



# LINKING PAY TO PERFORMANCE IN THE PUBLIC SECTOR

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A compensation philosophy with “pay for performance” is one of the new mantras for good governance in for-profit entities: it can be tied to a financial measure, such as earnings or revenue; a return measure, such as total shareholder return; or an objective measure, such as those provided by management buyouts.

The use of performance-related pay in the public sector or non-profit sector is often perceived as difficult, inappropriate and maybe even controversial. In many organisations Mercer finds that there are strong views both for and against its use, with difficulty in finding common ground. Arguments against it tend to be based on practical concerns as to how it can be properly designed to work. This *Perspective* will focus on performance-related pay in the public sector.

The objections that we typically hear are that:

- Individuals attracted to public service are there “to serve” and are not motivated by money.
- Performance is too difficult to measure in providing public services as there is no profit motive.
- The use of pay incentives (as we try to refrain from using the word “bonus”) in the public services is politically difficult to position with the funding taxpayers, especially in times when there is considerable pressure on public finances. Furthermore, there is often no money available to fund any performance-related pay.

Despite these objections, Mercer believes that performance-related pay can be successfully implemented at public sector entities if proper considerations are made. We have successfully designed and implemented a range of performance-related pay arrangements in different parts of the public sector across the world. Our experience demonstrates that performance-related pay can and (in most circumstances) should be implemented in public services organisations. Paying employees fixed salaries, regardless of the contribution that they make as individuals towards the overall success of the organisation, is not a good basis for developing highly-performing public services organisations.

In this *Perspective*, you will find three contrasting case studies in which performance-related pay has been successfully implemented in public services organisations:

- Senior manager pay in the Canadian health care system
- Pay for performance in the Singapore government
- Linking pay with performance in UK local government



*“Pay for senior management can be linked to performance based on short-term operational, long-term strategic and – in all cases – behavioural objectives that are measured by the board.”*

There are two main reasons for this:

- Pay can be the biggest cost for many public sector organisations and is always a central part of the employment deal. Therefore, when performance improvements are needed (as they usually are regardless of type of organisation), these are less likely to be achievable if pay remains fixed and unconnected with the need for change.
- Human nature is such that individuals perform at different levels, and this is especially the case for complex jobs; therefore, paying everyone the same without regard to performance outcome inevitably results in an unfair pay system.

In this article we provide three contrasting case studies in Canada, Singapore and the UK, where the successful implementation of performance-related pay in public services organisations has been accomplished.

### CASE STUDY 1 – SENIOR MANAGER PAY IN THE CANADIAN HEALTH CARE SYSTEM

**THE ISSUE:** A publicly funded CDN\$1 billion hospital needed to recruit and retain a top-talent CEO. The hospital board needed to address the following issues:

- Design a total rewards package that was linked to both operational results and the transformational change that is required within the hospital.
- Retain that CEO who has the ability to be attracted away by a for-profit health care entity.
- Demonstrate to the public that their tax dollars are being spent effectively in the published remuneration report.

Taken together, these issues required that a material proportion of the overall pay package should be variable, linked to the performance of the CEO.

**HOW THIS WAS ADDRESSED:** A “midpoint base salary” was determined based on a competitive market analysis and a framework developed to determine the complexity of the hospital. This midpoint base salary was agreed to be the accepted rate of pay for a fully competent CEO performing in accordance with a board-approved job mandate, based on the market data.

Mechanisms were then put in place to vary the midpoint salary two ways on the following basis:

- An amount of 10% of the base salary to be treated as “pay at risk”, deducted from the midpoint salary and earned back, based on the achievement of both SMART (specific, measurable, achievable, realistic and time-based) balanced scorecard operational objectives and behavioural expectations proposed by the CEO and approved by the board.
- An additional amount of 20% of midpoint salary to be treated as “pay for performance” that may be earned in addition to base salary, based on the achievement of “stretch” objectives linked to the hospital’s three-year strategic plan, which was also proposed by the CEO and approved by the board.

The board's annual performance review includes a self-assessment by the CEO and an assessment by the board of both the results obtained (i.e. the "what") and the demonstration of the organisational core values-based behaviours used to obtain those results (i.e. the "how"). The board has the facility to utilise a 360-degree feedback process, overseen by Mercer, to obtain feedback on the behaviours from direct reports and external partners.

**IMPLICATIONS:** This shows how the pay for senior management can be linked to performance, based on short-term operational, long-term strategic and – in all cases – behavioural objectives that are measured by the board. Concerns about the use of incentive pay for senior people can be addressed through the use of both "pay at risk" and "pay for performance", with full public transparency as to the objectives set and the results obtained in improving their hospital.

