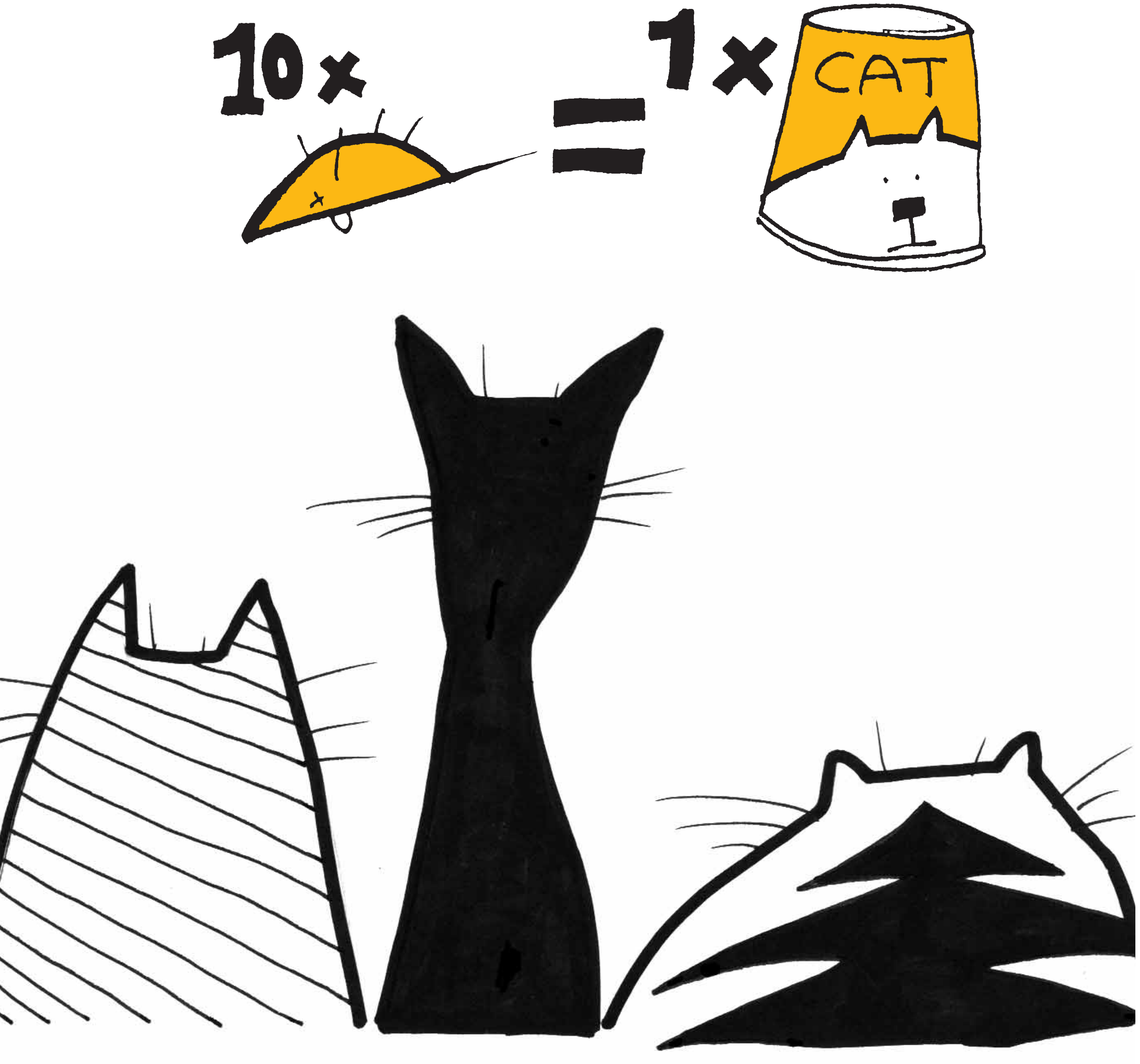
by David Marsden



Value for money

David Marsden looks at the record of performance related pay in the public sector.

