

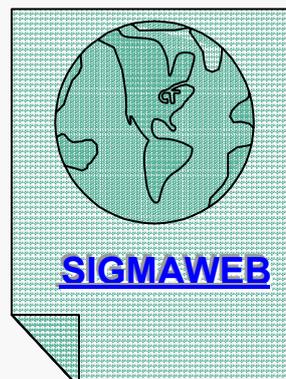
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PERFORMANCE-RELATED PAY (PRP) (Issue No. 8)

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Audit and Control



► PAYING FOR PERFORMANCE: POLICIES FOR GOVERNMENT EMPLOYEES

Over the past two decades, governments battling budget pressures and public perceptions of civil servants as underworked and overpaid have been seeking ways of making the public service perform better. The question of how to reward civil servants has remained a thorny one, in a changing world, where public service posts no longer necessarily offer a job for life and where the public employer is increasingly in competition with the private sector for the top performers. One solution — widely used in some parts of the private sector — is to replace or complement the traditional civil service system of automatic salary increases based on length of service with financial reward for good performance, or performance-related pay (PRP).

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PRP is increasingly used in public administrations of OECD member countries. In May 2005 the OECD will publish a book that provides a comprehensive overview of the trends in performance-related pay (PRP) policies for government employees (at the central level) in selected OECD countries over the past two decades and that draws some lessons from these experiences.

The results of such policies have been surprising in many ways. Staff are less motivated than might have been expected by the prospect of more money for working better. But performance-related pay can help improve performance when it is applied properly in the right managerial context, if not because of the financial rewards then indirectly through the changes in work and management organisation needed to implement it.

How widespread is PRP?

The first wave of PRP policies arrived in OECD member countries in the 1980s. The governments of Canada, Denmark, Netherlands, New Zealand, Spain, Sweden, United Kingdom and United States were among the first to adopt PRP in one form or another. A second round started in the early 1990s, with the adoption of PRP policies in Australia, Finland, Ireland and Italy. Most recently, countries such as Germany, Korea and Switzerland, as well as some in Central and Eastern Europe (Czech Republic, Hungary, Poland and Slovakia), began to put PRP mechanisms in place. In 2004 France started experimenting with the introduction of PRP for top-level civil servants (director level) in six pilot ministries. More than two-thirds of OECD countries have now introduced performance-related pay for at least part of their civil service.

Countries which have developed the strongest links between performance appraisals and pay as employee incentives are those which have the highest delegation of responsibility for human resources and budget management — usually position-based systems. However, this situation has started to change, and PRP policies have now been introduced into some career-based systems, such as in France, Hungary and Korea.

In addition to its expected impact on individual motivation and performance, PRP is always a politically interesting reform. It shows willingness to make civil service employees more accountable through regular monitoring of their level of performance.

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Performance-related pay has become a fashionable tool used in many settings. However, there are wide variations in the degree to which PRP is actually applied. In many cases, PRP concerns only managerial staff or specific ministries. Only a handful of OECD member countries can be considered to have an extended, formalised PRP policy (Denmark, Finland, Korea, New Zealand, Switzerland and United Kingdom). Elsewhere, the coverage of PRP varies greatly. In Canada, Ireland, Italy and Norway, PRP is applied only at management level, while Ireland, Norway and France have it in pilot ministries for the most senior officials. Sometimes, however, top managers are excluded from PRP (e.g. Finland). One reason for such an exclusion is to avoid assessing the performance of political appointees.

Also, many government organisations claim to have PRP, but in practice there is often a gap between the existence of a so-called “performance-related pay scheme” and its concrete functioning, which may be hardly linked to performance.

What rewards for what performance?

Although PRP systems have become increasingly common in OECD countries, their design and application varies considerably. Nevertheless, some common trends are emerging:

- Long-running standardised PRP schemes have evolved into more decentralised systems. This is the case for instance in Denmark, Italy, New Zealand, United Kingdom and United States.
- A notable development in recent years has been the extension of PRP from senior management to non-managerial staff.
- Several countries have strongly encouraged the move to a more collective approach to PRP over the past five years. In the United Kingdom, a number of departments made the transition from individual to team-based systems in 2004. In Finland, results-based rewards are applied at the team level. In Korea, as from 2002, four areas — defence, police, security (such as the Presidential Security Service) and railways — use a departmental base for PRP.

