

**WRITTEN TESTIMONY OF  
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INTERNAL REVENUE SERVICE  
BEFORE THE  
SENATE COMMITTEE ON HOMELAND SECURITY AND  
GOVERNMENTAL AFFAIRS  
SUBCOMMITTEE ON  
OVERSIGHT OF GOVERNMENT MANAGEMENT, THE FEDERAL  
WORKFORCE AND THE DISTRICT OF COLUMBIA  
ON  
IMPLEMENTATION OF PAY FOR PERFORMANCE**

**JULY 22, 2008**

Good afternoon Chairman Akaka, Ranking Member Voinovich, and Members of the Subcommittee. My name is Richard Spires and I am the Deputy Commissioner for Operations Support of the Internal Revenue Service. I am pleased to be here today to discuss IRS' efforts to implement pay for performance and respond to questions from the Subcommittee.

The IRS is not new to the pay for performance issue. We have over seven years of experience working on this matter, and we have tried to move deliberately to implement such a system for our more than 7,000 managers. Though there have been some bumps along the way, the creation of paybands and compensating employees for the quality of their work rather than their longevity with the agency has helped the IRS respond to the challenges presented in turning the agency into a modern and more efficient, 21<sup>st</sup> century organization.

The Senate recently confirmed Doug Shulman as the 47<sup>th</sup> Commissioner of the IRS. Commissioner Shulman has made it clear that one of his priorities as Commissioner is to reach our human capital goals. He understands the IRS probably has more interaction with individual Americans than any other Federal government agency. As such, he knows how important it is that we all do our jobs well because how we do our jobs probably shapes how Americans view their government.

By supporting and motivating employees through exceptional human capital programs, we can recruit and retain a highly skilled and high performing workforce. And if we can do that, the IRS will have what it needs to be an employer of choice and achieve our mission.

The Commissioner knows that our pay for performance program is an important component of a strong human capital program.

Today, I would like to offer you some background on why IRS introduced pay for performance, discuss a report issued by the Treasury Inspector General for Tax Administration (TIGTA) and how we responded to their recommendations, stress the importance of performing evaluations in a fair, non-discriminatory manner, and finally offer some observations on what our seven years of experience has taught us about implementing pay for performance.

## **Background**

In 1998, Congress passed the IRS Restructuring and Reorganization Act (RRA). As the name of the law indicates, RRA totally transformed the IRS and changed dramatically the way we did business.

For example, prior to enactment of RRA, IRS was organized geographically with leadership organizations and decision-making by managers dispersed across the country. After enactment, however, we reorganized along functional lines to support the different taxpayer segments – Wage and Investment, Small Business/Self-Employed, Large and Mid-Sized Businesses, and Tax Exempt/Government Entities – with much of the senior leadership based at the IRS headquarters located in Washington, DC.

Recognizing the dramatic shift that this and other changes included in RRA required and the potential impact on the tens of thousands of employees that might be affected, Congress included personnel flexibility provisions that authorized the Secretary of the Treasury to establish one or more paybanding systems covering all or any portion of the IRS workforce under the General Schedule (GS) pay system, subject to criteria to be issued by the Office of Personnel Management (OPM). Accordingly, OPM prescribed criteria for IRS payband system that followed the principles included in RRA in December 2000.

In providing this flexibility, Congress recognized that the IRS needed the ability to recruit and retain high-quality leadership to transform the Service into what Congress envisioned when it enacted RRA. Accordingly, IRS would have the flexibility to design its salary and incentive structures to support mission accomplishment, base pay decisions on performance rather than length of service, and implement a new Performance Management System that was aligned to organizational performance.

## **Program Implementation**

We implemented the first payband in March 2001. It was directed to Senior Managers (SM) and it consolidated Grades 14 and 15 in the GS into a single 10-step payband. This payband had salaries ranging from the equivalent of a GS-14 Step 1 through a GS-15 Step 10. Under the new system, Senior Managers continued to receive their basic pay, including locality pay, similar to that provided to GS employees. The entitlement to step increases that were previously available under the GS system was removed. Employees were eligible every two years for a performance based increase, and progressed to the

next step within the payband if their performance ratings met or exceeded certain performance standards.

