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Performance Evaluation and Pay for Performance: Does it Really Motivate Public Officials?

by

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Abstract

New Public Management based on principal agent theory has considered pay for performance schemes as a panacea for the reform of public institutions. During the 1990s the private sector has witnessed extensive managerial misbehaviour induced by variable pay, e.g. stock option plans. The same is likely to happen in public institutions when pay for performance schemes are introduced. We argue that, variable pay for performance may undermine public servants' efforts, as rewards crowd out intrinsic motivation. Consequently we provide several arguments for the return to fixed salaries. (87 words)

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1. Failures of New Public Management

New Public Management (NPM) aims at raising accountability in public service institutions by enforcing market mechanisms. The change to NPM “marked a radical shift from a public service whose purpose was to promote public welfare to an enterprise culture based on efficiency and economy” (Mascarenhas, 1993). Decisive characteristics are the establishment of output indicators as a means of performance measurement and the introduction of pay for performance schemes in public institutions. Especially pay for performance concepts are considered as a panacea leading to higher levels of professionalism in service delivery (Cardona, 2006). It is assumed to raise public servants’ motivation, which will lead to enhanced service quality. Therefore it is often praised as a symbol of modern quality management.

New Public Management is grounded on new institutional economics, in particular the principal agent view (Kaboolian, 1998) as proposed by Jensen and Murphy (1990). They take it as a matter of course that bureaucratic behaviour is far inferior to what a value-maximizing manager would do and conclude that “cash compensation should be structured to provide big rewards for outstanding performance and meaningful penalties for poor performance” (p. 141).

The bottom line is that interests between the agent and the principal are to be aligned via high powered monetary incentives. Additionally, the agent is assumed to have a stronger motivation as he or she can directly influence his salary through good performance.

Unfortunately, the adverse effects of pay for performance schemes (e.g. stock option programs) have become obvious during the last 15 years. The prospect of huge salaries has led some top managers to act in ways which are detrimental to their firms, as well as to the market system as a whole. Managers have turned from “legends” (Hegele & Kieser, 2001) into “crooks” (Osterloh & Frey, 2004). In particular, managers have jacked up short-term profits instead of focusing on long-term opportunities, and they have neglected paying out dividends to their shareholders (Lambert, Lanen, & Larcker, 1989). Many corporate scandals are also reflected in fraudulent accounts. Well-known examples are WorldCom, Xerox and Enron. However, significant contributors to agency theory tend to defend the existing system of CEO compensation.

The rise of executive compensation is also rooted in a failure of corporate governance. Top managers climb the hierarchy to positions where they have enough discretion to manipulate the factors by which they are evaluated themselves (Benz & Frey, 2007).

Given the negative consequences of pay for performance in private businesses, is it reasonable to assume that these effects will not occur in public institutions? Are high powered incentives the decisive feature of motivation in public institutions?

In Osterloh and Frey (2005) it is argued that high-powered incentive compensation, even if it could be optimally designed, does not solve the problems identified in the corporate sector, but aggravates them. This is also valid for public institutions which are designed to deliver socially desirable services. We argue that, variable pay for performance may undermine public servants' efforts, as rewards crowd out intrinsic motivation. This occurs when intrinsic motivation has been present beforehand. The latter can be assumed for public servants as we will show in section 4. A bonus system then makes employees and public servants lose interest in the immediate goal. Moreover, monetary incentives in complex and novel tasks tend to produce stereotyped repetition, and measurement is often dysfunctional. Therefore, intrinsic motivation is crucial for these tasks. We therefore call for a return to fixed compensation schemes.

2. Variable pay for performance and motivation

Variable pay for performance has become a fashionable proposal over the last few years, in private companies as well as in the public sector. In the public sector, efforts to raise productivity in the wake of new public management have resulted in attempts to adjust variably the compensation of public employees for their performance. This means that firms and public administrations increasingly rely on price incentives – i.e. on extrinsic motivations.

