

GAO

## Testimony

Before the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security and Governmental Affairs, U.S. Senate

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# HUMAN CAPITAL

## Designing and Managing Market-Based and More Performance-Oriented Pay Systems

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Comptroller General of the United States





Highlights of [GAO-05-1048T](#), a testimony before the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security and Governmental Affairs, U.S. Senate

## Why GAO Did This Study

The federal government must have the capacity to plan more strategically, react more expeditiously, and focus on achieving results. Critical to the success of this transformation are the federal government's people—its human capital. Yet, in many cases the federal government has not transformed how it classifies, compensates, develops, and motivates its employees to achieve maximum results within available resources and existing authorities. A key question is how to update the federal government's compensation system to be market-based and more performance-oriented.

To further the discussion of federal pay reform, GAO partnered with key human capital stakeholders to convene a symposium in March 2005 to discuss public, private, and nonprofit organizations' successes and challenges in designing and managing market-based and more performance-oriented pay systems.

This testimony presents the strategies that organizations considered in designing and managing market-based and more performance-oriented pay systems and describes how they are implementing them.

[www.gao.gov/cgi-bin/getrpt?GAO-05-1048T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-1048T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Lisa Shames at (202) 512-6806 or [shamesl@gao.gov](mailto:shamesl@gao.gov).

## HUMAN CAPITAL

# Designing and Managing Market-Based and More Performance-Oriented Pay Systems

## What GAO Found

GAO strongly supports the need to expand pay reform in the federal government. While implementing market-based and more performance-oriented pay systems is both doable and desirable, organizations' experiences in designing and managing their pay systems underscored three key themes that can guide federal agencies' efforts.

- The shift to market-based and more performance-oriented pay must be part of a broader strategy of change management and performance improvement initiatives.
- Market-based and more performance-oriented pay cannot be simply overlaid on most organizations' existing performance management systems. Rather, as a precondition to effective pay reform, individual expectations must be clearly aligned with organizational results, communication on individual contributions to annual goals must be ongoing and two-way, meaningful distinctions in employee performance must be made, and cultural changes must be undertaken.
- Organizations need to build up the basic management capacity of their organizations. Training and developing new and current staff to fill new roles and work in different ways will play a crucial part in building the capacity of the organizations.

Organizations presenting at our symposium considered the following strategies in designing and managing their pay systems.

1. Focus on a set of values and objectives to guide the pay system.
2. Examine the value of employees' total compensation to remain competitive in the market.
3. Build in safeguards to enhance the transparency and help ensure the fairness of pay decisions.
4. Devolve decision making on pay to appropriate levels.
5. Provide training on leadership, management, and interpersonal skills to facilitate effective communication.
6. Build consensus to gain ownership and acceptance for pay reforms.
7. Monitor and refine the implementation of the pay system.

Moving forward, it is possible to enact broad-based reforms that would enable agencies to move to market-based and more performance-oriented pay systems. However, before implementing reform, each executive branch agency should demonstrate and the Office of Personnel Management should certify that the agency has the institutional infrastructure in place to help ensure that the pay reform is effectively and equally implemented. At a minimum, this infrastructure includes a modern, effective, credible, and validated performance management system in place that provides a clear linkage between institutional, unit, and individual performance-oriented outcomes; results in meaningful distinctions in ratings; and incorporates adequate safeguards.

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Chairman Voinovich, Senator Akaka, and Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss what has been learned from alternative personnel systems' implementation of pay for performance. As the federal government transforms to be better positioned to address 21st century challenges, a key question is "How should the federal government update its compensation systems to be more market-based and performance-oriented?"<sup>1</sup> The federal government must have the institutional capacity to plan more strategically, react more expeditiously, and focus on achieving results. Critical to the success of this transformation are the federal government's people—its human capital. Yet the government has not transformed, in many cases, how it classifies, compensates, develops, and motivates its employees to achieve maximum results within available resources and existing authorities.

Recognizing that the federal government's pay system does not align well with modern compensation principles, Congress has provided various agencies exemptions from current statute in performance management and pay administration.<sup>2</sup> Most recently, the Departments of Homeland Security (DHS) and Defense (DOD) received the authority to establish "flexible and contemporary" human capital and pay systems.<sup>3</sup> We at GAO have also received human capital authorities and strive to lead by example, especially in implementing more market-based and performance-oriented classification and compensation systems.

GAO strongly supports the need to expand pay reform in the federal government. To further the discussion of federal pay reform, GAO partnered with the U.S. Office of Personnel Management (OPM), the U.S. Merit Systems Protection Board, the National Academy of Public Administration, and the Partnership for Public Service and convened a

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<sup>1</sup>GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, [GAO-05-325SP](#) (Washington, D.C.: February 2005).

<sup>2</sup>GAO, *Human Capital: Selected Agencies' Statutory Authorities Could Offer Options in Developing a Framework for Governmentwide Reform*, [GAO-05-398R](#) (Washington, D.C.: Apr. 21, 2005).

<sup>3</sup>For more information on DHS's and DOD's human capital authorities, see GAO, *Human Capital: Preliminary Observations on Final Department of Homeland Security Human Capital Regulations*, [GAO-05-320T](#) (Washington, D.C.: Feb. 10, 2005) and GAO, *Human Capital: Preliminary Observations on Proposed DOD National Security Personnel System Regulations*, [GAO-05-432T](#) (Washington, D.C.: Mar. 15, 2005).

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symposium in March 2005 to discuss public, private, and nonprofit organizations' successes and challenges with designing and managing market-based and more performance-oriented pay systems.<sup>4</sup>

While we believe that implementing market-based and more performance-oriented pay systems is both doable and desirable, these organizations' experiences in designing and managing their pay systems underscored three key themes that can guide federal agencies' efforts to better link pay with performance.

