

**Incentive Compensation in The Public Sector:
Evidence and Potential**

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INCENTIVE COMPENSATION IN THE PUBLIC SECTOR: EVIDENCE AND POTENTIAL

I. Introduction

To what extent is incentive compensation practiced in the U.S. public sector and what are the future prospects for its use? These are the focal questions herein. In Section II, a brief history of public sector compensation practices is presented. Section III analyzes recent evidence about the uses of incentive compensation in the public sector based on survey data from 17 state and 284 local governments. In Section IV, perceptions of and preferences regarding incentive compensation in the public sector are analyzed based on a second set of survey data drawn from samples of elected officials, managerial personnel, employees, and residents of four state and 18 local governments. Section V examines the prevailing wage rule that operates in these same governments, with emphasis on how implementation of this rule affects incentive compensation. In Section VI, some predictions about the future of incentive compensation in the public sector are offered. Section VII summarizes my main conclusions and predictions.

II. Historical Summary

Early in the 20th century, public sector compensation practices were largely ad hoc and unsystematic. In that period, political patronage primarily determined not only what public sector employees were paid but, more fundamentally, also who got public sector jobs. Access to public sector employment depended less on what you knew than whom you knew. In this employment "system," pay rates for individuals performing the same work varied widely among individuals. And, similar to a portion of the private sector during this period, payments, payoffs, or kickbacks from employees to supervisors, managers, and political bosses were commonly made to secure and maintain jobs (Loverd and Pavlak, 1983).

This patronage system of public sector employment and pay was challenged and for the most part supplanted between the two world wars by the "reform" movement. Civil service was at the heart of this movement, with public sector jobs becoming formally analyzed, graded, and classified. New rules and procedures were established for the specification and filling of jobs, recruitment became an open rather than closed process, employment tests were administered to applicants, protections from arbitrary dismissal

were put in place, and pay rates and rate ranges were established for civil service jobs. This new employment and pay system was adopted by the federal government and large state and local governments, and it eventually trickled down to small governments in cities, towns, and villages (Loverd and Pavlak, 1983).

To implement their new pay systems, governments increasingly looked to the private sector for comparison or benchmark rates. During the 1950s and 1960s, such comparisons became formalized under prevailing wage statutes and policies adopted by governments. Some governments, typically large ones, instituted their own pay surveys, while other, typically smaller, governments relied on pay surveys conducted by the U.S. Bureau of Labor Statistics, larger governments, and specialized organizations, such as the International City Managers' Association (ICMA), to obtain market data for setting their pay rates (Lewin, 1974a). Also during this period, and paralleling developments in the private sector, U.S. governments adopted pension plans and, later, health-care plans for their employees so that pay, per se, became a relatively smaller part of total compensation. Prevailing wage surveys, in turn, evolved into prevailing total compensation surveys.

Whatever else may be said about prevailing wage theory as a basis for governmental pay-setting, implementation of this theory was decided exclusively by governmental management; in other words, the public sector pay-setting process was virtually exclusively management-determined (Dunlop, 1944). Yet, the private sector pay data on which governments increasingly relied to set their pay rates included a substantial portion of rates that had been determined through collective bargaining between unionized employees and managers. Public sector employees became increasingly dissatisfied with a pay (and work) system in which they had little or no voice, so they began to organize with a vengeance. Over the 20-year span from 1960 to 1980, the U.S. public sector unionization rate grew from about 10 percent to about 33 percent and, by a few years later, surpassed the U.S. private sector unionization rate. This dramatic increase in the unionization of government employees was substantially aided by public sector collective bargaining statutes enacted by state legislatures. Thus, the pay-setting process in state and local government (as well as the federal government) changed from largely management determined to partly collectively determined and partly management determined (Lewin et al., 1988).

Nevertheless, under both collective bargaining and management determination public sector pay practices continued to feature "payment for time" in the forms of wage, salaries, and fringe benefits. To this point, the use of incentive compensation in government was as foreign as the reform movement had been during the patronage era of government employment and pay. But several developments subsequently spurred consideration and then selected use of incentive compensation in the U.S. public sector. One of these developments was the slowdown in growth, followed by actual decline, of the public sector. During the third quarter of the 20th century, state and local government was the fastest growing "industry" in the U.S., with government employment and pay both rising rapidly. But the mid-1970s recession, the second deepest recession of the 20th century, had especially pronounced effects on the public sector that, according to many observers, faced a fiscal crisis. Consequently, government hiring freezes were widely adopted, followed by layoffs (termed "reductions in force") and so-called concession bargaining in which unionized public employees "gave back" some pay and benefits to their government employers (Lewin, 1982). A few of these negotiations featured "productivity bargaining" in which certain unions, such as of sanitation employees, agreed to work-crew size reductions coupled with incentive pay in the form of bonuses for achieving higher levels of sewage disposal, snow removal, street maintenance, and the like (Lewin, 1987).

A second development spurring greater use of incentive compensation in government was the taxpayer revolt which, in states such as California and Massachusetts, took the form of new, permanent, lower property-tax assessments which, in turn, reduced the budgets available to fund public services, especially education. At the national level, this revolt led to reductions in individual and corporate income tax rates. More fundamentally, during this time, the dominant view among the citizenry was that "smaller was better" so far as government was concerned. For many, if not most, government employers, this political-economic climate meant choosing between having a smaller better-paid work force or a larger poorer-paid work force. It also meant searching for ways in which public employees' pay could become more incentive-based, such as through performance bonuses for teachers tied to student achievement on standardized tests, and for police personnel tied to reduced crime rates or increased arrest and clearance rates.

A third development, closely related to the second, spurring greater use of incentive compensation in government was increasing domestic and global economic competition, stimulated in part by de-regulation. In the third-quarter of the 20th century featured state and local government as the nation's fastest growing

industry, it also featured a majority of private industries that were officially classified as oligopolies and monopolies. By the end of the 1980s, however, a substantial majority of U.S. industries had become competitive, with much of this competition stemming from abroad. It is no coincidence that, during this period, the notion of the market-driven or customer-driven firm came of age (Kotler, 1991). And, this idea was extended to the public sector with the view that governments should be more citizen-customer driven. For some governments, embracing this idea led to instituting or increasing user fees for certain services, for others it resulted in the subcontracting or outsourcing of certain services, and for still others it meant privatizing some services that had previously been "publicly" delivered. But, in addition, this new emphasis on a more competitive, market-driven public sector led many governments to adopt new incentive compensation initiatives, including department-wide bonuses based on achievement of measurable performance objectives, gain-sharing, and productivity-sharing payments for some unionized employee groups, and more individual performance-based pay for mid-level and senior public sector managers (Gaebler and Osborne, 1992).