A similar payband structure was implemented in November 2001 for the new IRS campus functions, including Accounts Management, Submission Processing, and Compliance. This payband for Department Managers (DM) incorporated salary grades GS-11 through GS-13 into a single 16-step payband.

From two critical perspectives, implementation of the flexibilities was critical in successfully carrying out the mandates of RRA.

First, implementation of the new Performance Management System allowed us to link manager performance to the functional goals of the organization. Managers and their supervisors would develop specific goals and objectives designed to further the goals of the functional unit and the IRS. The manager could then be evaluated at the end of the year based on his or her success in meeting the agreed to goals.

Second, implementation of the paybands helped us realign Senior Management positions as the organization shifted from a decentralized, geographic based hierarchy to an organization where leadership was based on functional needs. It also helped realign Department Managers in our campus functions.

Former IRS Commissioner Everson decided to continue expansion of pay for performance in line with the President's Management Agenda. In September 2005, the IRS implemented a Frontline Manager (FM) payband using the same criteria as for the Senior Manager and Department Managers – the Office of Personnel Management criteria from 2000. Beginning in 2002, the IRS had an independent contractor conduct multiple evaluations of the SM and DM paybands. The results of these evaluations and feedback from Executives and SM and DM employees afforded the IRS the opportunity to incorporate modifications to the design of the FM payband.

Unlike the SM and DM paybands, the FM payband consisted of 11 single-grade bands (GS 5 through 15) with open-rate ranges of pay (no steps) that are the same as the GS Pay System for the correlating grade. Also unlike the original paybands, Frontline Managers are eligible for a performance based increases to their salary each year. The performance based increase replaces the GS Pay System within-grade step increases, quality step increases, and annual across-the-board pay adjustments.

Effective March 2006, the SM and DM paybands were modified to incorporate a stepless design (range of rates) and an annual review, just like the FM payband. However, SM and DM paybands remained multi-grade paybands. For example, the SM payband has a minimum rate of GS-14 Step 1 and a maximum rate of GS-15 Step 10. Only the 10 steps within this range that were established when the program was originally designed were eliminated. Similarly, the DM payband ranged from GS-11 Step 1 to GS-13 Step 10 and the 16 steps were removed. All managers continue to receive the GS locality pay for where they work.

## **TIGTA Report and IRS Response**

In July 2007 the Treasury Inspector General for Tax Administration (TIGTA) published a report entitled *The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders* (Ref. Number 2007-10-106).

The overall objective of this review was to determine whether the IRS pay for performance system effectively links compensation to individual performance. The report analyzed the implementation of the IRS pay for performance program, more specifically the implementation of the FM payband, and made four specific recommendations for program improvement.

The first recommendation concerned the fact that the payband system for Frontline Managers essentially retained the GS pay system and only removed the incremental steps within each grade. The single grade band structure was implemented to meet the diverse needs of the IRS workforce and mission, while recognizing the wide variety of occupations and grades that were difficult to group into common levels of work. And while the creation of broad occupational paybands has some obvious benefits, this allowed the focus to shift to performance based pay, and preserve the current classification framework until other occupations can be banded.

The second recommendation related to the fact that the IRS Commissioner retains the authority to determine the level of pay increases for managers, and TIGTA recommended that the IRS Commissioner guarantee a salary increase to those managers who are rated as having “Met” performance expectation. Specifically, the fear was that the Commissioner could determine not to provide an increase to managers who were classified as having “Met” performance expectations. This would mean such a manager could end up with less of an increase than a comparably situated employee under the GS system. This in turn could possibly act as a disincentive for individuals to move into management slots.