- First, the shift to market-based and more performance-oriented pay must be part of a broader strategy of change management and performance improvement initiatives. Market-based and more performance-oriented pay is only one part—albeit a critical one—of a larger effort to improve the performance of an organization.
- Second, market-based and more performance-oriented pay cannot be simply overlaid on most organizations' existing performance management systems. Rather, as a precondition to effective pay reform, individual expectations must be clearly aligned with organizational results, communication on individual contributions to annual goals must be ongoing and two-way, meaningful distinctions in employee performance must be made, and cultural changes must be undertaken. Specifically, these organizations recognize that pay increases are no longer an entitlement but should be based on employees' contributions to the organization's mission and goals.
- Third, organizations need to build up the basic management capacity of their organizations. Training and developing new and current staff to fill new roles and work in different ways will play a crucial part in building the capacity of the organizations. In particular, there needs to be growth and development at every level of the organization: top leaders with the vision, commitment, capabilities, and persistence to lead and facilitate the change; managers with the skills and abilities to fairly and honestly assess employee performance; and individual employees who are engaged and empowered to seek opportunities to enhance their careers.

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<sup>4</sup>The organizations included the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Commonwealth of Virginia, IBM Corporation, and American Red Cross. For more information, see GAO, *Human Capital: Symposium on Designing and Managing Market-Based and More Performance-Oriented Pay Systems*, [GAO-05-832SP](#) (Washington, D.C.: July 27, 2005).

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Federal agencies have also been experimenting with pay for performance through OPM's personnel demonstration projects authorized under Title 5. We reported that these demonstration projects show an understanding that linking pay to performance is very much a work in progress and that additional work is needed to strengthen efforts to ensure that performance management systems are tools to help them manage on a day-to-day basis.<sup>5</sup> In particular, there are opportunities to translate employee performance so that managers make meaningful distinctions between top and poor performers with objective and fact-based information and provide information to employees about the results of the performance appraisal and pay decisions to ensure reasonable transparency and appropriate accountability mechanisms are in place, among other things.<sup>6</sup>

In addition, as agencies develop their pay for performance systems, they will need to consider the appropriate mix between pay awarded as base pay increases versus one-time cash increases while still maintaining fiscally sustainable compensation systems that reward performance. A key question to consider is how the government can make an increasing percentage of federal compensation dependent on achieving individual and organizational results by, for example, providing more compensation as one-time cash bonuses rather than as permanent salary increases. However, agencies' use of cash bonuses or other monetary incentives has an impact on employees' retirement calculations since they are not included in calculating retirement benefits. Congress should consider potential legislative changes to allow cash bonuses to be calculated toward retirement and thrift savings benefits by specifically factoring bonuses into the employee's basic pay for purposes of calculating the employee's "high-3" for retirement benefits and making contributions to the thrift savings plan.

Nevertheless, we need to move forward with human capital reforms, but how it is done, when it is done, and the basis on which it is done can make all the difference in whether such efforts are successful. Human capital reforms to date recognize that the "one-size-fits-all" approach is not appropriate to each agency's demands, challenges, and missions. However, we have reported that a reasonable degree of consistency across the

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<sup>5</sup>GAO, *Human Capital: Implementing Pay for Performance at Selected Personnel Demonstration Projects*, GAO-04-83 (Washington, D.C.: Jan. 23, 2004).

<sup>6</sup>For more information on our review of OPM's demonstration projects and other GAO human capital reports, see app. I.

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government is still desirable and that broader reforms should be guided by a framework consisting of a common set of principles, criteria, and processes.<sup>7</sup>

Before implementing any human capital reforms, executive branch agencies should follow a phased approach that meets the “show me” test. That is, each agency should be authorized to implement a reform only after it has shown it has met certain requirements, including an assessment of its demonstrated institutional infrastructure and an independent certification by OPM of this infrastructure. This institutional infrastructure includes (1) a strategic human capital planning process linked to the agency’s overall strategic plan; (2) capabilities to design and implement a new human capital system effectively; (3) a modern, effective, credible, and validated performance management system that provides a clear linkage between institutional, unit, and individual performance-oriented outcomes, and results in meaningful distinctions in ratings; and (4) adequate internal and external safeguards to ensure the fair, effective, and nondiscriminatory implementation of the system.

GAO will continue to work with Congress, OPM, and other key stakeholders on future human capital reforms. This morning I will highlight the strategies that organizations considered in designing and managing market-based and more performance-oriented pay systems and how they are implementing them. These organizations include selected OPM demonstration projects, organizations presenting at the symposium, and GAO.

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## Strategies for Designing and Managing Market-Based and More Performance-Oriented Pay Systems

Even though people are critical to an agency’s successful transformation, a number of agencies still try to manage their people with a “one-size-fits-all” approach to compensation. For example, employees are compensated through an outmoded system that (1) rewards length of service rather than individual performance and contributions; (2) automatically provides across-the-board annual pay increases, even to poor performers; and (3) compensates employees living in various localities without adequately considering the local labor market rates for these employees. We have

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<sup>7</sup>GAO and the National Commission on the Public Service Implementation Initiative, *Highlights of a Forum: Human Capital: Principles, Criteria, and Processes for Governmentwide Federal Human Capital Reform*, [GAO-05-69SP](#) (Washington, D.C.: Dec. 1, 2004).

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observed that a competitive compensation system can help organizations attract and retain a quality workforce. To develop such a system, organizations assess the skills and knowledge they need; compare compensation against other public, private, or nonprofit entities competing for the same talent in a given locality; and classify positions along levels of responsibility.