A key issue is whether performance payments are given as permanent additions to the recipient’s basic pay or as one-off payments that have to be re-earned during each appraisal period. In recent years, several countries have developed bonuses to replace merit increments. The size of these payments varies considerably across OECD member countries, but it is generally a fairly modest percentage of the basic salary, especially among non-managerial employees. Merit increments tend to be smaller than one-off bonuses, often below a maximum of 5% of the basic salary. PRP bonuses are in general higher — but overall, maximum rewards usually represent less than 10% of the basic salary of civil servants. For managers, the size of performance payments is larger and represents, on average, 20% of the basic salary for maximum rewards.

The monitoring and measurement of performance — especially the conduct of staff performance appraisals — is a difficult process. Experience indicates that the introduction of highly formalised and detailed rating systems in public organisations is not successful, as it is very difficult to distinguish the average performance of the majority of employees who are working satisfactorily, no matter how complex and formal the criteria might be. For example, in the United States, in most PRP schemes in operation in the 1980s, more than 95% of managers were rated as “fully satisfactory or better”. Considering these limitations, there have been two notable trends:



- There has been a move to less detailed rating systems, focusing on the distinction between top and bad performers — as extreme performances can be more easily assessed — based on a three-point scale rather than on five, ten or twenty points.
- Another response has been the increasing use of quota systems and forced ranking systems, specifying the proportion of employees placed in the higher categories of the rating scale (for instance, in Canada, Germany, Korea, Switzerland, United Kingdom and United States).

Performance assessment is inherently difficult in the public sector, owing to the difficulty of finding suitable quantitative indicators. The performance appraisal process requires a large element of managerial judgement. Whether PRP will have a positive impact on staff is strongly dependent on how well the appraisal process is carried out and, in particular, on how well individual and team objectives are identified and based on performance rather than standard job criteria. Certain conditions, such as transparency, clear promotion mechanisms, and the trust of top and middle management, are essential before introducing a performance-oriented culture. PRP policies are counterproductive in an inadequate management framework, and may in such situations increase problems linked to a lack of trust and even lead to corruption and patronage.

Impact of PRP

While performance-related pay appears to motivate a minority of staff in the public sector, a large majority just do not see it as an incentive to work better. Studies show that most government workers, particularly those in non-managerial roles, see basic pay and how it compares to the wider job market as far more important than supplementary pay increases for performance. This is because performance rewards have often been limited in the public sector, but also because job content and career development prospects have been found to be the strongest incentives for public employees. PRP is unlikely to motivate a substantial majority of staff, irrespective of the design.

The weak incentive effect of PRP does not mean that all PRP policies are necessarily counter-productive. The OECD study indicates that when the wider effects of performance-related pay policies are observed, over and above their impact on staff motivation, it becomes apparent that PRP can act as a lever for the introduction of wider organisational and management changes. Such changes include effective appraisal and goal-setting processes, clarification of tasks, acquisition of skills, improved employee-manager dialogue, more teamwork, and increased flexibility in work organisation.

PRP gives managers an added incentive to manage effectively and stimulates them to fully endorse a goal-setting approach. Goal-setting and appraisal provide the motivation for the kind of one-on-one contact between employees and their line managers in which the manner of working can be discussed and explained. Goal-setting works well when accompanied by more interaction between manager and staff member so that any reduction of formal controls is substituted by informal control. Another decisive level at which the performance appraisal element of PRP has emerged lies in the scope it offers to linking broader organisational objectives to those of individual employees.

PRP can also act as a window of opportunity for introducing significant managerial changes. This is especially true for public service delivery — such as tax or social security — where work organisation can be more directly linked to outputs or citizen demands than to core administration. PRP may facilitate wide-ranging organisational changes by linking pay bonuses to new objectives at the individual and departmental levels. These objectives can include, for instance, the use of more flexible working methods (such as working hours) as well as the introduction of new working tools or new information and communication technologies as corollaries of PRP.



