. It is likely that they would show some similarly disparate gaps.

It is important to understand that a salary survey is a snapshot of salary rates at a specific point in time. Supply and demand represent a dynamic process that determines the pressure for salary increases over time. Salaries for job families where demand exceeds supply can be expected to experience above average increases while others will be below average. The essence of salary planning is tracking the gaps and allocating salary increase funds to close the gaps when possible.

Job families where employment is limited to public employers generally have experienced below average increase rates. When all occupational groups are paid under the same single salary schedule, the pay gap for high demand occupations can only increase.

Even when public employers adopt fully competitive salary increase budgets, the gaps will increase for occupations like engineering and health care specialists where demand is high. Differences in market increases are the reason for separate schedules for these types of occupations and for procedures to establish special rates. Corporations often use separate schedules for office support positions, as well as for information technology and engineering. There is a trend to adopt separate salary schedules for other occupation groups in the private sector. It is important to emphasize that federal agencies have a much more diverse group of occupations, including many only found in government.

Alignment with market rates is key for the reasons discussed above. Yet alignment only is one piece of the puzzle. Market rates increase over time and salary structures must be adjusted annually to maintain the planned alignment. Experience with FEPCA and the failure to budget the amounts needed to close pay gaps suggest that a longer-term perspective is critical.

Labor market dynamics are the primary reason for recommending separate banded structures for occupation groups. Some occupations always experience above average increases in pay, while others are well below the average. The typical practice is to analyze survey data to determine the gap for each benchmark job and to use the value to estimate the total amount needed to raise all salaries to planned market levels. Assuming an organization can afford the increase in payroll, the total is the salary increase budget for the following year. A separate analysis and budget should be completed for each occupational band schedule.

Nonetheless, an immediate shift to a more market-sensitive pay system may be difficult. Among the reasons:

- No existing salary survey would satisfy federal requirements. The national surveys that do exist have far smaller databases than those managed by the Bureau of Labor Statistics. Moreover, these surveys tend to be private sector in nature; data reported by state and metropolitan area are sparse, unsystematic samples. Also, larger companies do not commonly participate. When statistics from different surveys are compared, the results are inconsistent, attributable at least in part to the relatively small number of companies in some cities.

- The Defense office that conducts surveys for the Federal Wage System conceivably could conduct the annual surveys. Its work is far more extensive than any private sector survey organization, yet the wage surveys serve a different audience and satisfy a different standard than the Bureau of Labor Statistics surveys. Significant methodological changes in both would be needed to develop acceptable market data for covered occupations. The Society for Human Resources Management also conducts surveys for the private sector and might be willing to partner with OPM to do federal surveys.

- Consulting firms routinely conduct salary surveys but only two–Mercer and Watson Wyatt–conduct broad-based national ones. However, corporations use the statistics reported in both surveys as secondary or supplemental data. As with Defense, these firms would need to undertake major changes to satisfy federal quality requirements.

- The traditional methodology used to adjust the GS system focused on a limited number of jobs known to exist in the public and private sectors. Only a couple benchmark jobs from occupations were limited to government employers: firefighters and corrections officers. As long as private sector jobs dominate the survey, inflated salaries for public sector occupations may result. This may be an appropriate pay strategy from a public policy perspective, but it can deviate from a market-based pay strategy.

- A new survey is needed, but it is likely to face resistance from employers that are asked to participate. Hundreds of surveys are conducted annually, and it may prove difficult to convince an employer that participating in another one is a good use of time. Often, key to convincing them is that the data will have value. Another challenge is the lack of trust in providing information to government. The survey must be planned carefully to gain adequate participation.

- Policy changes that take prevailing market pay levels into account will entail a shift in how salary increase dollars are allocated. Assuming there is no "new money" for increases, more money must be allocated to jobs and job families where the gap is largest and taken away from those where the gap is smallest.

- Pay gaps have not been determined in the decade since the Bureau of Labor Statistics stopped conducting surveys based on benchmark jobs. New benchmark data, once assembled, may show that some federal jobs are paid much better than thought. Despite a commonly accepted understanding that all federal employees are badly underpaid, piecemeal data from other surveys show this is not universally true.