The strategies that the organizations at our symposium considered in designing and managing market-based and more performance-oriented pay systems and examples of how organizations are implementing them are as follows.

**1. Focus on a set of values and objectives to guide the pay system.**

Organizations need to focus on a set of values and objectives when designing and managing their market-based and more performance-oriented pay systems. Values are inherent and enduring principles that represent the organization's beliefs and boundaries. For example, GAO's core values—accountability, integrity, and reliability—were a focus in identifying and validating the competencies for our new performance management system. With authority from Congress, we have implemented a market-based compensation system that places greater emphasis on a person's skills, knowledge, and job performance and not the passage of time while, at a minimum, protecting the purchasing power of employees who are performing acceptably and are paid within competitive compensation ranges. Under the new market-based pay system, which is in the first phase of implementation, employee compensation now considers current salary and allocates individual performance-based compensation amounts between a merit increase (i.e., salary increase) and a performance bonus (i.e., cash). In addition, we received authority from Congress to adjust the rates of basic pay on a separate basis from the annual adjustments authorized for employees in the executive branch. We also recently finalized a performance-based compensation system with pay banding for the remainder of GAO's workforce, the administrative professional and support staff.

While core values define the organization's beliefs and boundaries, objectives articulate the strategy the organization plans to take to implement a market-based and more performance-oriented pay system to help it recognize and reward employees and maintain a competitive position in the market. For example, the Red Cross recognizes that salary is its main lever to fulfill its mission and values, and thus one of its objectives is to pay salaries that are externally competitive and internally equitable. To

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meet this objective, the Red Cross sets its employees' pay slightly higher than the market in order to remain competitive and attract, motivate, and retain its employees. Similarly, a main objective of the Office of the Comptroller of the Currency's (OCC) pay system is to maintain comparability regarding compensation and benefits with the other federal financial regulatory agencies, such as the Federal Deposit Insurance Corporation (FDIC) and the U.S. Securities and Exchange Commission. To maintain comparability in compensation and benefits, OCC participates in an annual survey that gathers information and data on the financial regulatory agencies' total compensation packages. This information helps OCC set its pay increase budget for the next year based on the average pay for its market.

**2. Examine the value of employees' total compensation to remain competitive in the market.** The organizations at our symposium found that it is important to be flexible in the mix of what constitutes total compensation so they can remain competitive with the market. Organizations should consider a mix of base pay plus other monetary incentives, benefits, and deferred compensation, such as retirement pay, as part of a competitive compensation system. For example, to help it compete in the market and retain its employees, IBM offers its employees a "total rewards" package including work-life benefits such as tuition reimbursement for employee development, along with retirement and health care benefits.

At GAO, we believe that providing employees with individualized total compensation summary statements each year helps provide clarity on the employees' total compensation packages and specifically, how employees' pay increases received during the year fit into their total compensation. The annual summary statements include GAO's contributions to employees' benefits, incentives and other awards, and other GAO paid or subsidized benefits. The statements include items such as student loan repayments and transit subsidies, as well as adjustments to employees' pay, such as across-the-board salary adjustments, performance-based pay adjustments, and promotion-related increases.

Transparency is becoming an urgent matter today as federal agencies face tough choices ahead managing the serious and growing long-term fiscal challenges facing the nation. We recently reported that DOD's historical piecemeal approach to military compensation has resulted in a lack of transparency that creates an inability to, for example, assess the allocation



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of total compensation investments to cash and benefits.<sup>8</sup> In order to help improve the transparency over total compensation, we recommended that DOD develop a comprehensive communication and education plan to inform servicemembers of the value of their pay and benefits and the competitiveness of their total compensation package when compared to their civilian counterparts that could be used as a recruiting and retention tool.

**3. Build in safeguards to enhance the transparency and help ensure the fairness of pay decisions.** Agencies need to have modern, effective, credible, and as appropriate validated performance management systems in place with adequate safeguards to ensure fairness and prevent politicization and abuse. These systems are the precondition to linking pay, incentive, and reward systems with employee knowledge, skills, and contributions to organizational results.

GAO's performance management and pay system has built in numerous safeguards, including multiple levels of review, to ensure consistency and fairness in the process and resulting decisions. Specifically, before performance ratings are finalized, they receive second-level reviews, typically by a senior executive within the employee's team. This reviewer checks if raters have consistently and reasonably applied the performance standards. Subsequently, the Human Capital Office and the Office of Opportunity and Inclusiveness review the performance ratings and pay decisions across all of GAO to determine whether there are any irregularities or potential adverse impacts to be addressed. To further help ensure consistency in ratings and in applying performance standards within and across GAO's teams, we implemented standardized rating scores (SRS) for employees for the first time in the fiscal year 2004 performance appraisal cycle. The SRS indicates the employee's position relative to the average rating of that employee's team. Employees in different teams with the same SRS have the same relative performance, thus achieving better comparability in ratings across teams. Employees' SRS and the midpoint for their pay range are key factors in calculating their performance-based compensation for that year. We are continually working with the employees to identify the best way to communicate the

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<sup>8</sup>GAO, *Military Personnel: DOD Needs to Improve the Transparency and Reassess the Reasonableness, Appropriateness, Affordability, and Sustainability of Its Military Compensation System*, [GAO-05-798](#) (Washington, D.C.: July 19, 2005).

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SRS information as part of GAO's ongoing commitment to employee feedback on the new system and transparency about pay decisions.