Performance-related pay, when implemented in a sound management framework, can be an effective lever for change in the workplace, both by shifting attitudes to work and by re-examining work organisation. It appears that it is not through the financial incentives it provides that PRP can contribute to improving performance, but rather through its secondary effects, that is the changes to work and management organisation needed to implement it.

What lessons for the future?

- **The design of PRP has to take into account the background culture of each organisation/country.** PRP should not be introduced to the detriment of the basic salary, as the basic salary has the more decisive incentive impact. On the other hand, performance rewards must not be too limited – a UK expert recommends not below 5% of the basic salary — and should be well above the rate of inflation. The balance between individual and team PRP is a key design issue. Team/unit PRP systems for employees can be introduced in a less disruptive way and appear to produce more positive results than strictly individualised PRP.
- **The performance appraisal process is at the heart of the whole system.** The success of PRP ultimately relies more on the quality of the performance measurement process than on the level of payment.
- **Implementation problems need to be anticipated.** This implies primarily: co-ordination with staff and unions on implementing PRP; preparing top and line management; and clearly anticipating the budget and costs linked to PRP and the ways of funding it, as well as the time and work required to introduce and monitor the system.
- **Performance pay goes hand in hand with delegating human resources management.** It is easier to articulate individual employees' objectives and those of their organisation in a meaningful way if the local management has a degree of autonomy to adapt the scheme to its own needs.
- **The significance and impact of PRP should not be overestimated.** PRP is of secondary importance as a managerial tool for increasing motivation. The evidence points, therefore, to the need for a broad approach to better performance management as against a narrow preoccupation with performance-related compensation.
- PRP should be applied in an environment that maintains and supports a trust-based work relationship. PRP requires a mature and well-established civil service culture and a stable political and policy environment.
- PRP should be used, above all, as a stimulus and a lever for introducing wider management and organisational change, rather than solely as a motivational tool for staff. Pay for performance should be viewed essentially as a management tool. The objectives of PRP should be set accordingly.

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► IMPLEMENTING PAY-FOR-PERFORMANCE IN THE ESTONIAN CIVIL SERVICE

Since regaining independence in 1991, Estonia has been busy with establishing a civil service system in line with democratic principles. In Soviet times, there had been ministries and agencies in Estonia, but public officials could not have been considered to be civil servants in a traditional sense. The individuals holding these offices were not accountable to the public but to the communist party. The time was not ripe for establishing a democratic civil service.

The extensive changes that occurred in the public domain after the 1980s put in question the whole concept of the civil service, which made the situation of transition countries difficult. On the one hand, these countries were eager to draw lessons from the more developed

countries. On the other hand, as Bossaert and Demmke argue, there was no clear example to follow, since: "the civil service [was] to some extent in crisis and [was] criticised from all sides"². Estonia found itself in a very difficult situation, as the civil service had to be built up in accordance with principles that were at the same time being questioned in the countries that it was trying to draw lessons from. The same situation applied to remuneration policy. By the late 1990s, when the Public Service Act (PSA) had been in force for only a couple of years³, talks about introducing performance management into the public service became increasingly popular.

These ideas resulted in a decree issued by the Estonian Government, which regulated the distribution of funds provided for performance management in public service organisations. In 2001-2 there were nearly 100 million kroons (6.4 m EUR) earmarked for pay-for-performance (PFP) in the state budget. This decree required organisations applying for these funds to compile annual working plans, to be used as a basis for the decision on the level of PFP allocations. The working plans had to be consistent with the action plans and strategy of the organisation as well as with the strategic goals of the sector and the government. According to the decree, the supervising organisation was responsible for the allocation of PFP funds to its subordinate agencies on the basis of organisational performance. It was up to the managers of organisations to decide how PFP funds allocated to the organisation were distributed among employees. This decree aimed to improve the performance of public agencies through clearly stated objectives and systematic overview of the progress made in achieving these objectives. It was also designed to reward well-performing public organisations in order to make public administration more efficient and effective.