There is a paradox to be explained concerning the spread of performance-related pay (PRP) in the British public services. It has been common to associate the introduction of PRP with the aim of improving incentives and motivation among public employees. Starting in the late 1980s, the British public services embarked on the most systematic and sustained policy of extending and developing performance-related pay of any OECD country, mostly replacing annual seniority-related pay increments with performance-related ones based on goal setting and appraisals by line managers.

Nevertheless, after surveying both academic research findings and inside management information, the government's Makinson report concluded in 2002 that performance pay had not motivated public employees in Britain and that its operation had been divisive. Given that the policy has been sustained by three successive prime ministers of quite different political persuasion – Margaret Thatcher, John Major and Tony Blair – as well as successive top public service managers, its continued use cannot plausibly be explained by political dogma. Likewise, in the face of such evidence, the perseverance of top public management and of successive governments with PRP is hard to understand, if employee motivation is the main story. We need to look elsewhere for an explanation.

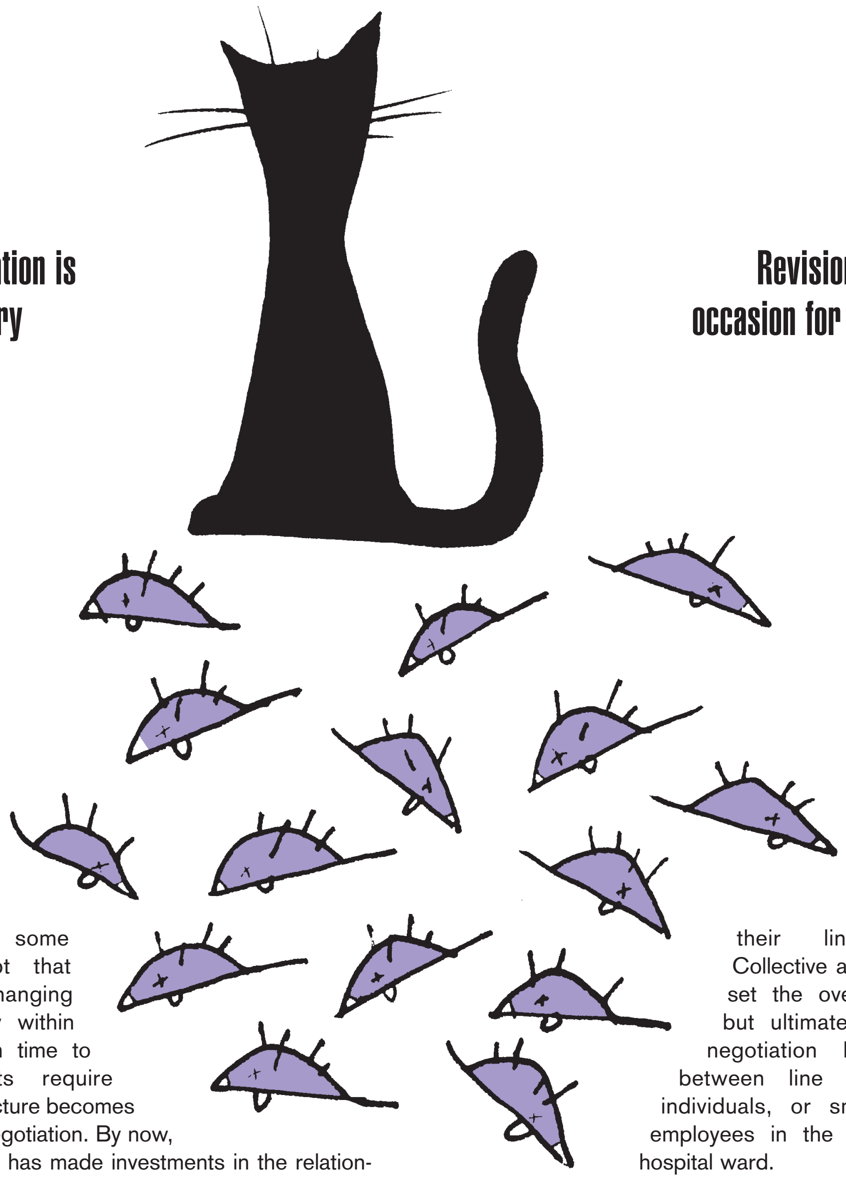
An alternative explanation can be found in the use of performance pay (and of performance management more widely) to provide a framework for *renegotiating* performance standards with employees. This is consistent both with rising organisational performance, which would explain top management's perseverance, and with all the evidence that PRP has failed to motivate many public employees.