These developments continued into the 1990s and the impetus they gave to greater use of incentive compensation in government was further reinforced by the economic recession that occurred early in that decade. Whereas the mid-1970s recession had particularly strong negative effects on the government of New York City, which bordered on bankruptcy and whose financial management and operations were taken over by a new State-level Emergency Financial Control Board, the early 1990s' recession had especially strong negative effects on local governments in California, most notably the County of Orange, the second largest county government in the state, which did declare bankruptcy. One of that County's post-bankruptcy initiatives was the adoption of a new management performance plan requiring all future management pay increases to be based on achievement of individual performance objectives which, in turn, were linked to larger departmental objectives (County of Orange, CA, 1998). At about the same time, the City of Los Angeles, the nation's second largest municipal government, adopted a new management performance assessment and compensation plan that substantially strengthened the link between pay and performance for the director and assistant director of each of the City's 35 departments (City Of Los Angeles, 1995).

This economic recession soon turned to recovery and was followed by exceptionally rapid economic growth during the remainder of the 1990s. In this unusually favorable economic environment, the federal government and almost all state and local governments ran budget surpluses, which might have served to dampen further initiatives toward using incentive compensation in government. But two additional developments appeared to strongly support such initiatives; one was the re-inventing government movement, the other was the pay-for-performance movement. Advocates of government reinvention envisioned smaller, leaner, more efficient governments whose leaders design new strategies for managing their organizations and for rendering high performance in the delivery of public services (Risher, 1997; Gaebler and Osborne, 1992). Incentive compensation is viewed by some of these advocates as a leading tool for the re-invention of government (Risher et al., 1997; Siegel, 1992; Meehan, 1991). Advocates of pay-for-performance envisioned public sector compensation systems in which employees at all levels from top executives to front-line personnel to operatives have significant portions of their pay tied to organizational, unit, department, or individual performance (Wise, 1994; Newland et al., 1991; Mitchell et al., 1990). These advocates rely heavily on motivation and compensation theories, traditionally applied more to the private than the public sector, in which tight links between rewards and performance lead to more favorable employee attitudes toward work followed, in turn, by greater (or smarter) work effort and enhanced job and organizational performance (Lawler, 2000; Gerhart et al., 1992; Vroom, 1964). Taken together, these two doctrines provide a conceptual basis for governments to use incentive compensation to motivate public employees — internal customers — to deliver high quality services to a discerning citizenry — external customers — and perhaps also thereby to ward off pressures for the privatization of public services.

Thus, several macro economic-political developments imply and certain conceptual frameworks support expanded use of incentive compensation in the public sector, and selected recent examples from large local governments illustrate such usage. Attention now turns to empirical evidence about incentive compensation usage in the public sector more broadly.

III. Incentive Compensation Usage in State and Local Government

A recent study analyzed the breadth, depth, and determinants of incentive compensation usage in the public sector (Lewin, 1992) based on a survey administered in late 1998 to 25 state governments and 400 local governments that collectively had more than 6 million employees (excluding education employees). In the survey, incentive compensation was defined to include (1) performance-based pay, (2) merit pay, (3) productivity-sharing, (4) gain-sharing, (5) skill-based-pay, (6) pay-for-knowledge, (7) bonus pay, and (8) other. Brief definitions of each of these types of incentive compensation were provided in the survey.¹ Respondents were asked to indicate which of these types of incentive compensation were used by their respective governments as well as for which major groups of employees—managerial, professional, technical, clerical, operators, manual, and other service—they were used and in which agencies/departments they were used². Completed surveys providing fully usable data were received from 17 or 68 percent of the state governments and 284 or 71 percent of the local governments.

Regarding the breadth of incentive compensation usage, Table 1 shows that all but one of the state governments and 242 or 85 percent of the local governments use incentive compensation. Performance-based pay and merit pay and are the most prevalent types of incentive compensation in these governments, followed by skill-based pay and gain-sharing, while bonus pay is least frequently used. Among major employee/occupational groups, Table 1 shows that incentive compensation is most prevalent among professional and technical employees and least prevalent among clerical and manual employees. There is also considerable variation by agency/department in the use of incentive compensation (not shown in Table 1), with such compensation being most widely used in taxation, finance (budget), welfare, health care, sanitation, highways, and utilities (i.e., water and power), and least widely used in public works, motor vehicles, general services, criminal justice (excluding police) and protective services (including police). Concerning the duration of incentive compensation plans, a few of these state and local governments adopted one or another incentive compensation plan in the mid-to-late 1970s, but the “typical” government in this sample began to use incentive compensation in the early-to-mid 1990s. Also of note, unionized employees in these governments tend to be covered by productivity-sharing and gain-sharing plans, while non union employees are primarily covered by performance-based-pay and merit-pay plans.

In these governments, the type of incentive compensation plan used also varies widely by employee/occupational group (Table 1). Performance-based-pay, merit pay, and pay-for-knowledge plans are most likely for professional and technical employees; productivity-sharing and gain-sharing plans for operatives; skill-based pay for technical employees and operatives and, to a lesser extent, professional and other service employees; and bonus pay for managerial and technical employees. The overall incidence of pay-for-knowledge and bonus plans in these governments, however, is far lower than the overall incidence of pay-for-performance, merit pay, skill-based pay, productivity-sharing and gain-sharing plans. Stated differently, an employee in any of these governments is far more likely — about five times as likely — to be covered by a pay-for-performance or merit-pay plan than by a pay-for-knowledge or bonus plan.