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² Bossaert, D. and Demmke, C. (2003), *Civil Services in the Accession States: New Trends and the Impact of the Integration Process*, European Institute of Public Administration, Maastricht.

³ The PSA came into force in 1996.



The effects of this initiative are rather dubious. In 2002 the State Audit Office carried out an audit in four ministries and their subordinate agencies on the effects of the decree⁴. One of the audited ministries was the Ministry of Finance, which had drafted the decree. The major conclusion of the audit was that the allocation of PFP funds to the audited organisations had not been dependent on the achievement of goals stated in the organisations' workplans. On the contrary, as it turned out, usually PFP funds had been distributed to subordinate agencies despite their results, and within organisations between all employees equally. Although the capacity of organisations to set measurable goals was rather low, most of the organisations participating in this scheme had received PFP funds. It was also concluded by the State Audit Office that this initiative had encouraged public agencies to hide problems instead of solving them. As performance pay was mechanically linked to the achievement of tasks set out in the organisation's workplan, leaving the more challenging tasks out of the plan could guarantee performance pay for the organisation at the end of the evaluation period⁵.

Several lessons can be drawn from Estonia's attempt to introduce performance management into the public service. Firstly, one of the major weaknesses of this initiative was underestimation of the effort required in the preparatory stages of the process. No pilot projects were carried out, and no training courses or guideline materials were provided to the persons responsible for introducing PFP into their organisations. Consequently, different organisations interpreted the initiative differently. Even the organisations that were taking this initiative seriously and actually wanted to improve the performance of their activities did not receive any methodological support from the Ministry of Finance. Ignoring the need for assistance created strong opposition and cynicism towards performance management.

Secondly, the PFP framework was not supported by the strategic planning process. Although the number of public agencies having stated strategic goals is constantly increasing, several ministries and many agencies still do not have them. Moreover, the quality and consistency of these drafted plans are very divergent. For instance, in 2001 when the Ministry of Finance introduced the PFP framework, this ministry did not have its own strategic plan. It is quite normal in Estonia that strategic plans are drafted in lower-level organisations, while their "owner" institutions, such as ministries, lack such a long-term vision. This situation indicates that tasks and objectives set by separate organisations cannot be in line with each other. Therefore, the value of evaluating performance in single agencies is rather questionable. The Ministry of Finance has been drafting a decree that would lay down basic principles of strategic planning to ensure a certain level of consistency between the strategic documents of public agencies and to set a hierarchy for these documents. Due to lengthy inter-ministerial disputes and the instability of coalition governments, this initiative has already been "under construction" for the past five years. Unless strategic documents are systemised and harmonised with the overall goals of the government, it is doubtful that the introduction of PFP into public agencies will lead to increased efficiency or effectiveness of the civil service on a larger scale.

⁴ State Audit Office (2002), *Decision of the Chief Auditor No. 043/2001*. [Estonian version](#) of this paper.

⁵ For a comprehensive analysis of this case, see Randma-Liiv, T. (2005), "Performance Management in Transitional Administration: Introduction of Pay-for-Performance in the Estonian Civil Service", *Journal of Comparative Policy Analysis*, forthcoming.



After experimenting with PFP, the Estonian Government decided to abandon this project in 2002. However, this decision does not mean that the aspirations to establish performance management have disappeared. For instance, the new draft of the Public Service Act, which has been in circulation for four years, and concept papers on the topic of public service development place great hopes in performance management. According to these documents, the efficiency and effectiveness of the Estonian public service can be best achieved through instruments such as performance contracts between ministers and public managers. Pay-for-performance is also seen as one of the tools to be used in compensation policy of the public service.

Fully acknowledging the positive aspects of performance management — such as setting and evaluating goals and creating quality circles — there are specific aspects that have to be taken into account in transition countries like Estonia. An individualised approach to strategic planning in the public service could result in increased competition and turf-fighting between public organisations. Such a situation would weaken co-operation within the civil service, which has already been identified as one of the major deficiencies of the Estonian public service. Mention should also be made of the demands on inter-departmental co-operation within the public service resulting from EU membership to ensure that a harmonised view is presented in European institutions. This requires a high level of co-operation and co-ordination between public agencies, which would be problematic in a highly competitive environment.