It has been common to analyse the workings of PRP through the lenses of three main theories: agency, expectancy, and goal setting. These theories shed much light on the *static* incentive and appraisal processes present in PRP. They have focused mainly on how management can influence employees' choice between different levels of effort or care in their work for a *given* set of performance norms. To understand what has happened with PRP in the British public services, however, one needs to complement the perspective provided by these theories with a more *dynamic* analysis of inducements for employees to agree to, and work within, a new set of performance norms.

The idea of *renegotiation* is most simply explained in terms of contract theory. A worker and a firm agree to the terms of their exchange when the worker is hired. A key feature of the employment contract is that it should be open-ended in terms of both its duration and its content. Workers agree to

Employee motivation is not the main story

Revision becomes an occasion for renegotiation



give management some flexibility to adapt that content to changing demands, but only within certain limits. From time to time, these limits require revision. Such a juncture becomes an occasion for renegotiation. By now, however, each party has made investments in the relationship and is vulnerable to pressure tactics from the other. Much of the contract literature emphasises pay, because of changes in the market valuation of employee output. Less visible, but just as important for management, is its ability to revise job boundaries and to redefine the nature and standards of performance that it requires from employees. These standards, which may include qualitative aspects of performance, are usually the subject of a tacit understanding between staff and management, sometimes called the "effort bargain".

By what processes does renegotiation come about? Many recent studies have focused on the role here of collective bargaining. Their main interest, however, has been in pay adjustments. Pay rules are generally codified by virtue of their inclusion in collective agreements and individual contracts of employment. In contrast, many of the rules relating to workers' job boundaries and performance standards contain a large uncodified element. It is common for jobs to deviate considerably from their formal job descriptions. The features of a given job are therefore accessible to higher management only through the eyes of first-line managers. To renegotiate performance, management needs to get right down to the level of individual jobs and to the relationship between individual employees and their line managers. Collective agreements often set the overall framework, but ultimately this kind of negotiation has to occur between line managers and individuals, or small groups of employees in the same office or hospital ward.

At the time of hiring, workers who do not like the supervisory practices and incentive systems that the employer offers can just walk away, so there is a process of self-selection matching these job features to workers' preferences. However, when the time comes for changing work practices and incentive systems in an established organisation, the employer faces an incumbent work force whose preferences for or against the new system may vary considerably. In the change, some will expect to be winners and others losers. To get everyone to engage positively in the new system, management would have to offer a very attractive and costly deal. It might, therefore, prefer to make the new deal attractive to a sufficient proportion of its staff, so that the scheme functions tolerably well, and to forego the support of the remaining staff in order to keep within some budgetary limit.