To examine the determinants of incentive compensation usage in these governments, an incentive compensation index was constructed from the survey data. The index incorporates (i.e., assigns points to) the types of incentive compensation plans used by each government, employee coverage of the plans in each government, and the agency/department coverage of the plans in each government.³ This index was regressed onto several independent and control variables. The statistically significant findings from this analysis (not shown here) were that larger and older governments, governments with relatively high retail sales and income tax rates, governments with high ratios of white-collar to blue-collar employees and total public expenditures to total economic activity, governments with prevailing wage policies, governments in the Midwest and Southwest regions, and governments that recently used a compensation consultant were most likely to use incentive compensation. Also, among local governments, those with a city manager form of government were significantly more likely to use incentive compensation than governments with mayor, mayor-council, council only, or other forms of government. By contrast, employee unionization and the presence of a living wage statute/policy/ were not significantly associated with the use of incentive compensation in state and local governments. These statistically insignificant findings are substantively significant, however, in that they suggest that governments' use of incentive compensation is not affected (i.e., constrained) by the unionization of their employees or by their adoption of living wage statutes or policies.

Additional regression analyses (also not shown here) confirmed that incentive compensation is most likely to be used for professional and technical employees, least likely to be used for clerical and manual

employees, of state and local governments. Managerial, operative, and other service employment were not significantly associated with incentive compensation usage by these state and local governments. The insignificant finding for managerial employees is nevertheless notable because of the contrasting practice in industry, where incentive compensation has its broadest (and deepest) coverage in management ranks (Milkovich and Newman, 1999).

Turning from the breadth to the depth of incentive compensation usage in government, "What proportion of total compensation paid to employees of state and local government is accounted for by incentive compensation?" This is an important question, especially in light of the continuing debate over the (relative) amount of incentive compensation that is required to motivate enhanced employee performance, whether in the public or private sector (Ingraham, 1993; Milkovich and Newman, 1999). Data to answer this question were provided by the survey, which asked respondents to state or estimate total direct compensation (i.e., excluding benefits) paid to employees of their respective state and local governments during the most recent fiscal year, and then to state or estimate total incentive compensation paid to these same employees during the most recent fiscal year.⁴ Additional questions elicited similar data for major employee/occupational groups and agencies/departments; the data are summarized in Table 2.

On the basis of these data, incentive compensation accounted for slightly more than six percent of base compensation (i.e., salaries and wage) paid to employees of state and local government in 1998. Among employee/occupational groups, incentive compensation as a proportion of base compensation was highest for technical and professional employees and lowest for clerical and managerial employees. Among agencies/departments, incentive compensation as a proportion of base compensation was highest in taxation, finance, and utilities and lowest in criminal justice, public works, and motor vehicles. On balance, then, the use of incentive compensation appears widespread, that is, broad, in state and local government, but the amount of such compensation relative to base compensation is small, that is, not very deep, falling well short of the depth that most experts believe is required to enhance employee and government performance (Levine, 1997; Risher, 1999).

IV. Incentive Compensation Perceptions and Preferences

Having considered patterns of actual incentive compensation usage in government, consider next the perceptions and preferences of key public sector "actors" regarding such compensation; the main groups of actors include public officials, managers, employees, and citizens. Of particular interest are (1) differences among these groups regarding perceived incentive compensation usage in government, (2) differences between actual and perceived use of incentive compensation, and (3) differences among these groups regarding their preferences for incentive compensation usage. For this purpose, the aforementioned study included surveys that were administered to samples of elected officials, managers, (non management) employees, and residents of four state governments and 18 local governments (none of which were located in the four states). Sample selection yielded 110 elected officials, 132 managers, 220 employees, and 440 residents to whom the survey was mailed.⁵ This procedure, together with a follow-up mailing and telephone calls to 20 percent of the total sample, resulted in an overall response rate of 62 percent, composed of 57 percent of elected officials, 64 percent of managers, 59 percent of employees, and 65 percent of residents.

As summarized in Table 3, large majorities of elected officials and managers believe that incentive compensation is used by their respective governments, compared to only 41 percent of employees and 26 percent of residents. When asked about the percentage of government employees covered by incentive compensation, the responses ranged from a high of 75 percent among elected officials to a low of 15 percent among residents. When asked to estimate the percentage of total direct employee compensation represented by incentive compensation in their governments, the mean responses were 15 percent among elected officials, nine percent among managers, six percent among employees, and three percent among residents. Several of these inter-group differences were statistically significant.

Instructively, employees were more accurate than elected officials, managers, and residents in their estimates of the ratio of incentive compensation to total direct compensation in these governments. Using data from this study's first survey, the mean ratio of incentive compensation to total direct compensation in these governments was 6.80 in the most recent fiscal year, with a standard deviation of 1.65 percent and a range from 3.50 to 8.10 percent. Thus, employees' mean estimate of six percent for this ratio was close to the actual ratio, whereas elected officials and managers substantially over-estimated the actual ratio and

residents substantially under-estimated the actual ratio of incentive compensation to total direct compensation in their respective governments (Table 3).

Survey respondents were also asked about their preferences for using incentive compensation by government. As shown in Table 3, 85 percent of officials, 78 percent of managers, 61 percent of employees, and 72 percent of residents favored incentive compensation. Across the four surveyed groups, the most common reason for favoring such use was "to improve government performance." Elected officials in particular cited "increased agency accountability" in favoring the use of incentive compensation by government, whereas managers most often cited "increased employee motivation," and residents cited "better quality services" in this regard. Employees who favor greater use of incentive compensation by their governments cited "increased compensation" as the main rationale for their position, while employees who oppose greater use of incentive compensation by their governments cited "management favoritism," "pay inequity," and "measurement problems" as the main reasons for their position.

Concerning the types of public sector incentive compensation favored by survey respondents, overall support was strongest for pay-for-performance and skill-based pay arrangements and weakest for bonus plans. Among the four surveyed groups, officials most strongly favored performance-based pay, managers most strongly favored bonus pay, employees most strongly favored skill-based pay and pay-for-knowledge, and residents most strongly favored productivity-sharing and gain-sharing type incentive compensation plans (Table 3). In explaining their preferences, managers view bonus pay as recognition for achievement of agency/department wide performance objectives and as a mechanism for bringing them "up (or closer) to par" with their private sector counterparts. Notably, and by contrast, employees explained their aversion to performance-based pay and merit-pay plans by questioning management's competence to establish performance/merit criteria and to judge employee performance/merit. These employees regard skill-based pay and pay-for-knowledge plans as relatively unambiguous and, because they are viewed as enhancing their work-related competencies, prefer them to other incentive compensation plans.

