CASE STUDY

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A Minnesota County's Successful Transition to a Performance-Based Compensation System

Background

The declining confidence in government policies and the opposition of taxpayers to higher taxes have heightened concerns about the efficient use of public funds and the productivity of public employees. In addition, the aging population and the consequent pressures on health care, Social Security and pension systems have been exacerbated by the recent economic crisis and the widening of the federal deficit. Current economic conditions have resulted in declining tax revenues, raising the urgency of many government agencies to look for ways to improve efficiency by transforming how they conduct business. Given the fact that labor costs make up a large portion of operating expenses, the forces of government accountability — including taxpayer associations and some elected officials — have pressed for changing the way tax dollars are spent and how public employee job performance is evaluated.

QUICK LOOK

- Declining tax revenues have made public-sector compensation systems based on employee seniority unaffordable — or even unreasonable — in today's economic environment.
- Scott County, Minn., experienced relative success in transitioning its employees from a seniority-based pay program to a performance-based system by securing the support of union leadership.
- Implementing a pay-for-performance system requires flawless execution, trust from employees and leadership collaboration.

By Saado Y. Abboud, Ph.D., CCP, Keystone Compensation Group, and Jack Kemme, Scott County, Minn.

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The Genesis and Purpose of Seniority Pay

Prior to the 1900s, public employment was considered a privilege. In other words, when political administrations changed, public employees had no constitutional right to keep their jobs. In late 1897, at the urging of the U.S. Civil Service Commission, rules restricting the release of public employees from their jobs were issued by President William McKinley. Securing of tenure was originally intended to help stabilize employment and improve personnel competence while providing quality service to citizens. That high emphasis on job security and tenure resulted in policies that contributed to increased personnel retention and compensation systems that rewarded employees for their length of service on the job. The step-pay program and its various permutations were developed to manage employee salaries and pay them for their tenure. However, such compensation programs led to salary increases becoming like a guaranteed annuity, and that put some organizations in the situation of having to give more dollars than available or needed. Given the scarcity of financial resources in most public entities, the compounding of pay for cost-of-living and step increases has proven to be unaffordable — or even unreasonable — in today's economic environment.

Basis for Differentiating Pay

One of the key elements in designing a compensation program is choosing the basis for granting salary increases to employees. This decision normally flows from the organization's compensation strategy and its philosophy statement around the desired behaviors and outcomes it intends to reward.

In compensation systems that put a premium on seniority, as represented by the step-pay programs, employees who have more years of experience are paid at higher levels than their junior counterparts, even when they do the same type of work. In practical terms, time in grade is the basis for differentiation — and that determines the size of the paycheck employees take to the bank.

In the pay-for-performance system, as represented by open ranges or some derivations of step-pay plans, differences in pay increases are tied generally to the level of employee contributions. Pay equity in this case translates into high performers receiving more pay in recognition for delivering on their established goals, without regard to their seniority.

Over the years, some government agencies have attempted to blend the objectives of retention and performance into one pay system. In most cases, this led to employees being rewarded for continuing employment, not for the quality of their performance on the job. Managers conveniently avoided communicating tough messages when goals were not achieved, or they neglected to take the time to set goals in the first place and then provide feedback. Giving high performers the same pay increases as everyone else causes their motivation to suffer and makes them less likely to voluntarily perform at high levels. Worse yet, they leave the organization. Naturally, this fosters an environment of underperformance at the individual and organizational levels and hinders the ability to attract and retain qualified talent.

Rewarding for Seniority vs. Performance

Creating alignment between compensation program objectives and business goals is a critical step in developing new effective pay programs. As pointed out earlier in this article, step-pay programs are designed with the objective of paying for seniority and encouraging long-term employment. They have proven successful at retention, as is evident from the low rate of turnover in public-service organizations compared with turnover in the private sector. The challenge with these programs, in many cases, is that they are not reward systems. They are schedules that dictate the next pay rate employees are entitled to receive if they stay long enough to qualify for the increase and meet certain minimum requirements on the job. Neither managers nor employees have the ability to modify or deviate from these schedules.

Paying for performance, on the other hand, is a reward system that attempts to connect the amount of rewards with individual, group or overall organizational performance. The design of this program is typically the outcome of a business performance management process that begins with defining performance, followed by agreeing on

performance goals, and then providing employees with timely feedback to better reach their goals.

Compensation programs that reward performance are also considered part of the overall talent-management system that includes selecting, rewarding and developing employees. For a talent system to be successful, the process of selecting, training, developing and rewarding employees must be consistent with the overall culture within the organization. Employees must have a support system that enables them to develop their skills and abilities so they can perform at high levels. Most of the challenges with performance-based compensation systems generally emerge from poor program design, lack of goal clarity and unreliable performance assessment processes.