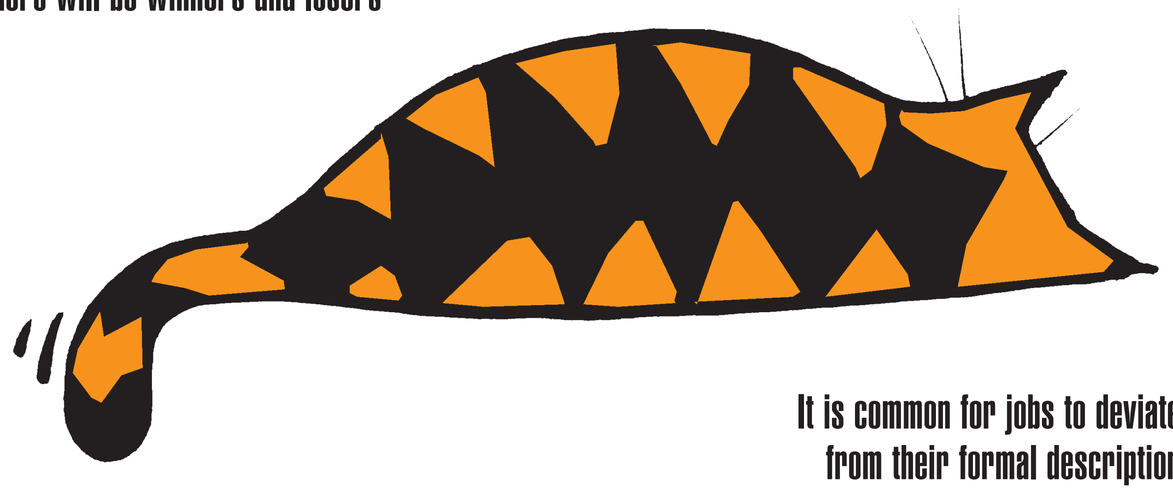
So the "renegotiation" explanation leads us to expect any net performance improvements in this study to depend on the combined effects of the move to new work norms and the attractiveness of the incentives provided by the new PRP system. However, neither effect is uniform across all employees. Some will be positively attracted to the new deal, which comprises both new norms and new incentives. They are likely to be motivated and to deliver higher performance. Others may resent the new arrangements and not find the pay scheme motivating. Nevertheless, their lack of motivation may not necessarily translate into a decline in their performance. Such employees must weigh the benefits of accepting the new scheme against the costs of finding an alternative. They may not like the new system, but they may still choose to work within it because changing jobs is not worth their while and they do not wish to be dismissed.

The greater management attention to goal setting and performance appraisal that accompanies PRP is likely to increase the effectiveness with which the new work norms are monitored and discourage reduced performance. Provided performance of the discontented does not fall too much, the organisation may still benefit from the increased performance of those who engage positively, assuming they do so in sufficient numbers.

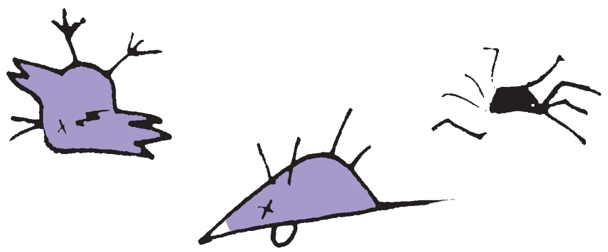
In this reading, renegotiation and incentive can be complementary functions of PRP. One can say that the incentive mechanisms and, particularly, the goal-setting mechanisms have to be working properly for PRP to be an effective means of changing work norms. Agency theory also provides a picture of the static functions of PRP. It explains how performance and output incentives encourage employees to work hard (and not to "shirk"), even when management finds it costly to monitor their effort closely. It suggests that management can respond by tying pay to output so as to induce employees to choose a higher level of effort and also, by investing in better systems of work design and performance evaluation, to improve the correlation between performance measures and effort, thus strengthening incentive effects. It also warns against the dysfunctions of inappropriate incentives, such as individual incentives that discourage cooperation among colleagues.