As to their preferences regarding the amount of total direct compensation that should be represented by incentive compensation in their governments, the mean response was 16 percent for the entire sample and 12 percent among officials, 20 percent among managers, 14 percent among employees, and 11 percent among residents (Table 3). Thus, all of these groups favor a significantly larger ratio of incentive

compensation to total direct compensation than actually exists in these governments as a whole (i.e., 6.80 percent) or in the single government with the highest ratio (i.e., 8.10 percent). However, managers, employees, and residents favor a larger ratio, while elected officials favor a lower ratio, of incentive compensation to total direct compensation than they, respectively, believe presently exists in these governments.

What factors influence the perceptions and preferences of elected officials, managers, employees, and residents about the use of incentive compensation by government? To answer this question, several perceptual and preference-type dependent variables were regressed onto sets of independent and control variables, and the four respondent groups were combined into one for most of the analyses ($n = 563$). The quantitative findings (not shown here) confirmed that elected officials and managers perceive incentive compensation to be more widely used, cover a larger portion of the work force, and constitute a larger proportion of total direct compensation in their respective governments than do employees and citizens of these same governments. Among respondents as a whole, age and length of residence in the current government jurisdiction are significantly associated with perceived high use of incentive compensation by governments, and men are significantly more likely than women to perceive such high use. By contrast, family income and voting in the most recent (state or local government) election are significantly associated with perceived low use of incentive compensation by these governments. Furthermore, respondents from smaller governments, governments with relatively low sales tax, income tax and public employee unionization rates, and governments in the Southwest region are significantly more likely than respondents from other jurisdictions to perceive incentive compensation as being highly used by their governments. When limited to the sample of residents of these government jurisdictions, the analysis found resident's occupation (ranked from low to high) to be significantly associated with perceived low use of incentive compensation by government, whereas being unemployed or retired was significantly associated with perceived high use of incentive compensation by government.

Concerning respondents' preferences about the compensation practices of their respective governments, the regression findings indicate that employees have a significantly lower preference than officials, managers, and residents for the use of incentive compensation. Among respondents as a whole, age and length of residence in the current government jurisdiction are significantly associated with a

preference for low use of incentive compensation by government, whereas family income and voting in the most recent election are significantly associated with a preference for high use of incentive compensation by government. Furthermore, men are significantly more likely than women to prefer the use of incentive compensation by their respective governments. Respondents from governments with relatively high sales tax, income tax, and public employee unionization rates and those located in the Northeast region are significantly more likely than respondents from other governments to prefer high use of incentive compensation by government. Among the sample of residents, occupational ranking was found to be significantly associated with a preference for high use of incentive compensation by government, while unemployed and retired residents preferred low use of incentive compensation by government.

Regarding the relative size of incentive compensation (or, depth of incentive compensation usage) in their respective governments, residents prefer a significantly lower ratio of incentive compensation to total direct compensation than do officials, managers, and employees. Younger, male, relatively high-income respondents and those who have lived for a relatively short time in their current government jurisdiction and voted in the most recent election have significantly stronger preferences than others for a high ratio of incentive compensation to total direct compensation. Moreover, respondents from governments with relatively high sales tax, income tax, and public employee unionization rates have significantly stronger preferences than respondents from other jurisdictions for a high ratio of incentive compensation to total direct compensation. Among residents of these government jurisdictions, occupational ranking was found to be significantly associated with a preference for a high ratio of incentive compensation to total direct compensation, whereas being unemployed or retired was significantly associated with a preference for a low ratio of incentive compensation to total direct compensation.

To summarize, analysis of data obtained from samples of elected officials, managers, employees, and residents of four state and 18 local governments indicates that all of these groups have strong, though varying, preferences for the use of incentive compensation by their respective governments. Additionally, all four groups prefer that incentive compensation be a larger proportion of total direct compensation than is actually the case in these governments — in other words, they prefer more pay at risk in public sector compensation systems. It has also been shown that perceptions of and preferences regarding the use of incentive compensation by government are systematically related to certain demographic characteristics of

survey respondents as well as to particular economic and organizational characteristics of the governments themselves.

V. The Prevailing Wage Rule and Incentive Compensation

Most U.S. governments have in place a prevailing wage statute, ordinance, or policy that requires public sector pay rates to be set based on consideration of pay rates prevailing in industry (or, for some jobs, elsewhere in government). To implement this rule, some governments conduct their own pay surveys while many others rely on pay surveys conducted by the U.S. Bureau of Labor Statistics and other organizations (Siegel, 1992; Lewin, 1974a). A typical pay survey specifies and describes certain benchmark jobs and is sent to a sample of private sector employers with a request that they provide compensation information about such jobs. Traditionally, wage and salary information as well as certain fringe benefit information has been elicited through these surveys. With the rising use of incentive compensation in the private sector, it is important to know if public jurisdictions are systematically seeking incentive compensation information from the private sector as part of their contemporary prevailing wage survey efforts. It is similarly important to know how public jurisdictions use prevailing wage data, especially incentive compensation data, in determining their own compensation practices and rates.

To analyze this issue, attention is again turned toward the aforementioned four state and 18 local governments. All of the state governments and 15 of the 18 local governments have one or another type of prevailing wage rule in place. To implement this rule, each of the state governments and nine of the local governments conduct a regular (typically, annual) pay survey. Copies of the most recent pay survey conducted by each of these governments were obtained and content analyzed for the information they provided about private sector incentive compensation usage, plans and rates, as summarized in Table 4.

Private employers reported using incentive compensation for 79 percent of the 174 jobs that were included in the 13 government pay surveys analyzed in this study. The most frequently used types of incentive compensation by these employers were merit pay (used by 77 percent of the private employers), performance-based pay (62 percent), stock ownership (55 percent), skill-based pay (51 percent), and bonus pay (44 percent), while the least frequently used types of incentive compensation were gain-sharing (16 percent) and productivity-sharing (11 percent). Stock-option plans, which are the fastest growing type of

incentive compensation in industry, were used by 24 percent of the private employers who responded to these pay surveys. Concerning major job groups, private employers use incentive compensation most frequently for management jobs (i.e., for 89 percent of the management jobs included in the pay surveys), followed by technical (85 percent), professional (83 percent), and operative jobs (58 percent). The lowest incidence of private employers' incentive compensation usage was for clerical jobs (37 percent).⁶

Among the private employers included in these government pay surveys, incentive compensation comprises about 19 percent of total direct compensation for all jobs and approximately 27 percent for management jobs, 15 percent for professional jobs, 18 percent for technical jobs, 12 percent for operative jobs, and nine percent for clerical jobs (Table 4). Moreover, these percentages grew substantially during the five-year period preceding these governments' most recent pay surveys. Thus, the pay surveys analyzed herein indicate that private employers use some type of incentive compensation for large majorities of their jobs and employees, and that the use of such compensation is growing in these firms. This suggests, in turn, that under strict implementation of the prevailing wage rule governments should also be using and increasing their use of incentive compensation for the bulk of their jobs and employees. Are they, in fact, doing so?