IBM built in several accountability mechanisms to help achieve consistency and equity in pay decisions across employee groups and teams. For example, to help ensure there is no discrimination in pay decisions, IBM conducts a base pay equity analysis to review the pay of women or minority employees if their proposed pay is one standard deviation away from the mean of the majority of employees and looks for an explanation for these pay differences, such as poor performance, a recent promotion into the pay band, or an extended leave of absence. In addition, IBM built in second-level reviews of pay decisions before employees receive any pay increases to ensure consistency in the compensation process. The first-line managers discuss their proposed pay decisions with managers at the next level—the up-line managers—to ensure the performance assessments and justifications are consistent across groups. Up-line managers can also shift pay allocations across groups if necessary in order to ensure employees who perform similarly are compensated the same regardless of their first-line managers. As a final check, the senior managers sign off on the pay decisions for each employee.

To help provide transparency on how employees' performance compares to the rest of the organization, we previously reported that the Naval Sea Systems Command Warfare Center's Newport division publishes the results of its annual performance cycle. Newport aggregates the data so that no individual employee's rating or payout can be determined to protect confidentiality. Employees can compare their performance rating category against others in the same unit, other units, and the entire division.

**4. Devolve decision making on pay to appropriate levels.** In implementing market-based and more performance-oriented pay systems, organizations need to determine what parts of their pay systems should be maintained centrally and what parts can be devolved to “lower” levels of the organization. When devolving these types of decisions, organizations have maintained overall core processes to help ensure reasonable consistency in how the systems are implemented.

Virginia shifted the responsibility for administering pay from its central office to the commonwealth's agencies and their managers as part of its compensation reforms and developed core processes outlining how agencies should develop and implement their pay systems. Specifically, Virginia developed a salary plan that provides broad guidelines regarding

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the commonwealth's overall compensation philosophy, funding for pay increases, and the pay ranges for the employees' positions that reflect market conditions. Each agency is held accountable for developing its own salary administration plan which is approved by the central office prior to being implemented. As part of this plan, the agency is to select from among designated "pay practices" that it considers useful to best meet its specific needs, such as promotions or in-band pay adjustments to recognize employees for taking on additional duties.

**5. Provide training on leadership, management, and interpersonal skills to facilitate effective communication.** We have reported that training and developing new and current staff to fill new roles and work in different ways will play a crucial part in the federal government's endeavors to meet its transformation challenges.<sup>9</sup> Agencies will need to invest resources to ensure that employees have the information, skills, and competencies they need to work effectively in a rapidly changing and complex environment.

Organizations found that training employees and managers on performance management skills, such as setting expectations, linking individual performance to organizational results, and effectively giving and receiving feedback, as well as placing an emphasis on communicating the content of the pay reforms in a simple and clear format, are needed to make market-based and more performance-oriented pay succeed. For example, FDIC emphasized the importance of training its managers on how to make the necessary distinctions in ratings and pay since it found that some managers have trouble making the distinctions and would prefer to give all employees the same pay increase.

Virginia found that employees needed the information on its compensation reforms in as simple and clear a format as possible without using technical compensation terms or "HR" terminology. As a result, Virginia used its Employee Advisory Committee to help develop training and supporting materials on the compensation reform initiatives and communicate the information to the other employees. Virginia found that using the committee was very effective and allowed employees to better understand how the reforms would affect them directly.

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<sup>9</sup>GAO, *Human Capital: A Guide for Assessing Strategic Training and Development Efforts in the Federal Government*, GAO-04-546G (Washington, D.C.: March 2004).

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Regarding the frequency of the training, we found that the OPM pay for performance demonstration projects trained employees on the performance management system prior to implementation to make employees aware of the new approach, as well as periodically after implementation to refresh employee familiarity with the system. For example, the Civilian Acquisition Workforce Personnel Demonstration Project (AcqDemo) found that, in addition to training prior to implementation, it needed more in-depth and varied training in later years for current AcqDemo employees to refresh their proficiency in the system; for new participants to familiarize them with appraisal and payout processes; as well as for senior management, pay pool managers and members, and human resources personnel to give them greater detail on the process. The training prior to implementation and throughout the project was designed to help employees understand competencies and performance standards; develop performance plans; write self-appraisals; become familiar with how performance is evaluated and how pay increases and awards decisions are made; and know the roles and responsibilities of managers, supervisors, and employees in the appraisal and payout processes.

Virginia defined a new role for its employees by holding them accountable for identifying the training they need to enhance the skills necessary to develop their careers. For example, Virginia developed career guides to inform employees on what they may personally need to do to develop, advance, or change their careers. The guides provide important occupational information for employees interested in developing their careers and improving opportunities for advancement in any work environment. Virginia found that an added benefit is that these career guides help employees understand that they have knowledge, skills, and abilities that cut across different occupations and are transferable across the commonwealth's government.

**6. Build consensus to gain ownership and acceptance for pay reforms.** Involving employees and other stakeholders helps to improve overall confidence and belief in the fairness of the system, enhance their understanding of how the system works, and increase their understanding and ownership of organizational goals and objectives. Organizations have found that the inclusion of employees and their representatives needs to be meaningful, not just pro forma.

At GAO, to obtain direct feedback from employees, we created the elected Employee Advisory Council (EAC) to serve as an advisory body to the

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Comptroller General and other senior executives on management and employee issues. Comprising employees who represent a cross-section of the agency, the EAC's participation is an important source of front-end input and feedback on our human capital and other major management initiatives. Specifically, EAC members convey the views and concerns of the groups they represent, while remaining sensitive to the collective best interest of all GAO employees; propose solutions to concerns raised by employees; provide input to and comment on GAO policies, procedures, plans, and practices; and help to communicate management's issues and concerns to employees. Similarly, FDIC found that in its experience it was better to have the union involved in the implementation of its pay reforms. When negotiating compensation for its bargaining unit employees with representatives of the National Treasury Employees Union, FDIC views them as true partners instead of following an "us versus them" approach. FDIC noted that both parties want to work together to reach an agreement in terms of compensation levels that will satisfy them.