We first clarify the underlying concepts of extrinsic and intrinsic motivation. On the basis of theoretical and empirical evidence we demonstrate that intrinsic and extrinsic motivations are not additive. Rather, there is a systematic dynamic relationship between the two, called “crowding effects”. In particular, monetary compensation can crowd out the intrinsic motivation to work for one's own sake.

2.1. Intrinsic and extrinsic motivation

Extrinsic motivation satisfies personal needs indirectly, e.g. giving monetary compensation. Money cannot produce direct utility but it enables an individual to acquire desired products. Agency theory assumes that managers' additional or marginal effort is solely motivated by one factor, extrinsic incentives.

But social psychology, as well as psychological economics, indicates that individuals' motivations are more broadly based. Intrinsic motivation, in contrast, satisfies personal needs directly, i.e. the execution of an intrinsically motivated activity leads directly to utility gains. Individuals derive utility from the activity itself or because they wish to comply with given normative standards for their own sake. The extent of intrinsically motivated behaviour systematically depends on conditions which can be shaped by appropriate institutions. They approximate the conditions identified by Max Weber (1978) in his model of bureaucracy, which he takes to be the most efficient mode of governance.

Intrinsic motivation can be directed to the activity's flow (Cikszentmihalyi, 1975), to a self-defined goal, such as, for example, running a marathon, or to the obligations of personal and social identities (March, 1999). The ideal incentive system resides in the work content itself, which must be satisfactory and fulfilling for the employees. It follows that, "if you want people motivated to do a good job, give them a good job to do" (Herzberg, as quoted by Kohn 1993: 49).

Intrinsic motivation is dealt with by only a few authors in economics; examples are trust (Arrow, 1974), sentiments (Akerlof & Yellen, 1986; Frank, 1992), firm loyalty (Baker, Jensen, & Murphy, 1988), managerial incentives (Güth, 1995) and implicit contracts or norms (Akerlof, 1982). Some economists admit the existence of intrinsic motivation but leave it aside because it is difficult to analyse and control (e.g. Williamson, 1985). Even if the assumption of opportunism is an "extreme caricature" (Milgrom & Roberts, 1992: 42), it is taken to be prudent to consider a worst-case scenario when designing institutional structures (see also Brennan & Buchanan, 1985 for the case of the constitution) – i.e. dealing only with extrinsic motivation.

Unfortunately, intrinsic and extrinsic motivations are not independent from one another: extrinsic incentives can crowd out intrinsic motivations (Bénabou & Tirole, 2003; Falk & Kosfeld, 2006; Fehr & Gächter, 2002; Frey, 1997; Lindenberg, 2001; Osterloh & Frey, 2000;

Weibel, Forthcoming). The crowding-out effect has been analyzed by psychologists and economists in hundreds of laboratory experiments e.g. Deci, Koestner and Ryan (1999) and Cameron, Banko and Pierce (2001), as well as the econometric studies of real life events (see e.g. Frey, Oberholzer-Gee, & Bohnet, 1997; Gneezy & Rustichini, 2000; Weibel, Rost, & Osterloh, forthcoming). The opposite effect, the “crowding-in” also exists, but we focus on the crowding-out effect.

2.2 The relationship between extrinsic and intrinsic motivation: crowding out effects

As mentioned above, intrinsic and extrinsic motivations are not additive. Extrinsic rewards crowd out intrinsic motivation under certain conditions. There are two conditions of decisive importance: *first*, intrinsic motivation must have been present before the crowding effect kicks in. *Second*, the reward must be perceived as controlling by the recipient.

This effect has been called the “hidden costs of reward” (Lepper & Greene, 1978) or “the corruption effect of extrinsic motivation” (Deci, 1975). Frey (1997) has introduced it into microeconomics as the “crowding-out theory”. Extensive surveys are given by Lepper and Greene (1978), Pittman and Heller (1987) and Lane (1991). Kohn (1993) and Deci and Flaste (1995) provide popular applications, and Frey and Jegen (2001) survey the empirical evidence.