One answer to this question is "yes," based on analysis of the compensation practices of the 13 governments included in this study that regularly conduct private sector pay surveys. As shown in Table 4, these governments use incentive compensation to about the same extent that it is used by the private firms against which these governments benchmark their own pay rates. Another answer to this question is "no," however, based on consideration of the types of incentive compensation practices existing in these 13 governments and the firms they survey. These governments make significantly more use of merit pay, somewhat less use of performance-based pay, and considerably less use of bonus pay than the surveyed firms. But the largest public-private sector differences in incentive compensation practices involve stock ownership and stock option plans. While stock ownership plans are used by a majority of the private firms and stock option plans are used by about one-quarter of the firms included in the pay surveys, these types of incentive compensation plans are not used at all by the governments that conducted the surveys (or by governments more broadly). Because stock ownership and especially stock option plans represent increasingly important types of incentive compensation in the surveyed firms, there is a marked and

growing difference in the mix of incentive compensation plans as between these firms on the one hand, and the governments that surveyed them on the other.

These inter-sectoral differences in incentive compensation mix lead to large differences between the 13 governments and the surveyed firms in the ratio of incentive compensation to total direct compensation (Table 4). In the firms, incentive compensation constituted about 19 percent of total direct compensation, for all job groups in the late 1990s, whereas for the 13 governments incentive compensation constituted about seven percent of total direct compensation. By job group the largest public-private sector differences in the ratio of incentive compensation to total direct compensation are for management jobs (about 27 percent v. 6 percent) followed by technical (about 18 percent v. 8.5 percent) and professional (about 15 percent v. 7 percent) jobs, while the smallest difference is for clerical jobs (about 9 percent v. 5.5 percent). Additional analysis of compensation practice and pay survey data from these governments found that public-private sector differentials in the ratio of incentive compensation to total direct compensation increased as a whole and for each major job/employee group during the late 1990s. Therefore, while these 13 governments use incentive compensation about as broadly in terms of job/employee coverage as the private firms they survey for pay information, they use incentive compensation much less deeply than those firms. This, in turn, indicates that these governments fall well short of (and are falling further behind in) full implementation of their respective prevailing wage policies.

This conclusion is even stronger for governments that have prevailing wage policies in place but do not conduct their own pay surveys. In this regard, incentive compensation use, mix, and relationship to total direct compensation were examined for the nine local governments that have prevailing wage policies but do not conduct pay surveys, and then compared with the nine local governments that have prevailing wage policies and do conduct pay surveys. While the percentage of jobs/employees covered by incentive compensation and the mix of incentive compensation plans do not differ significantly between these two sets of governments, the overall ratio of incentive compensation to total direct compensation in the governments with prevailing wage policies but without pay surveys is significantly lower, at about 4.5 percent, than in the governments with both prevailing wage policies and pay surveys, at about 7.0 percent.

Earlier in this paper the presence of a prevailing wage policy was reported to be significantly positively associated with an index of incentive compensation usage by 301 state and local governments. Extending

that analysis using data from responses to a question that asked whether or not a state or local government conducted its own pay survey, the estimated ratio of incentive compensation to total direct compensation in each of these 301 governments was regressed on the presence of a prevailing wage policy and on implementation of that policy by conducting a pay survey. The regression findings (not shown here) indicate that governments with a prevailing wage policy but without a pay survey have a marginally significantly higher ratio of incentive compensation to total direct compensation (1.0 percent, $p = < .10$) than governments without both a prevailing wage policy and a pay survey. Governments with both a prevailing wage policy and a pay survey, however, have a significantly higher ratio of incentive compensation to total direct compensation (7.0 percent) than governments without both a prevailing wage policy and a pay survey (1.4 percent, $p = < .01$) and governments with a prevailing wage policy but without a pay survey (2.2 percent, $p = < .05$). Therefore, the gap between private and public employers with respect to the ratio of incentive compensation to total direct compensation is likely to be greatest in those public jurisdictions that do not attempt to link themselves, through prevailing wage policies and pay surveys, to private sector labor markets in determining their compensation practices and rates. This gap is significantly (though modestly) smaller in governments that follow prevailing wage policies and conduct pay surveys, but insignificantly smaller in governments that follow prevailing wage policies but do not conduct pay surveys.

VI. The Future of Public Sector Incentive Compensation

On balance, the story told herein is one of broad but not deep use of incentive compensation in the U.S. public sector. Most jobs and employees in the governments studied here are covered by one or another type of incentive compensation plan, but the amount of such compensation as a proportion of total direct compensation is relatively small compared to private industry and also to the (relative) amount of compensation that motivation and compensation theories suggest is required to bring about improved individual and organizational performance. Looking ahead, it may be asked, "Will incentive compensation become more deeply practiced by government, remain at about the same level and depth of usage, or decline?" To answer this question requires prognostication about compensation developments in both the public and private sectors.

Among the factors that imply deeper future use of incentive compensation by government are the preferences of citizen-residents as well as employees, managers, and elected officials. As shown earlier, each of these groups clearly prefers more use of incentive compensation by government, especially a higher ratio of incentive compensation to total direct compensation, than presently exists. It is one thing for scholars, practitioners, and public sector experts to advocate greater use of pay-for-performance by government, but quite another, more compelling, thing for citizens, managers, employees, and elected officials to advocate the same. If representative democracy works effectively, the preferences of these actors should influence future practice and thereby lead to deeper use of incentive compensation by government.