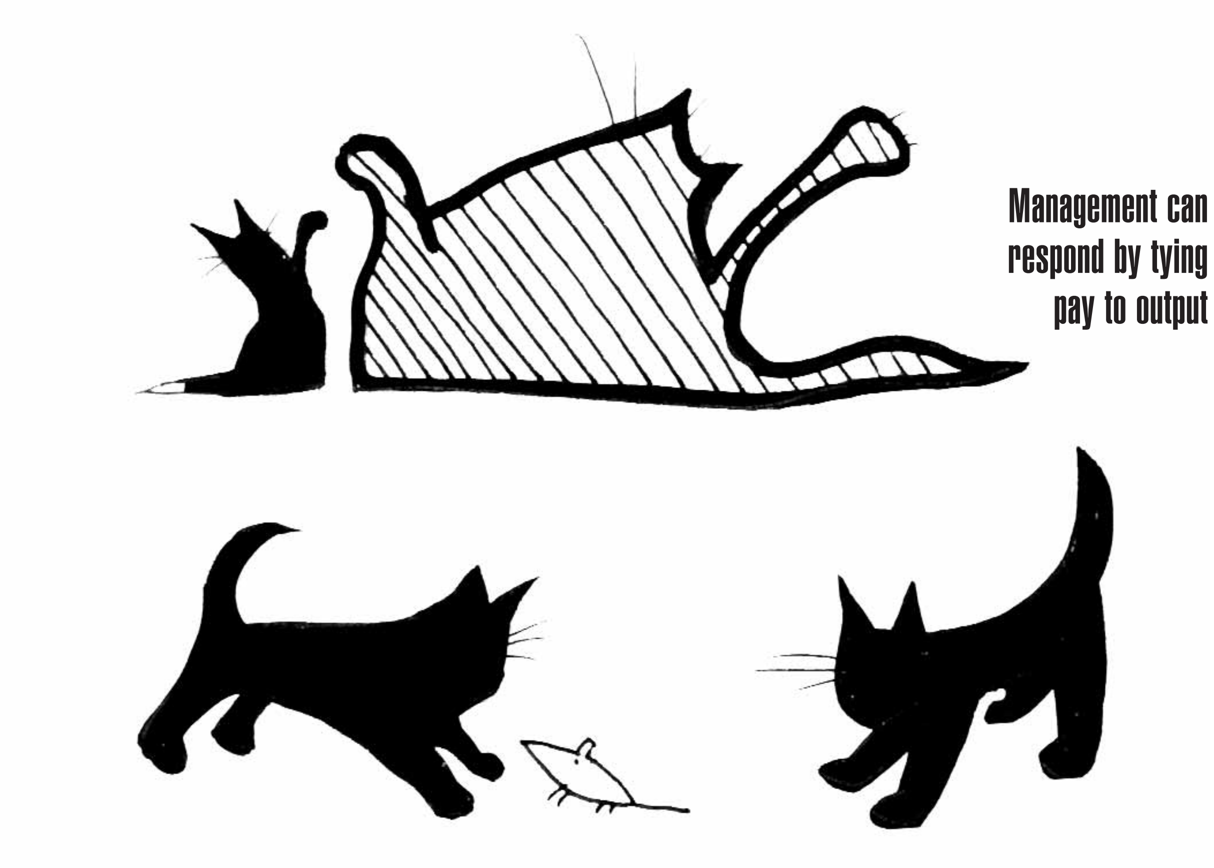
Expectancy theory, like agency theory, treats employees as having a degree of choice and places a strong emphasis on the motivational effects of incentives and on the problems posed by poorly defined targets. Simplifying somewhat, it identifies a potentially virtuous circle. Employees will respond to the incentive or reward on offer if they value it (*valence*), if they believe good performance will be instrumental in bringing the desired reward (*instrumentality*) and if they expect their efforts will achieve the desired performance (*expectancy*). The circle of valence-instrumentality-expectancy can be broken at a number of points. Employees may feel they lack scope to increase their effort, or that their effort will make little difference to their performance. This undermines expectancy. They may believe that management lacks the competence or the good faith to evaluate and reward their performance fairly, a view that undermines instrumentality. Applying these considerations to renegotiation, one can see that employees are more likely

There will be winners and losers



It is common for jobs to deviate from their formal description





to buy into a new incentive scheme when they perceive it as operating fairly and able to deliver the promised rewards.