However, since the inception of the IRS paybands in 2001, those managers with a “Met” performance rating have received a performance based increase that was the same as the increase provided to all GS employees. We continued that practice this year when we announced on May 21<sup>st</sup> that the GS increase would be the minimum increase for Met ratings and above.

The third recommendation was that the IRS should consider alternative sources of funding for the performance based salary pools and ensure amounts dedicated for increases are sufficient to both reward top performers and compensate other managers equitably, based on their performance.

Finally, TIGTA recommended the Chief Human Capital Officer should offer employees an opportunity to express concerns and questions about the new pay system directly to Human Capital Office experts. TIGTA further recommended that there be an effort

to communicate more openly and timely with employees before implementing any new changes to the employee's compensation and benefits.

The IRS takes seriously the TIGTA recommendations. We have already implemented one of the recommendations by improving communications with affected managers. Late last year, we completed a strategic communication framework. As part of this we partnered with management associations such as the Federal Managers Association (FMA) and the Professional Managers Association (PMA) as well as our internal stakeholders on communications relating to performance based increases and other aspects of pay for performance. Through this partnership, specific communications were developed to address questions surrounding performance based increases and shared with all managers. In 2006 managers expressed frustration and discontent that they were not informed until October that a "Met" rating would receive an increase equivalent to the GS. Consequently, in 2007 managers were informed in June that managers with a "Met" performance rating would receive a performance based increase equivalent to the GS. And, as I mentioned earlier, we made the similar announcement for 2008 in May.

In addition, we conducted a survey in February 2008 to determine how best to communicate with managers. We wanted to know how managers liked to receive their communications so we could tailor our program to meet those needs.

We also continue to conduct outreach sessions and focus groups to obtain stakeholder (employees, executives, and representatives from FMA and PMA) input on the IRS Paybanding System.

We have also updated our Payband Resource Center for Managers as information becomes available, and posted the performance based increased values, an updated salary calculator, and other frequently asked questions.

We also agreed with two of the recommendations. In fact, prior to the TIGTA audit we had already initiated a third-party evaluation of the IRS Pay for Performance System in its entirety, including an assessment of the Frontline Manager payband and a review of the performance-based salary pools. Since the IRS just implemented the FM payband in 2005, and redesigned the SM and DM in 2006, the IRS has just completed its second performance based increase and now can begin to evaluate trends. That evaluation is being conducted in three phases over a five year period, and will determine whether, and how strongly, our current pay-for-performance system supports our human capital organizational goals to recruit, retain, and motivate future leaders. We are also considering the TIGTA recommendation for modifying the IRS FM pay system.

The one recommendation that we did not agree with was the one that would inappropriately reduce the authority of the IRS Commissioner and guarantee a salary increase to those managers that were rated as having "Met" expectations. As I indicated earlier, the Commissioner has always approved a standard increase for those that are rated as having "Met" expectations.

I should point out that OPM issued proposed changes to the IRS broad banding criteria in April 2007. The proposed revised criteria did not guarantee or provide for a minimum base pay increase for employees rated “Fully Successful” (i.e., a rating of “Met” under the IRS performance appraisal system). The Professional Managers Association, Federal Managers Association, and the National Treasury Employees Union commented that employees rated “Fully Successful” or “Met” should be guaranteed an increase at least equal to the base pay increase in the band rate ranges. OPM is considering these comments, along with Treasury’s and IRS’s views concerning a minimum base pay increase for “Fully Successful” employees, as it develops the final regulations. It is possible that OPM could decide to revise the criteria to guarantee a minimum increase for “Fully Successful” employees.

### **Performing Evaluations Fairly**

IRS has approximately 7,200 permanent managers. Of this total, approximately 5,300 are permanent Frontline Managers; 1,500 are permanent Senior Managers; and 350 are permanent Department Managers. During filing season, the IRS may have an additional 1,000+ temporary managers.

To maintain credibility in the performance management evaluation process, it is important that performance evaluations be done in a fair, non-discriminatory manner. IRS is committed to that.