More extensive adoption by governments of prevailing wage policies and more aggressive implementation of such policies by governments that already have them in place should also lead to broader and deeper use of incentive compensation in the public sector. The available evidence shows that governments with prevailing wage policies are more likely to practice incentive compensation than governments without such policies. Furthermore, governments that implement their prevailing wage policies by conducting their own pay (compensation) surveys use incentive compensation more broadly and deeply than governments that have prevailing wage policies but don't conduct their own pay surveys. In this regard, the preference of elected officials for greater use of incentive compensation in the public sector is likely to lead more governments to adopt prevailing wage policies, especially if coupled with similar efforts by those who advocate government re-invention. And, additional pressure on governments with prevailing wage policies to conduct their own pay surveys is most likely to emanate from unionized public employees, thereby leading to deeper use of incentive compensation by government. This view is consistent with the empirical finding that public employee unionization is not negatively associated with — does not serve as a barrier to — the use of incentive compensation by government.

As noted earlier, proponents of government re-invention typically contend that such re-invention will result in smaller, less hierarchical, more efficient and responsive government. But the movement to re-invent government may also be seen as a movement to preserve government and, in this regard, to limit the extent to which public services are sub-contracted to industry or privatized altogether. From this perspective, achieving the relatively limited goals of government re-invention will likely be aided by

greater use of incentive compensation in the public sector, especially for executives and managers. Such incentives can include bonuses for department heads in municipal governments who manage their operations particularly efficiently over a multi-year period, meaning that their operational expenditures do not exceed or even fall below budgeted expenditures. In another example, citizen (external customer) satisfaction with government services, as determined through surveys of random samples of residents of local government jurisdictions, can serve as one criterion for determining bonus or performance-based payments to local, state, and even federal government executives and managers. The more fundamental point, however, is that the government re-invention movement is likely to enhance rather than retard the use of incentive compensation by government.

Just as the economic recession of the early 1990s spurred additional use of incentive compensation by government, the economic recession of the early 2000s is likely to do the same. Through relatively mild by historical standards, the current recession, like others before it, has already resulted in shrinking governmental revenues and budgets, conversion in many governments of budget surpluses to budget deficits, and public sector work force reductions. In order to preserve and deliver public services in such an economic environment, and also to ward off further erosion of their resources, governments will likely go further and deeper in their use of incentive compensation — perhaps in the same way that firms that become overly mature make greater use of incentive compensation as a tool for renewing themselves (Milkovich and Stevens, 2000).

In addition, the early 2000s recession has substantially shrunk the (current and future) value of stock options, especially but not only in the high-technology sector. This development has and, even more, will have the effect of reducing the ratio of incentive compensation to total direct compensation in industry. It also makes employees at all levels more risk averse with respect to their compensation preferences, so in the future they will prefer relatively more conventional, less risky, time-based pay (i.e., wage and salaries) and perhaps less risky forms of variable pay (i.e., profit-sharing and bonuses). This shifting risk preference is further and substantially strengthened by the rising incidence and growing recognition of malfeasance and fraud in company financial reporting, as illustrated by the recent examples of Xerox, Waste Management, Enron, Tyco, and WorldCom. Such “cooking the books” led to artificially inflated stock prices and unmerited financial gain, especially for executives and managers, from the exercise of stock

options and sale of company stock. Therefore, stock options as a form of compensation are and will increasingly be viewed as being far more risky than in the recent past, with the result that the extent of their use in industry will decline. All of this suggests that public-private sector differences in the ratio of incentive compensation to total direct compensation will also decline.

These prognostications would not be complete without some consideration of the potential effects of global terrorism on governments' use of incentive compensation. The cataclysmic events of 9/11 reminded the nation and the world that the first function of government is to provide for the national defense, meaning the safety and security of the populace. In the wake of 9/11, the federal government assumed responsibility for airport security (becoming the employer of formerly privately-employed security personnel), and a new federal government, cabinet-level Department of Homeland Security is about to be created. The most direct effect of the events of 9/11 on public sector compensation took the form of large amounts of overtime pay to firefighters and police personnel of New York City (and certain other public entities, such as the Port Authority of New York and New Jersey). Beyond this immediate effect, however, major emphasis on government's role in providing safety/security is likely to lead to new incentive compensation initiatives for those who actually provide public safety and security. Cash awards for exceptional individual service, bonus pay for achieving departmental objectives, and special payments for outstanding inter-departmental and inter-agency cooperation are but some of the forms of incentive compensation that can be more widely and deeply used in this regard.

It may be argued that a focus on direct compensation, including incentive compensation, in the public sector overlooks employment stability and fringe benefits in this sector, both of which are often claimed to be significantly greater than in industry (Kellough and Selden, 1997; Risher et al., 1997). From this perspective, consideration of incentive compensation and other direct compensation together with fringe benefits and employee turnover/retention will show that, on balance, the private and public sectors are in rough equilibrium in so far as their compensation/reward practices and labor market positioning are concerned. Stated another way, the higher ratio of incentive compensation to total direct compensation in industry than in government can be explained — and is offset — by the comparatively lower rates of employment stability and fringe benefits in industry than in government. Following this reasoning, there is

no rationale for increasing either the use of incentive compensation or the ratio of incentive compensation to total direct compensation in government.

While it is true that continuity of employment is relatively greater in government than in industry, this has been true for a long time, including when governments did not use incentive compensation.⁷ Furthermore, there is now more volatility — less stability — in government employment than in prior eras. As to fringe benefits, government employers do expend a larger portion of a payroll dollar on fringe benefits than private employers (U.S. Department of Labor, 2000), but this was also the case when governments did not use incentive compensation. What has changed most in recent years is the rapid growth in the private sector of incentive compensation as a proportion of total direct compensation, which contrasts sharply with the modest growth of such compensation in the public sector. In light of this widening difference or gap, arguments about the superior employment stability and fringe benefits in government compared to industry are unlikely to stem other, aforementioned pressures for expanded use of incentive compensation in the public sector.

Still other factors, however, may indeed mitigate expanded future use of incentive compensation by government. As noted earlier, many governments have in place prevailing wage policies that require public sector pay to be set in consideration of private sector pay. While there are both market and equity rationale to support a prevailing wage policy, governments have been shown systematically to implement this policy by “overpaying” employees at the lower end of the skill/occupation distribution and “underpaying” employees at the upper end of the skill/occupation distribution (Fogel and Lewin, 1974; Lewin, 1974b) so that governments to some extent ignore private market pay data (even when they collect it) and adopt more egalitarian pay structures than those in industry. Such egalitarianism is further reinforced by the widespread use of minimum wage statutes by state and local governments, statutes that typically provide for higher minimums than those required of private employers. Hence, equity considerations dominate market considerations in public sector pay-setting, resulting in significantly less steep occupational pay structures and much smaller executive-to-employee pay ratios than in the private sector. It is unlikely that these inter-sectoral pay policy and practice differences will change in future. To the extent that new incentive compensation initiatives threaten relatively egalitarian public sector pay structures, such initiatives are likely to be curtailed or abandoned.