Moreover, as mentioned above, the concept of a professional civil service is rather new in Estonia. Although civil service principles have been put in question in the past decades, some traditional civil service values are acknowledged even by the strongest advocates of the *new public management* (NPM) approach. Values such as reliability and predictability, openness and transparency, and accountability — as stated in *European Principles for Public Administration* (Sigma Paper No. 27, 1999)⁶ — are by no means less important than efficiency or effectiveness. In fact, they are crucial in administrations with short traditions of democratic rule. In the case of old administrations, it is understandable when they try to loosen up tight bureaucratic rules that have developed over the past hundred years. It is quite different in the case of countries where there are almost no traditions of democratic civil service and where the value base of civil servants is unsettled. Putting stronger stress on efficiency and effectiveness, while overlooking more fundamental values, would make the establishment of a professional public service extremely difficult.

⁶ Available on the [Sigma web site](#).



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In summary, without a doubt performance management has many positive effects that lead to improved public services, more transparent administration and accountability. Also the initiative described in this article has made public servants more aware of the importance of systematic planning and evaluation and helped them to see their daily activities in a broader perspective. However, Estonia's experience tells us that the fruits of performance management can only be reaped through comprehensive preparatory work and continuous assistance from the co-ordinating agency. Also, ensuring the general framework of performance management through consistent strategic planning throughout the public service is an essential precondition. However, even if these aspects are ensured, it has to be kept in mind that performance management is not a universal tool or magic medicine that can resolve all of the public administration's problems. An extensive literature is available on the pitfalls of performance management. Before designing a performance management framework, a good overview of the problems inherent in this concept is required. Unfortunately, in Estonia the rhetoric in favour of performance management has usually been based only on conference discussions or simplified success stories. Finally, the transitional context of the Estonian public service complicates matters even further. In young democracies NPM-driven values of efficiency and effectiveness have to be balanced with more traditional public service values. Neglecting these lessons would quite likely result in strong opposition to the developments related to performance management, which in turn would be accompanied by strong cynicism. Even worse, this situation could lead to serious problems of co-operation and co-ordination within the civil service.

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► PERFORMANCE ASSESSMENT IN HUNGARY

Hungary introduced its performance assessment system after parliament had passed Act No. XXXVI of 2001 on the status of civil servants (hereinafter referred to as the Civil Service Act, amending Act No. XXIII of 1992), which included the creation of a performance-based pay system. This legal instrument came into effect on 1 January 2002. Prior to that date, Hungary had had no extensive experience in the application of performance assessment.

The Civil Service Act provides the framework regulation, which has basic features that are applied uniformly across the civil service. Performance assessment is obligatory for central and regional public administration bodies as well as for local governments (municipalities). Beyond its compliance with statutory requirements, each public administration body has full responsibility for deciding on the application of the regulation.

The performance assessment system embraces the majority of civil service personnel, from interns to department heads. It provides for personal assessment exclusively. The primary aim of its introduction was to improve the performance of civil service personnel, assisting them in developing their competencies to the fullest, in order to achieve the goals of public administration bodies.

Based on performance assessment models incorporated in public administration systems of several OECD member countries, Hungary introduced an annual performance appraisal system aimed at providing an incentive for responsible and professional management and continuously ensuring and improving professional know-how. Performance assessment was further linked to the remuneration of performance, thereby creating a performance-based pay system. The basic objectives of this system — in compliance with 21st century public administration requirements — included: encouraging effective working methods, strengthening motivation, clearly emphasizing accountability and responsibility, promoting the integration of personal and institutional interests and objectives, and defining and improving training strategies for the development of a performance-based and outcome-oriented organisational culture.

The performance of civil servants is assessed annually in writing by the person exercising the employer's rights and acting in his/her assessment competence. The assessment is based on defined performance criteria in accordance with the job description and with the key objectives of the public administration body. The written assessment report is transmitted to the civil servant in the course of an oral interview.