Making salaries more reflective of employee performance has been the focus of several pay reform initiatives in public sector organizations. This, in combination with giving managers more authority in setting pay levels, provides a framework to limit pay increases to poor performers while freeing up sufficient funds to provide meaningful increases to outstanding performers. Fear of favoritism and lack of equity have caused legitimate concerns for labor unions about granting managers more leeway in determining employee compensation. They remain reluctant about tying pay increases directly to performance appraisals because it takes away their ability to set employee pay levels. This is especially true when employees perceive the pay system to be unfair due to lack of understanding, lack of trust or insufficient leadership credibility.

Despite many case studies about the challenges of implementing pay-for-performance programs in unionized environments, one government entity in Minnesota embarked on this journey several years ago. Scott County experienced relative success in transitioning its employees from a seniority-based pay program to a performance-based compensation system by securing the support and partnership of union leadership. This partnership was critically important as the recent economic crisis worsened and tough decisions had to be made to balance the county budget.

Performance-Based Pay Program at Scott County

Scott County is located on the southern edge of the Minneapolis-St. Paul metropolitan area. The county has about 700 employees, 80 percent of whom are in one of nine separate collective-bargaining units.

As a result of a long-range strategic plan, the county developed its mission "To deliver quality public service to all citizens in an effective, professional and efficient manner." In line with this mission, the county created this compensation philosophy statement: "To support, encourage and engage employees in a performance-oriented work culture using a fiscally responsible, market-based pay delivery system." Implementing this compensation philosophy took several years of planning, analysis, communication and education of employees and their union leaders. After all, the county's vision is "To be the best public service provider and employer in the business." For Scott County to move in the direction of its vision, all stakeholders agreed to work through a system that rewarded outcomes. This was a complete departure from the previous legacy system that rewarded seniority.

The change began in the mid-1990s with the formation of employee workgroups to help define performance expectations and the overall process of performance assessment. The outcomes

FIGURE 1: MERIT INCREASE GUIDE

Salary Level Between Grade Minimum and Market Midpoint

Performance Level	Needs Improvement	Meets Expectations	Exceeds Expectations	Outstanding
Base Adjustment	0.0%	2.5%	4.0%	6.0%
Lump Sum Payment	0.0%	0.0%	0.0%	0.0%

Salary Level Between Market Midpoint and Grade Maximum

Performance Level	Needs Improvement	Meets Expectations	Exceeds Expectations	Outstanding
Base Adjustment	0.0%	1.5%	3.0%	5.0%
Lump Sum Payment	0.0%	1.0%	1.0%	1.0%

Salary Level Between Grade Maximum and Performance Maximum

Performance Level	Needs Improvement	Meets Expectations	Exceeds Expectations	Outstanding
Base Adjustment	0.0%	0.0%	0.0%	1.0%
Lump Sum Payment	0.0%	2.5%	4.0%	5.0%

of this assessment were used to determine the amount of increase in base salary and lump-sum cash payments as dictated by individual performance and the current pay level within the salary range (see Figure 1 on page 42). This program was tested with the nonunion employee group, but union leaders were kept informed of all the discussions as part of a strategy to establish trust and gain their support. Initially, unions were understandably skeptical about the fairness of the performance assessment and how well it would reflect employee performance. They were concerned about supervisor subjectivity, a propensity for bias in ranking and the potential use of the new system as a hidden budget-control mechanism. However, by 2006, all nine unions agreed to move to the merit-based system following the successful implementation and positive feedback from the nonunion employee group.

Defining the Competitive Market

Most public-sector entities typically survey each other to determine their pay ranges for various positions. Their toughest challenge is to decide which organizations to include in the peer group. In most cases, they end up selecting entities based on their geographic location and the types of services they provide. In reality, this approach often does not accurately reflect the market from which new hires are recruited. When Scott County analyzed its pool of applicants, it found that new hires were drawn from a variety of industries and geographic locations, depending on job level. Recognizing this fact, the county commissioned a compensation benchmarking study that included public- and private-sector survey sources. This market pricing study provided the going rates that were used to design the new pay structures for nonexempt (see Figure 2) and exempt (see Figure 3) jobs. Both ranges included an 11-percent segment above the range maximum to grant salary increases to outstanding performers.

Employee Communication and Education

While the overall transition from the seniority-based pay program to the performance-based system took years, a steady emphasis was put on open communication with all employees, county leaders and union stewards. Transparent communication and the integrity of the outcomes helped take the perception of possible gaming and manipulative maneuvering out of the process. In addition, union leaders were notified of all communications prior to informing the general employee population. This gave them time to understand the program and prepare their own views about it, and prepared them to respond to inquiries from their members. Many employee meetings were held at various project milestones to share findings and solicit input. This communication planning and execution gave the process a positive credibility and contributed to building high levels of trust in the new program among employees. One of the important reasons for the perception of fairness was the time managers spent working with their employees to set goals and follow them with frequent feedback, helping make the year-end assessments more constructive.

