The Heritage Foundation
LEADERSHIP FOR AMERICA
214 Massachusetts Avenue, NE • Washington, DC 20002 • (202) 546-4400 • heritage.org

CONGRESSIONAL TESTIMONY

The Federal Pay System: Inflated Compensation, Ignored Performance

Testimony before the Committee on Oversight and Government Reform United States House of Representatives

March 9, 2011

James Sherk
Senior Policy Analyst in Labor Economics
The Heritage Foundation

My name is James Sherk. I am a senior policy analyst in labor economics at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The Federal pay system unnecessarily inflates federal pay. My research shows that on average federal employees earn hourly wages 22 percent higher than otherwise comparable private-sector workers. Numerous studies by researchers whose personal views span the political spectrum come to similar conclusions.

The only significant study that finds that federal employees are underpaid is the President's Pay Agent Report. However, even the Office of Personnel Management has serious concerns with this study's methodology and believes that this finding lacks credibility.

If the federal government underpaid its workers it would have severe retention problems. Instead, the opposite occurs. Federal employees are considerably less likely than private-sector workers to quit their jobs. Federal employees demonstrate that they earn above-market pay through their actions.

Federal employees also receive premium benefits. They receive both a defined-benefit and defined-contribution pension plan, can retire with full benefits at 56, and receive significantly more paid leave than their private-sector counterparts. Accounting for the value of these benefits raises the federal compensation premium to between 30 percent and 40 percent above similar private-sector workers. All told, the federal compensation premium will cost taxpayers $47 billion this year.

A major factor inflating federal pay is the fact that the federal government promotes employees faster than private-sector employers. My research found that most of the federal pay premium resulted from federal employees receiving raises more rapidly than their private-sector counterparts.

This is a consequence of the General Schedule, which primarily bases pay on time served rather than performance. Federal employees who put in a minimal amount of effort automatically earn within-grade increases in pay. Over three-quarters of federal pay increases are based on time served, not performance. This systematically inflates federal pay.

The federal pay premium is a government-wide average: not all federal employees are overpaid. The federal pay system lumps workers of different occupations, skills, and specialties into one level of work to determine pay for that General Schedule grade. Private-sector employers do not do this. Consequently, federal pay diverges wildly from private-sector norms. Some federal employees receive a 40 percent to 50 percent pay premium while others do not get inflated pay. In fact, a few federal employees actually earn cash wages slightly below market rates. Highly skilled employees are particularly likely to earn at or below market rates in the federal government.

Consequently, the federal government should not uniformly freeze federal pay. Instead, the government should contract out as much work as possible to the competitive private sector. Those jobs that cannot be done by private-sector workers should be moved to a performance-pay system with pay tied to market rates and market signals of demand. This would reduce costs for taxpayers without penalizing those federal employees who do not enjoy premium pay.

No Market Forces in Government

Market forces drive private-sector workers' pay toward their productivity. A company that pays its workers more than they contribute will soon go out of business. A company that pays its workers less than their productivity risks the possibility of competitors hiring its employees away. In most circumstances, private-sector companies cannot systematically over or underpay their employees.

These market forces do not exist in government. The government earns no profits and does not go out of business. Competition for workers limits the government's ability to pay below market rates. Nothing, however, prevents the federal government from paying its employees more than they would earn in the private sector.

Inflated Federal Pay

The federal government does exactly that. The average federal employee earns hourly wages 57 percent above average private-sector wages.[1]

Defenders of the federal pay system respond by arguing that the average federal employee is more experienced and highly skilled than the average private-sector worker. They contend this is an apples-to-oranges comparison.

They are correct. The average federal employee performs more skilled work and should earn more than the average private-sector worker.[2] The fact that federal employees earn more on average than private-sector workers does not by itself prove that the federal government overpays them.

Economists have developed statistical techniques to account for differences in skills, experience, and other variables. This allows economists to make an apples-to-apples comparison of pay between different groups—such as federal and private-sector workers.

I conducted such an analysis using data from the Current Population Survey. My research shows that, after controlling for differences in education, experience,

---

[1]James Sherk, "Inflated Federal Pay: How Americans Are Overtaxed To Overpay The Civil Service," Heritage Foundation *Center for Data Analysis Report* No. CDA10-05, July 7, 2010, p. 4, at *http://www.heritage.org/research/reports/2010/07/inflated-federal-pay-how-americans-are-overtaxed-to-overpay-the-civil-service*.
[2]*Ibid*.

occupation, and other observable characteristics, federal employees earn hourly wages 22 percent higher than that of comparable private-sector workers.[3] Accounting for federal employees greater skills reduces—but does not eliminate—the federal pay premium. Employees in the federal government earn more than they would in the private sector.