The problems may be difficult to resolve, but answers can be developed. One overriding issue is understanding market equity and how to balance it with other factors. Another is the need for federal agencies to recruit and retain qualified people. Upcoming retirements will be significant and hiring data suggest that agencies have had trouble filling job openings with individuals who have the promise to be successful. Staffing issues for mission critical skills, particularly related to national security, make it imperative for federal agencies to be more competitive.

Until survey data are available, it will be difficult to foresee how changes can be planned in the GS system. No change should be considered without understanding how federal salaries compare with those paid by other employers. Understanding labor markets also will enable agencies to make better use of limited funds. A salary system cannot be managed in a vacuum.

APPENDIX B
PAY-FOR-PERFORMANCE

Labor market policies dictate that a third party will be responsible for developing market data. In contrast, pay-for-performance policy is predicated on delegated decision making to agency managers and supervisors. The salary increase policy may be controversial, but the pay policy cannot be successful if the performance management system is ineffective. Factors that influence the performance system are far different than those that affect the salary system. However, both are linked when ratings determine salary increases.

It is likely that pay-for-performance will be adopted as a key component of any new federal pay system.[30] It has been central to every demonstration project and in cases where agencies were authorized to develop new human resources systems. At the same time, this change will be challenging, especially given employee anxiety and skepticism. Yet the demonstration projects have produced solid evidence, including more than 20 years' experience at China Lake, that the concept can be successful in federal work settings.

Making pay-for-performance successful is more difficult to do in the public sector than in the private sector for several reasons.

- Performance ratings and merit increases are treated as confidential in business, making it easier for a supervisor to give honest feedback and communicate an unsatisfactory rating.

- In the federal environment, employees have the right to appeal portions of the performance ratings process. Some may claim the problems are legitimate if a supervisor has rendered an unfair or unclear decision. The right to appeal is much more limited in the private sector.

- Existing performance management systems are not fully adequate in the public sector, a problem compounded by inadequate training for supervisors. Performance systems cannot be successful in a culture where good performance is not a top priority.

- There is scattered evidence that federal employees do not trust their agency's career and/or political management, making it more difficult to promote the shift to a risk-and-reward culture. This is compounded by general federal employees belief that they are underpaid and are entitled to higher salaries.

[30]The common understanding of "pay-for-performance" is broader in government than in the private sector. In the latter, it refers to individual or group incentive plans, such as gainsharing. "Merit pay" refers to differential salary increases linked to performance ratings. In the public sector, "pay-for-performance" is used for both practices. On a related note, "contribution" is not well defined but increasingly is used as a replacement for merit pay.

- Private sector managers work in an environment where performance is a daily priority; they know individual performance is linked to the organization's success. They are accustomed to rewards for their performance and know that managing performance and employee pay is fundamental to their job.

A slowly disappearing distinction is the business world's focus on performance goals and results. When planned results are the basis for performance evaluations, it is easier to rate individual performance and defend the rating. Federal agencies do not have as much experience with performance planning and measurement, but they are developing increasingly effective practices. The next step is to link agency performance goals and measures to individual performance. This step is central to the new SES changes and to a pay-for-performance system.

Some experts argue that desired or expected results can be defined for any job. They also contend that focusing on results makes it possible for the supervisor and employee alike to track performance throughout the year, take action to change plans as necessary, and discuss year-end results. Evaluating performance relative to planned results is widely accepted. Perhaps more important, focusing on results gives people a sense of satisfaction and accomplishment. These practices represent a significant change for some federal agencies, but success stories suggest that hurdles can be overcome and practices accepted.

Corporate best practices base individual performance management on the "what" and the "how"—the "what" being the planned results or performance goals and the "how" being the assessment of individual competence. Assessing results is a retrospective evaluation, while focusing on competencies provides a forward-looking perspective of individual strengths and weaknesses. The combination of both assessments provides a balanced view of an individual's contribution.