The theoretical underpinnings of the crowding out effect of intrinsic motivation are found in self-determination theory (Deci & Ryan, 2000). According to this theory self-determination suffers when external events such as external control or monetary incentives are introduced. As a result individuals shift their “locus of causality” to the outside, directing their attention away from the task itself to the controlling element (e.g. reward or sanction). The intrinsically rewarding content of the task drifts into the background.

This crowding out effect of intrinsic motivation occurs especially in relation to pay for performance schemes. Such reward systems usually, not always, make employees lose interest in the immediate goal (such as delivering a service). As a consequence, performance is lowered and service quality plummets. Moreover, research has shown, that the crowding out effect is stronger with material than with symbolic rewards. E.g., when a superior acknowledges an employee’s extraordinary effort with a symbolic gift (such as a bunch of flowers), the intrinsic motivation of the employee tends to be raised because he or she feels that his or her intrinsic motivation is appreciated. However, if the employee feels that the superior’s gesture serves only in an instrumental purpose, his/her intrinsic motivation is

impaired. The bunch of flowers is perceived to be controlling. It is also larger with expected than with unexpected rewards.

When the problems at issue are complicated, the negative relationship between reward and performance is stronger than when the problems are simple (Heckhausen, 1991). In all these cases, it is required that the behaviour was initially perceived to be interesting and therefore intrinsically rewarding (see Calder & Staw, 1975).

2.3 Empirical Evidence

In order to test the crowding out effect of intrinsic motivation a wealth of laboratory and field experiments has been conducted. The following section presents a selection of those experiments and their results which we consider illustrative, important and interesting:

Blood Donation

Titmuss (1970) found that paying blood donors for giving blood crowds out intrinsic motivation to do so. Not only the aggregate supply of blood diminished but also the quality of the donated blood dropped.

NIMBY Syndrome

Frey and Oberholzer-Gee (1997) conducted a field study in central Switzerland. In a carefully designed survey for a community, more than half the respondents (50.8 percent) agreed to have a nuclear waste repository built in their community. When monetary compensation was offered, the level of acceptance dropped to 24.6 percent.

Social norms of good conduct

Gneezy and Rustichini (2000) found in a field study that fining parents for picking up their children late from a childcare center had an adverse effect. The fine led to a significantly lower level of punctuality. When the fine was discontinued, punctuality remained at the lower level. Obviously the parents' obligation to norms of good conduct was undermined by the external monetary intervention.

Corruption

Schulze and Frank (2003) conducted a laboratory experiment with students on corruption and bribery. They found that monitoring (i.e. larger probability of detection) reduced honesty. The

motivation to be honest is crowded out by monitoring as monitoring means that the principal does not trust his agent anymore.

Working hours

An econometric study of 116 managers in medium-sized Dutch firms showed that the number of hours worked in the company decreased with the intensity of personal control effected by the superiors (Barkema, 1995).

Pay for performance

A large-scale study conducted in 3,860 family businesses found that performance pay is ineffective because it violates a psychological contract, directed on higher-order goals such as affiliation and recognition (Buchholtz, Schulze, & Dino, 1996).

Complex tasks

Austin (1996) shows, on the basis of interviews with eight experts, that performance measurement is highly counterproductive for complex and ambiguous tasks in computer software development.

3. Benefits of intrinsic motivation

Intrinsic motivation fosters creativity, overcomes difficulties that arise from multiple tasking and supports the transfer of tacit knowledge.

3.1 Creativity

Intrinsic motivation is the basis for the fulfilment of creative tasks. According to Amabile (1996, 1998) and Schwartz (1990) extrinsically motivated persons tend to produce stereotyped repetition of what already works. Additionally, experiments have shown that the speed of learning and conceptual understanding are both reduced when people are monitored. The pressure of sanctions leads to lower levels of learning, and the work is performed in a more superficial way than with intrinsically motivated employees (Deci & Flaste, 1995: 47). The latter point has a decisive impact on the service quality of public institutions.