In designing its compensation reforms, Virginia involved stakeholders, such as representatives from Virginia's legislative and executive branches, as well as human resource representatives from private sector organizations. Virginia also formed an Employee Advisory Committee of nonsupervisory employees from diverse occupations, demographic groups, and geographic locations to help the commonwealth as a whole improve its compensation program, not just for their select interest groups. Further, to implement the compensation reforms, Virginia developed implementation teams—composed of human resource staff across the agencies—to help ensure the details of the compensation reforms were consistently communicated to all the employees across the commonwealth. The teams represented various priority areas, such as funding, compensation management, performance management, training, and communications.

**7. Monitor and refine the implementation of the pay system.** High-performing organizations understand they need to continuously review and revise their performance management systems to achieve results and accelerate change. These organizations continually review and revise their human capital management systems based on data-driven lessons learned and changing needs in the environment. We have reported that agencies seeking human capital reform should consider doing evaluations that are broadly modeled on the evaluation requirements of the OPM

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demonstration projects.<sup>10</sup> Under the demonstration project authority, agencies must evaluate and periodically report on results, implementation of the demonstration project, cost and benefits, impacts on veterans and other equal employment opportunity groups, adherence to merit system principles, and the extent to which the lessons from the project can be applied governmentwide. Such an evaluation could facilitate congressional oversight; allow for any midcourse corrections; assist the agency in benchmarking its progress with other efforts; and provide for documenting best practices and sharing lessons learned with employees, stakeholders, other federal agencies, and the public.

For example, at GAO, we recently saw the need to restructure part of our pay banding system to better reflect real differences in responsibilities and competencies as well as respective pay within the pay band for our senior analysts by creating two sub-band categories. To begin the process of this restructuring effort, GAO formed task teams to study and develop proposals, and engaged employees by holding town hall meetings, focus groups, meeting with employee representatives, and having a review and comment period for each phase of the restructuring.

Organizations monitor their systems by listening to employees' and stakeholders' views—informally and formally—on the pay systems. FDIC found that listening to the “level of noise” among employees and stakeholders, such as the union, is essential in evaluating whether a new initiative is working or not. To track employee views, IBM sends out a pulse survey quarterly with only a few questions on the compensation program to a sample of its 300,000 employees. IBM believes it is doing well in implementing the program if over 70 percent of the employees' responses to these questions are “neutral” or “favorable.” When consolidating its classification structure, Virginia made some revisions as a result of employee feedback so that employees could more easily see where they fit into the structure. Virginia plans to continually monitor the structure and identify needed refinements by soliciting employee feedback at least annually.

Organizations also use other metrics as an indicator of the employees' acceptance of pay and performance management decisions to track the effectiveness of their pay systems. For example, IBM tracks its attrition rates to determine why employees are leaving and compares them to its

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<sup>10</sup>GAO-05-69SP.

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competitors' attrition rates. Virginia tracks the number of employee grievances and works with managers to educate them on what the metrics mean and how they affect their agencies and employees.

Monitoring the implementation of new pay systems is important because unintended consequences may arise. Organizations have found they should be open to refining their systems. For example, in order to spread the pay increases among as many employees as possible, FDIC found that managers tended not to award merit pay increases to top-performing employees when they were to be promoted in the career ladder and as a result, these high-performing employees were not getting the merit pay increases they deserved. FDIC recognized that this unintended consequence needed to be corrected in future iterations of the pay system and managers needed help in learning how to make the necessary distinctions in employees' contributions.

While the need for refining the system is inevitable, organizations found that there is value in stabilizing the pay system for a period of time to let employees get accustomed to the new initiative and see how it works. For example, OCC plans to reassess its labor market pay differentials every 3 years rather than annually to provide continuity in implementing the system. This continuity benefits employees because they know how much their geographic differential will be for a period of time and benefits OCC because it makes managing the pay system more stable.

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## Next Steps for Results-Oriented Pay and Human Capital Reform

In summary, there is widespread agreement that the basic approach to federal pay is broken and we need to move to a market-based and more performance-oriented approach. Doing so will be essential if we expect to maximize the performance within available resources and assure the accountability of the federal government for the benefit of the American people. While reasonable people can and will disagree about the merits of individual reform proposals, there is widespread recognition that pay increases are no longer an entitlement but should be based on employees' contributions to the organization's mission and goals. Experience shows that this shift to market-based and more performance-oriented pay must be part of a broader strategy of change management and performance improvement initiatives and cannot be simply overlaid on most organizations' existing performance management systems. Before implementing any pay reform, each executive branch agency should have demonstrated and OPM should have certified that the agency has in place

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the institutional infrastructure to help ensure that this reform is effectively and equally implemented.

We need to move forward with human capital reforms. In the short term, such reforms could include select and targeted authorities, such as prohibiting guaranteed pay increases for persons who do not perform at acceptable levels; allowing agency heads to make a limited number of term appointments awarded noncompetitively; and rightsizing and restructuring that can place additional emphasis on factors such as knowledge, skills, and performance. As momentum continues to accelerate to make strategic human capital management the centerpiece of the government's overall management transformation effort, comprehensive reforms should be guided by a framework consisting of a common set of principles, criteria, and processes.

Chairman Voinovich, Senator Akaka, and Members of the Subcommittee, this concludes my statement. I would be pleased to respond to any questions that you may have.