The performance evaluation process really begins a year in advance when managers meet with their supervisors to discuss their goals for the year and how they plan to meet those goals. They meet again mid-way through the year to discuss progress toward those goals. Finally at the end of the year, the supervisor meets again with the manager and rates him or her based on one of five levels of performance: Outstanding, Exceeded, Met, Minimally Satisfactory or Not Met.

In an effort to further monitor the performance evaluation process and to ensure objectivity and consistency, the initial evaluation of a supervisor will be reviewed by a Performance Review Board (PRB). It is the policy of the IRS that annually each division/function will review the summary evaluation ratings of their managers on a corporate basis. Each PRB ensures that ratings consistently reflect similar performance across work unit lines, and validates that the ratings support individual and organizational performance.

Within the IRS, performance based increases as well as bonus parameters are consistent across all functional units. That means that a manager within our Wage and Investment Division who is rated as “Outstanding” will receive the same performance increase as a manager in our Small Business division with an identical rating. Managers across all functional units with the same rating will receive the same performance based increase. Each functional unit has discretion to determine the specific performance bonus amount; however, the overall performance bonus parameters are applied across functional units.

Accordingly, the performance based increase for Outstanding will always be greater than for someone who was rated as “Exceeded,” which in turn will be higher than someone rated as “Met.” Someone who was rated “Not Met” would not receive any performance based increase.

A similar system exists for bonuses. A manager receiving an “Outstanding” summary evaluation will receive a bonus. Someone rated as “Exceeded” *may* receive a bonus and someone who is rated as “Met” would only receive a bonus under extraordinary circumstances.

It is also important that evaluations be made free of any discrimination based on race, gender or national origin. We asked the third party contractor that is conducting the overall evaluation of the entire program to look at this issue and offer its assessment. The contractor has concluded its evaluation and found that since Fiscal Year 2004, there has been no disparate impact on any group of employees in the Senior Manager (SM), Department Manager (DM), or Frontline Manager (FM) paybands. The contractor analyzed the trends of the ratings data grouped by gender, age (Over 40 and Under 40) and ethnicity. In each group, ratings trended in a similar path to the average ratings across all groups.

### **Lessons Learned**

As the interest in pay for performance escalates across the Federal government, the IRS finds itself in the unique position of having information to share. We have certainly gained experience along the way, made adjustments to our system, and are still learning as we go. We will continually reassess all aspects of our pay for performance system and refine it to support the mission and goals of the IRS.

Based on our seven years of experience with our own program, we can offer some suggestions that might prove useful to agencies that might pursue paybanding or pay for performance in the future.

Specifically, we have found first-hand that a successful pay-for-performance system must incorporate the following key elements:

- Agencies should move deliberately and cautiously to implement the program that is “right” for its organization. There is no “cookie cutter” program that an agency can adapt as its own;
- Communication is critical. Managers must understand how the program will work and how they will be affected. There also must be forums to have their concerns and questions answered;
- An effective performance evaluation system must be in place. Managers must understand the basis for their evaluation and there should be a review system in place to make sure evaluations are being made on a consistent basis;

- Supervisors/managers must be trained properly on how to use the system and make sound evaluations; and
- On-going program evaluation is essential to ensure that the pay for performance system is operating as intended. Agencies must be willing to modify and revise their systems to meet the changing needs of their organizations.

### **Summary**

We have found that a properly implemented pay for performance plan can have obvious positive benefits for any agency. Perhaps most important of these is the fact that employees are rewarded for the quality of their work and not the tenure in their job. But perhaps equally important is the fact that such a system necessitates that managers at all levels are forced to interact in such a way that they discuss the agency's goals and how their individual performance relates to those goals.

As I indicated at the beginning, we tried to move deliberately in implementing pay for performance, but we still faced numerous bumps in the road. However, the benefits far outweigh the problems. It has helped us make the organizational transition required by RRA and link compensation to performance.

Thank you again, Mr. Chairman for the opportunity to be here and I am happy to respond to any questions.