## CASE STUDY 2 – PAY FOR PERFORMANCE IN THE SINGAPORE GOVERNMENT\*

**THE ISSUE:** The government undertook a fundamental review of the basis and level of political salaries, including that of the Prime Minister, political appointment holders and members of Parliament. The report resulted in a substantial reduction in the base pay for political appointments but with the inclusion of variable pay based on performance.

**HOW THIS WAS ADDRESSED:** A fixed monthly salary is determined based on the salary level of an entry level Minister at 60% of the median of the top 1,000 Singapore citizen income earners. In addition to this base salary, there is additional pay for performance on the following basis:

- An annual variable component which will typically be one month of salary based on economic performance.
- An amount based on individual performance under which good performers would typically receive three months' worth of salary. For the Prime Minister there is no individual performance element (because this cannot readily be measured) and an additional national bonus is paid instead.
- A National Bonus producing a payment of up to six months of salary based on the following national improvements: (a) real median income growth rate; (b) real growth rate of the lowest 20th percentile income; (c) unemployment rate; and (d) real GDP growth rate. These four indicators will have equal weight.

The effect of this is that political appointees can typically expect to receive variable pay of between 50% and 60% of their base salary, provided that performance is at the expected levels.

\*The information in this case study is based on publicly available documents which can be accessed at <http://reviewcommittee2011.sg>.



**IMPLICATIONS:** In a dynamic economy, a substantial proportion of the pay of political leaders receive is directly linked to that of the overall performance of the economy and other key indicators on a basis that is open and transparent. Therefore, the additional pay for political leaders is fully aligned with growth in the wealth of citizens, with clarity as to how performance is measured and assessed.

### CASE STUDY 3 – LINKING PAY WITH PERFORMANCE IN UK LOCAL GOVERNMENT

**THE ISSUE:** The local authority had a traditional pay system in which each of its 4,000 employees progressed to the top of a fixed pay range, based on time served. It decided to improve its pay system in order to:

- Support the modernisation of the business and its performance improvement agenda.
- Ensure that employees progress through the pay ranges based on personal contribution rather than time served, in order to provide better value for money.
- Find a sustainable way to reward high performance (especially for those at the top of their pay scales).

In order to achieve these objectives, the local authority decided to introduce a new “contribution-based-pay” system.

**HOW THIS WAS ADDRESSED:** In the future, base pay progression will depend both on an employee’s position in the pay range and on his or her performance. Employees may receive a pay range uplift and also receive a proportion of a variable pay percentage as well as a non-consolidated payment. The effects of these changes are that:

- Employees move to individual pay points within a broad pay range, rather than being on fixed pay points.
- Money that would previously have been used for an annual pay increase for everyone can now be allocated more flexibly depending on performance, both at the organisational and the individual level.

The new pay system links directly with delivering successful performance which is a new automated performance management framework which assesses both:

- “What has been achieved”, and
- How it was achieved

The performance management framework was implemented in 2011, and pay will be linked to performance for the first time in 2013.

All employees have been asked to move to a new contract of employment which includes the new performance-related pay arrangements.



*“Properly designed performance-related pay can make a significant contribution towards improving the quality of public services...”*

**IMPLICATIONS:** This case study shows how it is possible to modernise pay structures and use pay to drive improved performance where strong political leadership is in place. The local authority is better able to control pay costs and ensure that employees share in its successes, based on the contributions that they make.

## CONCLUSION

The successful use of performance-related pay in public services organisations requires care to ensure that the design is appropriate to the circumstances for each organisation. In particular:

- The objectives to be achieved should be mutually agreed to at the outset. The key objective should be to ensure that differences in individual performance are fairly established, recognised and rewarded. This means that performance-related pay should be commensurate with those differences in performance, with the higher levels of bonus commonly seen in the private sector not typically appropriate. It also means that performance-related pay may not be appropriate for jobs in which it is hard to differentiate or measure performance or to link pay to individual performance (although organisation-wide and team-based rewards should be considered for these roles).
- It is essential that there is a clear view of what good performance and exceptional performance look like at the top of the organisation and that this is effectively communicated to users of the services and to the public.
- The organisation must have the capabilities and processes in place to successfully establish the right objectives and measure performance fairly, accurately and consistently.

Pay is one of the biggest costs in public services, and taking a strategic approach to how this money is spent should always include consideration as to how pay should be aligned with performance.

Properly designed performance-related pay can make a significant contribution towards improving the quality of public services and ensuring value for money. Mercer's experiences of working on these issues in Canada, Singapore and the UK show that well-designed approaches to performance-related pay can be successfully implemented in public services organisations and can make a significant contribution towards improving the services that are used by citizens.



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