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## Contact and Acknowledgments

For further information regarding this statement, please contact Lisa Shames, Acting Director, Strategic Issues, at (202) 512-6806 or [shamesl@gao.gov](mailto:shamesl@gao.gov). Individuals making key contributions to this statement include Janice Latimer and Katherine H. Walker.



# “Highlights” of Selected GAO Reports



## Why GAO Convened This Symposium

Critical to the success of the federal government's transformation are its people—human capital. Yet the government has not transformed, in many cases, how it classifies, compensates, develops, and motivates its employees to achieve maximum results within available resources and existing authorities. One of the questions being addressed as the federal government transforms is how to update its compensation system to be more market based and performance oriented.

To further the discussion of federal pay reform, GAO, the U.S. Office of Personnel Management, the U.S. Merit Systems Protection Board, the National Academy of Public Administration, and the Partnership for Public Service convened a symposium on March 9, 2005, to discuss organizations' experiences with market-based and more performance-oriented pay systems. Representatives from public, private, and nonprofit organizations made presentations on the successes and challenges they experienced in designing and managing their market-based and more performance-oriented pay systems. A cross section of human capital stakeholders was invited to further explore these successes and challenges and engage in open discussion. While participants were asked to review the overall substance and context of the draft summary, GAO did not seek consensus on the key themes and supporting examples.

[www.gao.gov/cgi-bin/getrpt?GAO-05-832SP](http://www.gao.gov/cgi-bin/getrpt?GAO-05-832SP).

To view the full product, including the scope and methodology, click on the link above. For more information, contact J. Christopher Mihm at (202) 512-6806 or [mihmj@gao.gov](mailto:mihmj@gao.gov).

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## HUMAN CAPITAL

### Symposium on Designing and Managing Market-Based and More Performance-Oriented Pay Systems

#### What Participants Said

While implementing market-based and more performance-oriented pay systems is both doable and desirable, organizations' experiences show that the shift to market-based and more performance-oriented pay must be part of a broader strategy of change management and performance improvement initiatives. GAO identified the following key themes that highlight the leadership and management strategies these organizations collectively considered in designing and managing market-based and more performance-oriented pay systems.

- 1. Focus on a set of values and objectives to guide the pay system.** Values represent an organization's beliefs and boundaries and objectives articulate the strategy to implement the system.
- 2. Examine the value of employees' total compensation to remain competitive in the market.** Organizations consider a mix of base pay plus other monetary incentives, benefits, and deferred compensation, such as retirement pay, as part of a competitive compensation system.
- 3. Build in safeguards to enhance the transparency and ensure the fairness of pay decisions.** Safeguards are the precondition to linking pay systems with employee knowledge, skills, and contributions to results.
- 4. Devolve decision making on pay to appropriate levels.** When devolving such decision making, overall core processes help ensure reasonable consistency in how the system is implemented.
- 5. Provide training on leadership, management, and interpersonal skills to facilitate effective communication.** Such skills as setting expectations, linking individual performance to organizational results, and giving and receiving feedback need renewed emphasis to make such systems succeed.
- 6. Build consensus to gain ownership and acceptance for pay reforms.** Employee and stakeholder involvement needs to be meaningful and not pro forma.
- 7. Monitor and refine the implementation of the pay system.** While changes are usually inevitable, listening to employee views and using metrics helps identify and correct problems over time.

These organizations found that the key challenge with implementing market-based and more performance-oriented pay is changing the culture. To begin to make this change, organizations need to build up their basic management capacity at every level of the organization. Transitioning to these pay systems is a huge undertaking and will require constant monitoring and refining in order to implement and sustain the reforms.

United States Government Accountability Office



### Why GAO Did This Study

There is a growing understanding that the federal government needs to fundamentally rethink its current approach to pay and to better link pay to individual and organizational performance. Federal agencies have been experimenting with pay for performance through the Office of Personnel Management's (OPM) personnel demonstration projects.

GAO identified the approaches that selected personnel demonstration projects have taken to implement their pay for performance systems. These projects include: the Navy Demonstration Project at China Lake (China Lake), the National Institute of Standards and Technology (NIST), the Department of Commerce (DOC), the Naval Research Laboratory (NRL), the Naval Sea Systems Command Warfare Centers (NAVSEA) at Dahlgren and Newport, and the Civilian Acquisition Workforce Personnel Demonstration Project (AcqDemo). We selected these demonstration projects based on factors such as status of the project and makeup of employee groups covered.

We provided drafts of this report to officials in the Department of Defense (DOD) and DOC for their review and comment. DOD provided written comments concurring with our report. DOC provided minor technical clarifications and updated information. We provided a draft of the report to the Director of OPM for her information.

[www.gao.gov/cgi-bin/getrpt?GAO-04-83](http://www.gao.gov/cgi-bin/getrpt?GAO-04-83).

To view the full product, including the scope and methodology, click on the link above. For more information, contact J. Christopher Mihm at (202) 512-6806 or [mihmj@gao.gov](mailto:mihmj@gao.gov).

January 2004

## HUMAN CAPITAL

### Implementing Pay for Performance at Selected Personnel Demonstration Projects

#### What GAO Found

The demonstration projects took a variety of approaches to designing and implementing their pay for performance systems to meet the unique needs of their cultures and organizational structures, as shown in the table below.

#### Demonstration Project Approaches to Implementing Pay for Performance

##### Using competencies to evaluate employee performance.

High-performing organizations use validated core competencies as a key part of evaluating individual contributions to organizational results. To this end, AcqDemo and NRL use core competencies for all positions. Other demonstration projects, such as NIST, DOC, and China Lake, use competencies based on the individual employee's position.