Further evidence of government's dominant concern for pay equity rests in the recent adoption by numerous local governments of "living-wage" statutes and policies, which go beyond minimum wage laws that apply only to governments' own employees. Fueled in part by rapid economic growth during much of the 1990s and in part by perceived widening of economic inequality, elected officials in Los Angeles, Philadelphia, Chicago, Santa Monica, Saint Louis, and other cities enacted living-wage statutes requiring contractors, sub-contractors, and consultants to the local governments to pay (at least) the specified living wage to their employees. Indeed, under these statutes, a written commitment to paying this wage is required of contractors, sub-contractors, and consultants as a condition of their doing business and securing contracts with a municipal government. Typically, these living wage statutes specify two pay rates, one being lower if the employer provides fringe benefits to employees, the other being higher if the employer does not provide fringe benefits. As an example, the City of Santa Monica's living wage statute calls for contractors, sub-contractors, and consultants to pay their employees \$10.50 per hour if fringe benefits are provided, \$13.25 per hour if fringe benefits are not provided (*Los Angeles Times*, 2000). In light of the economic recession of the early 2000s, the further spread of governmental living wage statutes is problematic. But existing statutes provide further evidence of government's dominant concern for equity over market considerations in the area of compensation — whether public sector or private sector compensation. Instructively, none of these governments' living wage statutes so much as mentions incentive compensation for private employees, implying that such compensation is also of relatively minor concern to these governments, per se.

On balance, and looking ahead to the next several years, I expect incentive compensation to become somewhat more widely used by governments. This forecast gives substantial weight to the argument that, for many of the services it provides, government is not or is no longer a monopolist, and there are various private market alternatives or supplements to publicly provided services. This forecast is also based in part on the evidence that elected officials, government managers, public employees, and citizens-residents of government jurisdictions prefer deeper use of incentive compensation. But I do not envision greatly deepened use of incentive compensation by governments, in large part because of governments' dominant concern for equity in pay determination, as expressed in various statutes and policies. Ironically, though, the gap between the public and private sectors in the proportion of total compensation accounted for by

incentive compensation is likely to shrink in future, not because of new governmental incentive compensation initiatives but, rather, because of shifting compensation risk preferences among private employees that portend, in particular, sharply declining use of stock options as a form of compensation.

VII. *Conclusions*

During much of the 20th century, the U.S. public sector underwent a conversion from a patronage to a civil service system of work and pay. Later in that century, a substantial proportion of public employees became unionized, with the consequence that pay (and other terms and conditions of employment) became less single-mindedly management determined and more collectively determined. Still later, fiscal crisis, the government re-invention movement, and broadened economic competition spurred governments to shift away from strict payment for time practices and adopt various incentive compensation initiatives based on the principle of pay-for-performance. That this is not the only pay principle operative in governments, however, is attested to by the existence of prevailing wage, minimum wage, and, most recently, living-wage statutes in many if not most governments.

Empirical evidence from a recent study of 17 state and 284 local governments shows that they quite broadly use incentive compensation, with 86 percent of the sample having one or more incentive compensation plans in place. Performance-based pay and merit pay are most often used by these governments, while productivity-sharing and gain-sharing pay are least used. Professional and technical employees of these governments are most likely to be covered by incentive compensation plans, clerical and manual employees least likely to be covered. There is also substantial variation in incentive compensation plan coverage by agencies/departments in these governments. Multivariate analysis found several organizational characteristics, e.g., size and ratio of white-collar to blue-collar employees, systematically related to variation in the use of incentive compensation. But while it is broadly used, incentive compensation is not deeply used by these governments, as reflected in a mean ratio of incentive compensation to total direct compensation of little more than six percent. This ratio also varied considerably by employee group and agency/department.

Additional empirical evidence from a sub-sample of 4 state and 18 local governments shows that employees are more knowledgeable than elected officials, managers, and citizens about the ratio of

incentive compensation to total direct compensation in government, which is estimated to be about seven percent in these governments compared to 19 percent in the private sector. However, all four groups prefer government to make greater use of incentive compensation than it does at present, primarily because such compensation is perceived to improve governmental performance. Within this sub-sample, governments with prevailing wage rules that conduct their own pay surveys have a significantly higher ratio of incentive compensation to total direct compensation than governments with prevailing wage rules that don't conduct pay surveys and than governments without prevailing wage rules.

Several factors presage increased use of incentive compensation by government. These include the preferences of the key actors mentioned above as well as the government re-invention movement, increasing economic competition, spells of economic recession, and even the 9/11 terrorist attacks. By contrast, the ways in which governments have chosen to implement their prevailing wage rules together with governments' minimum wage policies and newly adopted living-wage statutes imply that, in the future as well as at present, governments will continue to value equity over market or efficiency considerations in pay determination, thereby implying little in the way of new incentive compensation initiatives. Nevertheless, the deeper use of incentive compensation by industry than government, as reflected in comparative ratios of incentive compensation to total direct compensation, is likely to decline due to private sector employee risk preferences shifting away from incentive compensation, especially stock-based compensation. Consequently, in future, the public and private sectors are more likely to converge rather than diverge with respect to both the breadth and depth of incentive compensation usage.