The performance assessment comprises three layers. The first layer focuses on the definition of the key objectives of the relevant public administration body. In accordance with the Civil Service Act, ministers or heads of public administration bodies set these objectives annually for the organisations under their management, control or supervision. In the case of local governments, the key objectives are set by the body of representatives.

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The second layer of performance assessment focuses on the definition of personal criteria. The person exercising the employer's rights defines in writing the objectives of the civil servant for the coming year, based on key personal objectives. When first defining performance criteria and then assessing performance, the employer takes into consideration the job description of the civil servant together with the definition of key objectives of the public administration body. These two bases for performance assessment are linked primarily to the fact that performance criteria are set as a function of the tasks contained in the job description that in turn match sectoral objectives. Linking these two bases guarantees that the employer sets performance criteria that are real and achievable and that relate to the job description of the civil servant being assessed.

The third level of performance assessment focuses on the written evaluation of the civil servant's performance — at the latest by the end of the year under review — by the person exercising the employer's rights and acting in his assessment competence. No performance assessment takes place if the civil servant has worked less than six months in the year.

The tasks related to performance assessment fall within the scope of competence of the person exercising the employer's rights. In the case of public administration bodies, the employer's rights are exercised by the head of the organisation. The head may decide to confer these rights on a senior civil servant in the organisation. However, the conferred rights cannot be further granted to a third person.

The outcome of the performance assessment may influence the remuneration of the civil servant. The head of the organisation exercising the employer's rights may decide, in view of the results of the assessment, to alter the rank-based remuneration of the civil servant for the following year. The basic remuneration may be increased or decreased by a degree ranging between +30% and -20% (this range was established on 1 January 2005; from January 2002 through December 2004 the range had been +/- 20%). Such a decision to increase or decrease the basic remuneration of a civil servant is not obligatory; it must be taken by the head of the organisation and not by a senior civil servant who may have been conferred the rights to carry out the performance appraisal.

In the event that a civil servant brings an action to court concerning a performance assessment, any false or incorrect statements of fact contained in the assessment report may be invalidated. The deadline for submitting such an action is within 30 days of receipt of the performance assessment report.

A possible problem at present with the system is the lack of a separate budgetary allocation for public administration bodies to back up the possible +30 / -20% fluctuation in remuneration following the assessment process. These possible alterations must therefore be financed by the organisations themselves from their own budgets. Experience has shown that this situation hinders the realisation of potential opportunities incorporated in the system of performance assessment in Hungary.

It would be worthwhile to consider the introduction of a so-called competence criteria system, which would help to identify the most important professional criteria in relation to a given position as well as the personal criteria for further improvement by the individual civil servant.

In summary, the introduction of performance assessment has enabled the civil service in Hungary to accomplish the aims for which this instrument was devised. These aims are as follows:



- To ensure the development and operation of an effective and efficient state; to improve the efficiency of operations, to increase the professional level of work, to promote a change in the organisational culture;
- In line with the job description of the civil servant, to further improve individual performance, which can be demonstrated qualitatively and quantitatively; to transform the relationship between top officials and their subordinates; to positively alter the attitudes and increase the level of satisfaction and motivation among civil servants; and to support individual career goals.

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Performance-related Pay

Over the past two decades there has been a continuous extension of performance-related pay (PRP) policies across OECD civil service systems. Two-thirds of OECD member countries have implemented PRP in their civil services or are in the process of doing so. PRP fits within the wider performance budgeting and management movement in vogue over the past two decades in a context of economic and budgetary difficulties in OECD member countries. In fact, the introduction of PRP is only one facet of a wider movement towards increased pay flexibility and individualisation in OECD public sectors.

The OECD has recently published a report on performance-related pay, which provides a comprehensive overview of the trends in PRP policies across civil services of OECD countries and draws some lessons from experience.

For more information on the overview report and individual country reports, now available online:

[Performance-related Pay Policies for Government Employees: Main Trends in OECD Member Countries](#)

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