##### Translating employee performance ratings into pay increases and awards.

Some projects, such as China Lake and NAVSEA's Newport division, established predetermined pay increases, awards, or both depending on a given performance rating, while others, such as DOC and NIST, delegated the flexibility to individual pay pools to determine how ratings would translate into performance pay increases, awards, or both. The demonstration projects made some distinctions among employees' performance.

##### Considering current salary in making performance-based pay decisions.

Several of the demonstration projects, such as AcqDemo and NRL, consider an employee's current salary when making performance pay increases and award decisions to make a better match between an employee's compensation and contribution to the organization.

##### Managing costs of the pay for performance system.

According to officials, salaries, training, and automation and data systems were the major cost drivers of implementing their pay for performance systems. The demonstration projects used a number of approaches to manage the costs.

##### Providing information to employees about the results of performance appraisal and pay decisions.

To ensure fairness and safeguard against abuse, performance-based pay programs should have adequate safeguards, including reasonable transparency in connection with the results of the performance management process. To this end, several of the demonstration projects publish information, such as the average performance rating, performance pay increase, and award.

Source: GAO.

GAO strongly supports the need to expand pay for performance in the federal government. How it is done, when it is done, and the basis on which it is done can make all the difference in whether such efforts are successful. High-performing organizations continuously review and revise their performance management systems. These demonstration projects show an understanding that how to better link pay to performance is very much a work in progress at the federal level. Additional work is needed to strengthen efforts to ensure that performance management systems are tools to help them manage on a day-to-day basis. In particular, there are opportunities to use organizationwide competencies to evaluate employee performance that reinforce behaviors and actions that support the organization's mission, translate employee performance so that managers make meaningful distinctions between top and poor performers with objective and fact-based information, and provide information to employees about the results of the performance appraisals and pay decisions to ensure reasonable transparency and appropriate accountability mechanisms are in place.

United States General Accounting Office

December 2004



## HIGHLIGHTS OF A FORUM

### Human Capital: Principles, Criteria, and Processes for Governmentwide Federal Human Capital Reform

#### Why GAO Convened This Forum

There is widespread agreement that the federal government faces a range of challenges in the 21<sup>st</sup> century that it must confront to enhance performance, ensure accountability, and position the nation for the future. Federal agencies will need the most effective human capital systems to address these challenges and succeed in their transformation efforts during a period of likely sustained budget constraints.

More progress in addressing human capital challenges was made in the last 3 years than in the last 20, and significant changes in how the federal workforce is managed are underway.

On April 14, 2004, GAO and the National Commission on the Public Service Implementation Initiative hosted a forum with selected executive branch officials, key stakeholders, and other experts to help advance the discussion concerning how governmentwide human capital reform should proceed.

[www.gao.gov/cgi-bin/getrpt?GAO-05-69SP](http://www.gao.gov/cgi-bin/getrpt?GAO-05-69SP)

To view the full product, including the scope and methodology, click on the link above. For more information, contact J. Christopher Mihm at (202) 512-6806 or [mihmj@gao.gov](mailto:mihmj@gao.gov).

#### What Participants Said

Forum participants discussed (1) Should there be a governmentwide framework for human capital reform? and (2) If yes, what should a governmentwide framework include?

There was widespread recognition that a “one size fits all” approach to human capital management is not appropriate for the challenges and demands government faces. However, there was equally broad agreement that there should be a governmentwide framework to guide human capital reform built on a set of beliefs that entail fundamental principles and boundaries that include criteria and processes that establish the checks and limitations when agencies seek and implement their authorities. While there were divergent views among the participants, there was general agreement that the following served as a starting point for further discussion in developing a governmentwide framework to advance needed human capital reform.

#### Principles

- Merit principles that balance organizational mission, goals, and performance objectives with individual rights and responsibilities
- Ability to organize, bargain collectively, and participate through labor organizations
- Certain prohibited personnel practices
- Guaranteed due process that is fair, fast, and final

#### Criteria

- Demonstrated business case or readiness for use of targeted authorities
- An integrated approach to results-oriented strategic planning and human capital planning and management
- Adequate resources for planning, implementation, training, and evaluation
- A modern, effective, credible, and integrated performance management system that includes adequate safeguards to ensure equity and prevent discrimination

#### Processes

- Prescribing regulations in consultation or jointly with the Office of Personnel Management
- Establishing appeals processes in consultation with the Merit Systems Protection Board
- Involving employees and stakeholders in the design and implementation of new human capital systems
- Phasing in implementation of new human capital systems
- Committing to transparency, reporting, and evaluation
- Establishing a communications strategy
- Assuring adequate training

United States Government Accountability Office



Highlights of GAO-03-488, a report to congressional requesters

### Why GAO Did This Study

The federal government is in a period of profound transition and faces an array of challenges and opportunities to enhance performance, ensure accountability, and position the nation for the future. High-performing organizations have found that to successfully transform themselves, they must often fundamentally change their cultures so that they are more results-oriented, customer-focused, and collaborative in nature. To foster such cultures, these organizations recognize that an effective performance management system can be a strategic tool to drive internal change and achieve desired results.

Based on previously issued reports on public sector organizations' approaches to reinforce individual accountability for results, GAO identified key practices that federal agencies can consider as they develop modern, effective, and credible performance management systems.

[www.gao.gov/cgi-bin/getrpt?GAO-03-488](http://www.gao.gov/cgi-bin/getrpt?GAO-03-488).

To view the full report, including the scope and methodology, click on the link above. For more information, contact J. Christopher Mihm at (202) 512-6806 or [mihmj@gao.gov](mailto:mihmj@gao.gov).