Goal-setting theory places less emphasis on rewards and stresses the motivating power of defining appropriate work goals and engaging employee commitment to them. Of special relevance in the current context is its emphasis on dialogue between line managers and employees to exchange information about realistic goals and on agreeing to them, so that employees adopt them as their own. This framework already contains the germs of a negotiation process between employees and their managers. So it is easy to see how the basic idea can be applied in the context of renegotiating performance norms. Goal setting may be especially important for the employees who do not like the new system, but still prefer not to change jobs. In such cases, it provides management with a channel to clarify the new standards and establish agreed levels of compliance. Thus, although the last three approaches – agency, expectancy and goal setting – differ in emphasis, they point to the same key processes and variables for the analysis of performance pay systems: reward and motivation on the one hand and goal definition and evaluation on the other.

My argument is that the main impact of the introduction of PRP across large sections of the British public services during the 1990s was to facilitate the renegotiation of performance norms. When introducing a new incentive scheme to an established work force, management is almost certain to encounter a wide spread of employee preferences and the problem of winners and losers. Thus, even when a scheme is well designed and managers are well prepared to operate it, there will frequently be not only employees who respond favorably and agree to the new norms, but also others who resent the norms and consider themselves worse off. Whereas the former are positively motivated to improve or adapt their performance, the latter are not and managers hold them to the new performance norms by means of goal setting and appraisal. In this way, one can explain why successive governments and top managers have believed in the merits of PRP for the public services despite the evidence – of which they were certainly aware – that many employees saw little incentive and much divisiveness in them.

To some extent, renegotiation has emerged as a latent rather than an explicitly stated goal of PRP in the public services. When senior managers at the Inland Revenue were asked in 1991 about the goals of the PRP scheme they operated then, they responded in terms of motivation. Likewise, officials of the union representing Inland Revenue staff had encouraged their members to complete the questionnaires because they expected the survey to demonstrate publicly what they already knew: that the scheme was not motivating staff. The second Inland Revenue scheme, introduced in 1993, did not speak of renegotiation, but used the language of agreeing to objectives and establishing a "contract" with individual employees and of relating these to the department's operating plans.

This is where contract theory, and some of the older industrial relations literature, may prove helpful in understanding what is going on. Unions and their workplace representatives may be weaker now than in years past, but the labour market continues to confer sometimes considerable individual bargaining power on workers. Of course, a large organisation can always face down an individual worker, no matter how skilled or talented, but it cannot afford a gradual bleeding away of its skilled personnel. It is not possible for a management just to impose its optimal design. It has to negotiate its way to an approximation of that design and, in so doing, to respect the various budgetary and efficiency constraints it must satisfy to meet its own objectives.

In his 1999 *Journal of Economic Literature* review of work on incentives, Canice Prendergast commented on the need to extend the study of incentives beyond CEOs, sales personnel and sports stars. Such people often have short job tenures and their high rate of labour turnover means that self-selection often brings about a match between employee preferences and the type of incentive offered by the organisation. The public service has highlighted the opposite problem, where high labour stability, especially during the early to mid-1990s, meant that employers had to obtain results from new incentive schemes when implementing them for a large incumbent work force.

The public services' experience of PRP has also highlighted the key role of line managers. They are essential to the renegotiation process because they are the link between top management's goals and the way ordinary staff carry out their jobs. This introduces another layer in the principal-agent analysis of incentives. Line managers' abilities and interests are not identical to those of top management and they have no protective gatekeepers controlling staff access to them. When agreeing to performance objectives with individual staff, the pressures on them to be lenient are great. What seems to have kept these pressures mostly at bay has been the articulation between performance objectives at different levels within the public organisations. This has provided support to line managers and given them the means to keep a focus on broader organisational performance when establishing individual objectives.

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This article is based on the data from a series of attitude surveys of employees and line managers in six areas of the public service: the Inland Revenue, the Employment Service, two NHS trust hospitals and head teachers in primary and secondary schools. A fuller article, including an extended discussion of the data, will be published in the *Industrial and Labor Relations Review* in April.

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