Standing the Tests of Tough Economic Times

The recent global economic crisis hit the private and public sectors equally hard. Many government agencies have responded by making quick, unpopular

FIGURE 2: SCOTT COUNTY PAY STRUCTURE SAMPLE (NONEXEMPT)

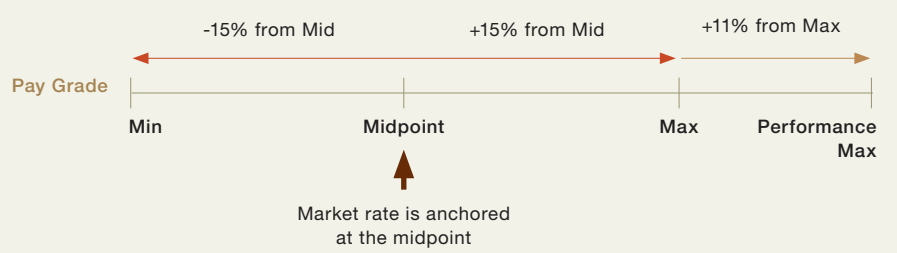
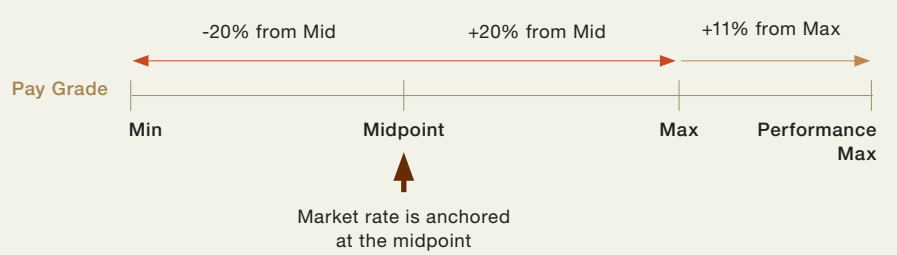


FIGURE 3: SCOTT COUNTY PAY STRUCTURE SAMPLE (EXEMPT)



short-term fixes, such as workforce reduction, furloughs, unpaid leaves and program cuts. The leaders in Scott County were determined to use staff reduction only as a last-ditch effort to balance the budget. To avoid layoffs and reduce operating expenses, most bargaining units voluntarily agreed to reopen their current contracts and adjust salary increase guidelines down. That was a true test of the strength of the partnership between union leaders and the county administration that has developed throughout this journey. In the words of the American Federation of State, County and Municipal Employees (AFSCME) local leader, "As far as I know, this has never happened. It is a big deal." In explaining why AFSCME was willing to revise existing contracts, union and county officials pointed to the unusually positive labor-management relations. The Local 2440 union president confirmed this when he said, "The real reason this passed is there was a sense we were treated fairly." In an unusual move, unions took the proactive side and extended the revised contract through 2011 to help alleviate economic pressures until the overall economy rebounds. In spite of the necessity to cut its budget, Scott County kept the spirit of its pay-for-performance program intact by reducing the overall amount of salary increases but retaining the degree of differentiation based on performance level (see Figure 4). As one of the county commissioners said, "It is a great story of the culture we have."

In neighboring Carver County, which has a step-pay program in place, dealing with the economic challenges resulted in negotiating a wage freeze with its largest unions in 2010. The county did not attempt — nor did its unions offer — to renegotiate its 2009 contracts to find ways to reduce payroll and prevent layoffs. At a recent meeting of the Minnesota Inter-County Association, other county commissioners said they wouldn't even consider asking unions to revise contracts. When a commissioner from Dakota County was asked about opening up contracts, the response was, "Are you kidding? I want to live to see tomorrow." In contrast, the strategy Scott County followed to solve the budget shortfalls focused on preserving the performance culture it had been building for several years. In the words of Scott County Employee Relations Director Jack Kemme, "Wage freeze was a last-resort option because it hampers the culture that has been developing with the pay-for-performance system."

Conclusion

Pay for performance is not necessarily suitable for all public agencies, and the recent economic crisis might increase the urgency for some to explore alternative pay programs. Conflicting opinions about the value of public service makes it difficult to establish the high level of trust and cooperation necessary for the success of pay-for-performance programs. For this system to work, it requires flawless execution, trust from employees, and leadership collaboration. For Scott County, it started with building the shared vision and mission of the organization, followed by developing a compensation philosophy consistent with them. Our study showed that performance culture requires a clear definition of performance, a solid goal-setting process, and a significant investment in education and communication to foster an environment of trust. Finally, this study also taught us that pay for performance is an extension of the organization's culture, which takes years to build. WS

FIGURE 4: **REDUCED MERIT INCREASE GUIDE FOR 2009 TO BALANCE THE BUDGET**

Performance Level	Needs Improvement	Meets Expectations	Exceeds Expectations	Outstanding
Base Adjustment	0.0%	0.5%	2.0%	4.0%
Lump Sum Payment	0.0%	0.0%	0.0%	0.0%

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