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Table 1

*Incentive Compensation Usage in State and Local Governments,
by Level of Government and Employee Occupational Group, 1998
(in percent)*

Characteristic	Overall Usage	Incentive Compensation Usage by Type of Plan						
		Perf. Based Pay	Merit Pay	Productivity-Sharing	Gain-Sharing	Skill-Based Pay	Pay-for-Knowledge	Bonus Pay
<u>Level of Govt.</u>								
State Govs. (n=17)	94 %	82 %	88 %	18 %	29 %	41 %	12 %	12 %
Local Govs. (n=284)	85 %	69%	73 %	17 %	35 %	42 %	14 %	7 %
Total Govs. (n=301)	86 %	70 %	74 %	17 %	35 %	42 %	14 %	8 %
<u>Employee Group</u>								
Manager	69 %	54 %	56 %	9 %	15 %	16 %	8 %	11 %
Professional	82 %	64 %	67 %	13 %	19 %	39 %	26 %	8 %
Technical	79 %	63 %	64 %	15 %	17 %	51 %	21 %	12 %
Clerical	38 %	34 %	36 %	7 %	13 %	32 %	13 %	4 %
Operative	58 %	51 %	42 %	26 %	41 %	44 %	8 %	6 %
Manual	34 %	28 %	24 %	12 %	28 %	34 %	5 %	5 %
Other Service	51 %	43 %	42 %	14 %	19 %	39 %	9 %	3 %

Table 2

Incentive Compensation As a Percent of Total Direct Compensation in State and Local Governments, by Agency/Department and Employee Group, Fiscal 1998

<u>Employee Group</u>		<u>Agency/Department</u>	
All Employee Groups	6.15 %	All Agencies/Departments	6.15%
Professional	7.75 %	Taxation	8.10%
Technical	7.60 %	Finance	7.55%
Operative	6.45 %	Utilities	7.45%
Other Service	5.65 %	Sanitation	6.35%
Manual	4.80 %*	Highways	6.10%
Managerial	4.40 %*	Health Care	5.75%
Clerical	4.15 %*	Welfare	5.45%
		General Services	5.05%
		Protective Services	4.85%
		Motor Vehicles	4.15%
		Public Works	3.85%
		Criminal Justice	3.05%**

() Significantly different from other employee groups at $p < .10$ (.05).**

Table 3

*Perceptions of and Preferences About Incentive Compensation Usage
in Four State and Eighteen Local Governments, by Respondent Group*

Perceptions of:			
Respondent Group	Incentive Comp. Used by Own Government (% responded "yes")	Percent of Employees Covered by Incentive Comp. (response mean %)	Incentive Comp. As Percent of Total Direct Comp. (response mean %)
All Groups (n = 563)	51 %	49 %	8 %
Elected Officials (n = 63)	71 %	75 %	15 %
Managers (n = 84)	66 %	64 %	9 %***
Employees (n = 130)	41 %*	44 %**	6 %***
Residents (n = 286)	26 %*	15 %**	3 %***
Preferences About:			
Respondent Group	Incentive Comp. Use by Own Government (% favoring)	Type of Incentive Comp. Plan (plan with highest % favoring)	Incentive Comp. As Percent of Total Direct Comp. (response mean %)
All Groups (n = 563)	74 %	71 % (skill-based pay) 69 % (gain-sharing)	16 %
Elected Officials (n = 63)	85 %	91 % (pay-for-performance)	12 %***
Managers (n = 84)	78 %	84 % (bonus pay)	20 %
Employees (n = 130)	61 %**	72 % (skill-based pay) 64 % (pay-for-knowledge)	14 %***
Residents (n = 286)	72 %	77 % (productivity-sharing) 74 % (gain-sharing)	11 %***

*(**, ***) Significantly different from elected officials, managers and/or residents at $p = < .10 (.05, .01)$.

Table 4

Incentive Compensation Usage by Four State and Nine Local Governments and by Private Firms Surveyed by These Governments, by Job Group

Job Group	Incentive Compensation Use by Percent of Jobs in Group		Incentive Compensation as a Percent of Total Direct Compensation	
	S & L Governments	Private Firms	S & L Governments	Private Firms
All Job Groups (n of jobs = 174)	73 %	79 %	6.8 %***	19.2 %***
Management Jobs (n = 24)	81 %	89 %	6.0 %***	27.3 %***
Professional Jobs (n = 48)	76 %	83 %	7.2%***	17.9 %***
Technical Jobs (n = 43)	69 %**	85 %**	8.5 %***	21.2 %***
Operative Jobs (n = 36)	46 %**	58 %**	6.2 %***	11.9 %***
Clerical Jobs (n = 23)	44 %	37 %	5.5 %**	9.2 %**

** (***) Significant public-private sector difference at $p < .05$ (.01)

NOTES

¹ As examples, performance-based pay was defined as "pay changes based on achievement of individual employee performance goals, such as those set through Management by Objectives (MBO)," and merit pay was defined as "pay changes based on the results of a supervisor's appraisal of an employee's job performance."

² The survey was sent to the head personnel officer of each of the four states governments and the chief administrative officer, head personnel officer or, in some cases, city manager of the 284 local governments. Of the 301 completed surveys, about 70 percent were signed by a head personnel officer, 20 percent by a chief administrative officer and 10 percent by other officials or managers (e.g., city manager, head budget officer, and head financial officer).

³ Values for this index ranged between 0 and 40, with a mean value of 17 and a standard deviation of 3.6. Another version of the index includes the length of time, in years, that each incentive plan has been in place. For this version, the incentive compensation index ranged between 0 and 50, the mean value was 20, and the standard deviation was 3.9. On average, incentive compensation plans in these governments had been in place for 7.2 years. Two local governments had one or another type of incentive compensation plan in place for more than 50 years.

⁴ The survey did not ask respondents for data on or estimates of fringe benefits for employees, which are more difficult to value than direct compensation. More to the point, fringe benefits are generally not considered a form of incentive compensation and benefit coverages typically do not vary by agency/department or employee group in state and local government (Risher et al., 1997).

⁵ None of the residents were elected officials, managers, or employees of the four state or 18 local governments. That is, the resident sample is entirely separate from the three other groups and is regarded as representing citizens of the respective government jurisdictions included in this portion of the study. A variety of sources were used to identify and select the four sample populations, including state and local government personnel listings, human resource/personnel directors, and zip code listings. Additional information about sample selection for the four surveyed groups as well as design and administration of the surveys is available from the author.

⁶ Private employer use of incentive compensation for the manual and "other service" job categories were excluded from this analysis since so few of these types of jobs were included in the state and local governments' pay surveys. Together, managerial, professional, technical, operative, and clerical jobs accounted for 92 percent of all jobs that were included in these surveys.

⁷ For example, unemployment among "government workers," as reported by the U.S. Bureau of Labor Statistics, is typically much lower than among nonagricultural wage and salary workers in the U.S. economy, and this continues to be true even as overall unemployment has declined sharply in recent years. Thus, in 1997, 1998, and 1999 unemployment rates were 5.0, 4.6, and 4.3 percent, respectively, among nonagricultural wage and salary workers, compared with 2.6, 2.3 and 2.2 percent, respectively, among government workers (U.S. Department of Labor, 2000).