3.2 Multiple tasking

Public service institutions have to deliver complex and to certain degree abstract products and services such as “good health”, “good education” or “knowledge” (Plant, 2003). Already in 1976 Rainey, Backhoff and Levine hint at the difficulties to identify clear objectives and performance measures in public institutions. In order to have a well-working pay for performance scheme, it would be necessary to specify every aspect of a task, e.g. via output indicators. Since this is never possible in complex work environments incomplete contracts arise (Masten, 2006). Due to the fact that indicators are known and the desire to score high, the person subject to such a pay for performance system has a strong incentive to fulfill solely what is measured, i.e. the quantifiable performance related aspect of a task. As a consequence what is easy to measure dominates the execution of tasks. What is not easy to measure is disregarded though it might be important for fulfilling the task. The fact that principals struggle to identify the correct goals contributes to the problem. Especially when public services are involved the first best public outcome is hard to establish. Financial goals cannot always be broken down into operational goals for public servants. Ouchi (1977: 98) takes the US Foreign Services as an example: its goal is to improve international relations with other states. In this case neither outputs are measurable nor can specific advice be given on how to “transform manpower into good foreign relations”. This problem has contributed to the recent success of the balanced scorecard concept (Kaplan & Norton, 1996), which is nowadays transmitted to public institutions, too. As a result, contracts offering incentives to reach given goals can give rise to dysfunctional behavioural responses. Agents focus only on the rewarded aspects of the job and disregard the unrewarded ones. Neither do they have sufficient incentives to reflect on the adequacy of the goals they should achieve for the overall success of the firm.

This phenomenon is well-known in economics as “multiple tasking” (Fehr & Schmidt, 2004; Holmstrom & Milgrom, 1991; Kerr, 1975) and can be overcome when intrinsic motivation is strengthened by institutional incentives. The avoidance of the multiple tasking problem justifies the decision to step back from pay for performance schemes.

3.3 Lower levels of free-riding

In a situation where individuals need to cooperate the opportunity to free-ride arises. Consider e.g. a project in a public service institution where the public servants have to share (tacit) knowledge to produce the desired outcome. The amount of contribution cannot be attributed to a single person. Nevertheless, intrinsically motivated individuals are unlikely to free-ride (e.g. by not contributing knowledge at all) because they are genuinely interested in the project. The spirit of cooperation tends to be overridden by the spirit of competition when individual rewards are considered (Emery, 2004: 160).

4. Characteristics of public officials

One cannot simply transfer the pay for performance concept from the corporate world into public institutions without considering the different characteristics of tasks and motivations. We explained the underlying principal-agent rationale for pay for performance schemes in public institutions. We also argued that in private business environments pay for performance schemes tend to be abused. Employing pay for performance in public institutions implicitly assumes that the public and private work forces are identical (Crewson, 1997). This need not necessarily be the case: several early qualitative and quantitative studies (e.g. Guyot, 1962; Kilpatrick, Cummings, & Jennings, 1964; Warner et al., 1963) as well as more recent ones (e.g. Rainey, 1982) conclude that civil officials tend to put more weight on the belief in the importance of work, are higher on the achievement motive scale, are less attracted by financial rewards and have a greater interest in altruistic activities and socially desirable outcomes. They also rate intrinsic incentives higher than extrinsic ones whereas private sector employees rate extrinsic incentives higher (Crewson, 1997). More recently, Emery (2004: 159) notes that “within public sector organizations, financial incentives rarely come first amongst sources of motivation in comparison to the private sector.”

Public servants are also more inclined to show voluntary rule following behaviour: they are prepared to follow rules and regulations that limit their self-interests without sanctions as long as they accept their legitimacy (Tyler, 1999, Tyler & Blader, 2000). This supports the arguments by Max Weber (1978) that legitimacy is a property that is not only instrumental but reflects a social value orientation towards authority.

Although empirical evidence is inconsistent, i.e. some studies conclude that there are no major differences between public sector employees and private sector employees (e.g. Gabris

& Simo, 1995; a good review is provided by Wright, 2001), one should consider that this does not exclude the presence of intrinsic motivation in the case of public sector employees. The presence of very low levels of intrinsic motivation is sufficient.