March 2003

## RESULTS-ORIENTED CULTURES

### Creating a Clear Linkage between Individual Performance and Organizational Success

#### What GAO Found

Public sector organizations both in the United States and abroad have implemented a selected, generally consistent set of key practices for effective performance management that collectively create a clear linkage—“line of sight”—between individual performance and organizational success. These key practices include the following.

- 1. Align individual performance expectations with organizational goals.** An explicit alignment helps individuals see the connection between their daily activities and organizational goals.
- 2. Connect performance expectations to crosscutting goals.** Placing an emphasis on collaboration, interaction, and teamwork across organizational boundaries helps strengthen accountability for results.
- 3. Provide and routinely use performance information to track organizational priorities.** Individuals use performance information to manage during the year, identify performance gaps, and pinpoint improvement opportunities.
- 4. Require follow-up actions to address organizational priorities.** By requiring and tracking follow-up actions on performance gaps, organizations underscore the importance of holding individuals accountable for making progress on their priorities.
- 5. Use competencies to provide a fuller assessment of performance.** Competencies define the skills and supporting behaviors that individuals need to effectively contribute to organizational results.
- 6. Link pay to individual and organizational performance.** Pay, incentive, and reward systems that link employee knowledge, skills, and contributions to organizational results are based on valid, reliable, and transparent performance management systems with adequate safeguards.
- 7. Make meaningful distinctions in performance.** Effective performance management systems strive to provide candid and constructive feedback and the necessary objective information and documentation to reward top performers and deal with poor performers.
- 8. Involve employees and stakeholders to gain ownership of performance management systems.** Early and direct involvement helps increase employees' and stakeholders' understanding and ownership of the system and belief in its fairness.
- 9. Maintain continuity during transitions.** Because cultural transformations take time, performance management systems reinforce accountability for change management and other organizational goals.

United States General Accounting Office



July 2005

## MILITARY PERSONNEL

### DOD Needs to Improve the Transparency and Reassess the Reasonableness, Appropriateness, Affordability, and Sustainability of Its Military Compensation System

#### Why GAO Did This Study

Over the years, the Department of Defense's (DOD) military compensation system has become an increasingly complex and piecemeal accretion of pays, allowances, benefits, and special tax preferences. DOD leaders have expressed concern that rising compensation costs may not be sustainable in the future and could crowd out other important investments needed to recapitalize equipment and infrastructure. Given the looming fiscal challenges facing the nation in the 21<sup>st</sup> century, GAO believes it is time for a baseline review of all federal programs to ensure that they are efficiently meeting their objectives. Under the Comptroller General's authority, GAO (1) assessed whether DOD's approach to compensation provides adequate transparency over costs; (2) identified recent trends in active duty compensation, and how costs have been allocated to cash and benefits; and (3) reviewed how active duty servicemembers perceive their compensation and whether DOD has effectively explained the value of the military compensation package to its members.

#### What GAO Recommends

GAO is making a number of recommendations to improve the transparency, reasonableness, appropriateness, affordability, and sustainability of the military compensation system. DOD generally concurred with GAO's recommendations. [www.gao.gov/cgi-bin/getrpt?GAO-05-798](http://www.gao.gov/cgi-bin/getrpt?GAO-05-798).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Derek Stewart at (202) 512-5559 or [stewardt@gao.gov](mailto:stewardt@gao.gov).

#### What GAO Found

DOD's historical piecemeal approach to military compensation has resulted in a lack of transparency that creates an inability to (1) identify the total cost of military compensation to the U.S. government and (2) assess the allocation of total compensation investments to cash and benefits. No single source exists to show the total cost of military compensation, and tallying the full cost requires synthesizing about a dozen information sources from four federal departments and the Office of Management and Budget. Without adequate transparency, decision makers do not have a true picture of what it costs to compensate servicemembers. They also lack sufficient information to identify long-term trends, determine how best to allocate available resources to ensure the optimum return on compensation investments, and better assess the efficiency and effectiveness of DOD's current compensation system in meeting recruiting and retention goals. To address this and other major business transformation challenges in a more strategic and integrated fashion, GAO recently recommended the creation of a chief management official at DOD.

Transparency over military compensation is critical because costs to provide compensation are substantial and rising, with over half of the costs allocated to noncash and deferred benefits. In fiscal year 2004, it cost the federal government about \$112,000, on average, to provide annual compensation to active duty enlisted and officer personnel. Adjusted for inflation, the total cost of providing active duty compensation increased about 29 percent from fiscal year 2000 to fiscal year 2004, from about \$123 to \$158 billion. During this time, health care was one of the major cost drivers, increasing 69 percent to about \$23 billion in fiscal year 2004. In addition, military compensation is weighted more toward benefits compared with other government and private sector civilian compensation systems. Furthermore, less than one in five service members will serve 20 years of active duty service to become eligible for retirement benefits. Increasing compensation costs make the need to address the appropriateness and reasonableness of the compensation mix and the long-term affordability and sustainability of the system more urgent.

DOD survey results and analysis of GAO focus groups and survey data have shown that servicemembers are dissatisfied and harbor misperceptions about their pay and benefits in part because DOD does not effectively educate them about the competitiveness of their total compensation packages. About 80 percent of the 400 servicemembers that GAO surveyed believed they would earn more as civilians; in contrast, a 2002 study showed that servicemembers generally earn more cash compensation alone than 70 percent of like-educated civilians. Servicemembers also expressed confusion over aspects of their compensation, like retirement, and many complained that benefits were eroding despite recent efforts by Congress and DOD to enhance pay and benefits. By not systematically educating servicemembers about the value of their total compensation, DOD is essentially allowing a culture of dissatisfaction and misunderstanding to perpetuate.

United States Government Accountability Office

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