Federal agencies appear to be ready for the competency side of the performance equation, as several have begun to develop competency-based human resources systems. The use of competencies in this respect differs from their use in selection systems. Managers and supervisors handle performance management across an organization, and they need to be comfortable with the rating process. With selection systems, a human resources specialist may play a prominent lead or supporting role and work with line managers in assessing candidates. The use of competencies is new and evolving as employers gain experience. Managers need support when making rating decisions.

Performance management works best, as do employees, when performance criteria and expectations are job specific. Each job has specific duties, planned results and requisite knowledge, skills and abilities. Generic performance standards may save time, but they diminish the criteria's relevance. The shift to occupation pay systems will facilitate the development of credible performance systems. The basis for evaluating an engineer is logically different than for a nurse, and should be reflected as such with performance management.

Although not a prominent consideration, performance systems are subject to the uniform guidelines and equal employment requirements because ratings affect promotion decisions. The courts have not studied appraisal systems closely; generally, however, job-specific performance criteria would make it easier to defend ratings, which is especially important in the grievance process.

Supervisors also find defending performance ratings to be important, as well. Researchers have tried to develop rating models that are valid and reliable without any lasting success. Dr. W. Edwards Deming highlighted one of the common problems: One supervisor might rate an employee's performance at one level while another supervisor might rate the same performance differently using the same criteria. The supervisors could be consistent or reliable in their ratings but their failure to agree is a problem.

Federal agencies must decide how to link pay to performance or contribution. Employees who perform at planned or expected levels should expect a normal increase, star performers a somewhat larger increase, and those less than fully adequate a smaller or no increase.

Shifting to pay-for-performance highlights the need for someone in each agency to "manage" the performance management and salary increase systems. Corporations have someone who fulfills this role, which is more administrative than managerial, but is well prepared for performance management. It rarely represents a radical change in policy for a company. OPM's proposal to create the senior performance official post is consistent with the organizational change needed to support effective performance management and pay-for performance. The position should enjoy a broad mandate to influence how an agency manages the changes and have the credibility to be a champion for the change agents.

BEST PRACTICES IN PERFORMANCE MANAGEMENT

A recent study by Dr. Edward Lawler, one of the recognized experts in pay and performance management, focuses on practices that contribute to the effectiveness of systems used to manage employee performance. The study was triggered by the recognition that it is difficult to manage human capital without a system that measures performance and capabilities needed to achieve organizational goals.[31]

Study respondents were human resources managers who work in medium or large corporations. The practices identified as most effective were those that enabled the organization to reward top talent and identify poor performers. The sequence of practices is based on impact.

[31]Source: Study by Dr. Edward Lawler and reported in WorldatWork Journal, Vol. 12, No. 2, 2003.

Ownership of performance management by line managers. How managers handle performance management is key to system effectiveness. They need to take control.

Training for managers and individuals being appraised. Both managers and employees need to understand the process, their roles, and the skills and behaviors important to the process. The training also contributes to accuracy of the ratings.

Leadership by top management. Executives need to demonstrate their strong commitment to the performance system, the importance of high performance and the associated culture changes.

Performance goals that are driven by business strategy. Most companies rely on individual goals with explicit ties to the strategy. The best practice relies on goals jointly set by managers and employees. The linkage helps to justify the ratings.

Ongoing feedback from managers. Employees should receive regular feedback on results and their performance throughout the year.

Use of competencies, development planning, and assessments of how individuals achieve their results. The feedback should focus on the individual's strengths and weaknesses and involve development planning to improve future performance.

Ties between financial rewards and performance ratings. In order to manage the budget for salary increases, managers need to differentiate among their people.

Calibration meetings for managers to compare and level ratings. When managers meet to discuss performance ratings, it strengthens the credibility and validity of the ratings and reinforces the perceived importance of the process.

Use of e-HR appraisal systems to integrate performance management. Web-enabled systems facilitate the integration of performance data with performance plans and ratings. e-HR systems also make the process more than a year-end event.

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