These results are highly relevant for our purposes because they support the assumption that civil servants are to a large part intrinsically motivated. As stated above, the existence of intrinsic motivation in the first place is a necessary prerequisite for the crowding-out effect to occur. The findings are also consistent with the argument that non-pecuniary incentives are higher valued by public servants (e.g. Rainey, Backoff, & Levine, 1976) and that public service is related to a variety of norm-based and affective motives (Perry & Wise, 1990: 369). Bearing these points in mind, one is induced to follow Crewson's (1997: 515) conclusion:

“A delicate balance must be achieved between providing adequate economic rewards and taking care not to destroy or ignore the intrinsic or service needs of public employees. The balancing of rewards in the public sector cannot rely solely on private-sector assumptions and techniques.”

A pay for performance scheme in public administration has an undermining effect on the intrinsic motivation of public servants. This effect is brought about by the close connection between output based controls and monetary rewards. Intrinsically motivated public servants may shift their interest from delivering a socially desirable public service itself to money. The mind's attention becomes focused on material rewards. This is known as the “overjustification effect” which substitutes internal by external incentives (Kruglanski et al., 1978) and thus may undermine intrinsic motivation. Extrinsic incentives connected to output based control systems are perceived as controlling (not as supporting) by persons submitted to them. Furthermore they run counter to public servants preferences (of intrinsic rewards). This leads to a crowding out of intrinsic motivation.

5. A call for fixed compensation

A simple way to contain the negative effects of pay for performance schemes is a return to fixed compensation schemes. Since public officials (and others e.g. judges, politicians) should

not be induced to change performance evaluation criteria to their own favour fixed compensation is a promising low cost alternative. As a consequence the incentives to change the performance evaluation criteria are likely to disappear (Benz & Frey 2006).

Apart from keeping intrinsic motivation on a desired level it also insulates the multitasking problem against misbehaviour. Fixed compensation schemes shift the incentives from the salary to the work content. This in turn mitigates the multitasking problem as time, effort and energy are more likely to be directed towards the important aspects of a work task.

Recent OECD analyses referring to pay for performance in the public administration point into the same direction, when asserting that “there is no conclusive empirical evidence that such an approach has effectively helped to improve motivation and performance within the public service. No link has been found between performance related pay for managers and improvements in organizational performance.” (Cardona, 2006: 2). These reports state clearly that pay for performance is working rather badly in OECD countries and has no positive effects on the motivation of public servants (OECD, 2005).

Fixed salaries save time that can be devoted to productive work, since pay for performance systems have to be managed constantly. Establishing quantifiable indicators for tasks which are difficult to quantify is a time consuming aspect of work. The same is true for evaluating employees according to defined standards.

Emery (2004: 158) observed a different point which he termed as an individual vs. team paradox: “Management literature is placing increasing emphasis on the importance of teams in the success and performance of organizations (...) whilst human resources management practices within public organizations and, in particular, those linked to pay are becoming increasingly individualistic.” Cooperation in teams is the foundation for added value also in public institutions. According to this view pay for performance schemes induce individualistic behavior which is contrary to the desired teamwork. Hence pay for performance schemes are conceptually flawed.

The return to a fixed compensation scheme can avoid a vicious circle in recruitment. A pay for performance scheme is likely to attract candidates who prefer individualistic pay for performance systems. The quality of the pool of candidates able to fulfil the specific requirements of the public sector is lowered. The quality of public service is bound to suffer.

6. Conclusion

This paper considers the motivational consequences on public officials when pay for performance schemes are introduced. We show that intrinsic and extrinsic motivations are not additive. Due to this fact intrinsic motivation can be crowded out by extrinsic incentives. This is likely to occur strongly in the case of public servants. Fixed salaries are a remedy to the crowding out of intrinsic motivation and avoids noxious side effects that come with pay for performance schemes.

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