Many Studies Confirm

This is not an isolated finding. Many economists have examined this question. Their studies almost uniformly come to this same conclusion.[4] *The Handbook of Labor Economics* summarizes the research on this subject: "Studies for the United States and United Kingdom have generally found a positive wage premium for public sector employees … there is evidence for the United States that the public sector wage premium is higher for federal government employees than for state of local government employees."[5]

The personal views of these researchers span the political spectrum. Their research leads them to the same conclusion. Alan Krueger, President Obama's choice as Chief Economist in the Treasury Department, conducted an influential study on the federal pay premium. He concluded that "the federal government appears to consistently pay higher wages than the private sector for comparable employees."[6]

Pay Agent Report

The only major study to disagree with this conclusion is the President's Pay Agent report. This report uses a different methodology than labor economists use to analyze pay differences. The accepted economic model for comparing pay differences is the "human capital" model. This model assumes that workers' productive characteristics, such as experience and education—their human capital—affect their pay. Human capital studies compare workers across occupations and industries while controlling for their observable characteristics.

The President's Pay Agent does not compare workers at all. Instead, the law requires it to compare positions. The Bureau of Labor Statistics evaluates jobs in the

---

[3]*Ibid.*, p. 6.

[4]See, for example, Steven Venti, "Wages in the Federal and Private Sectors," in D. Wide, ed., *Public Sector Payrolls* (Chicago: University of Chicago Press, 1987), pp.147–182; Joseph Gyourko and Joseph Tracy, "An Analysis of Public- and Private-Sector Wages Allowing for Endogenous Choices of Both Government and Union Status," *Journal of Labor Economics*, Vol. 6, No. 2 (1988), pp. 229–253; and William Moore and John Raisian, "Government Wage Differentials Revisited," *Journal of Labor Research,* Vol. 12, No. 1 (1991), pp. 13–33.

[5]Robert Gregory and Jeff Borland, "Recent Developments in Public Sector Labor Markets," in O. Ashenfelter and D. Card, ed., *Handbook of Labor Economics*, 1st Ed., Vol. 3 (1999). chap. 53, p. 3594. Elsevier.

[6]Alan B. Krueger, "Are Public Sector Workers Paid More Than Their Alternative Wage? Evidence from Longitudinal Data and Job Queues," in NBER Chapters, *When Public Sector Workers Unionize* (Cambridge, MA: National Bureau of Economic Research, Inc., 1988), pp. 217–242, at *http://www.nber.org/chapters/c7910.pdf* (March 4, 2011).

private sector and the federal government on the basis of their qualifications required, level of difficulty, and amount of responsibility. It uses these surveys to determine the "level of work" involved in the job, and what grade a job of that level of work would translate to in the General Schedule. The Pay Agent report then compares pay between the private sector and those federal jobs this method deems equivalent. The Pay Agent consistently finds that federal employees earn 20 percent to 25 percent less than comparable private-sector workers.

No Administration has ever found this methodology credible. No Administration has ever proposed closing the reported "pay gap." The Pay Agent report itself frequently expresses concerns with the methodology the law requires it to use. As the 2008 Pay Agent report stated, "We continue to have major methodological concerns about the underlying model for estimating pay gaps."[7]

The Office of Personnel Management identifies three factors that undermine the creditability of the Pay Agent's report. First, the current methodology collapses the factors influencing pay into just two-dimensions: the level of work and a locality-based adjustment. In the private sector many factors, including occupations, skills, and specialties, determine labor market demand and pay. The current methodology does not reflect the reality of differences in pay between occupations that involve the same "level of work." Second, it takes a long time to conduct and analyze the surveys that underlie the pay agent's report. As a result there is little correlation between current market pay and federal pay adjustments. Third, the statute requires the Pay Agent to calculate a single locality pay adjustment that spans all General Schedule grades and occupations. This averages differences in relative demand across positions to produce a figure that approximates nothing well.[8]

Low Federal Turnover

The Pay Agent report finds that federal workers are underpaid while economists find they are overpaid. Workers' decisions shed light on who is correct. If federal employees were substantially underpaid then the federal government would have severe retention problems. Just the opposite occurs: federal employees rarely quit. Federal employees voluntarily leave their jobs just one-third as often as private-sector workers.[9] Even that figure understates the situation—many federal employees who quit do so to take another job in the federal government. Federal employees demonstrate by their actions that they get a better deal than they could in the private sector. The President's Pay Agent is right to have concerns with its methodology.

Premium Benefits at Taxpayer Expense

Federal compensation includes both pay and benefits. In addition to inflated pay, federal employees receive substantially better benefits than most private-sector workers.

---

[7]The President's Pay Agent, "Memorandum to the President: Annual Report on General Schedule Locality-Based Comparability Payments," December 2, 2008, at *http://www.opm.gov/oca/payagent/2008/2008PayAgentReport.pdf* (March 4, 2011).
[8]United States Office of Personnel Management, "A Fresh State for Federal Pay: The Case for Modernization," White Paper, April 2002, pp. 14–15.
[9]U.S. Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey.

Federal employees receive both a generous defined-contribution pension and a defined-benefit pension. Federal employees with 30 years of service can retire with full pension benefits at 56. Federal retirees receive retiree health coverage, something rarely offered in the private sector. Federal employees also receive more paid leave than private-sector workers. A federal employee with five years on the job is entitled to 20 days of paid vacation, all ten federal holidays, and 13 days of paid sick leave.[10] The typical private-sector worker with that tenure receives 10 days of paid sick leave, 15 days of paid vacation, and 9 paid holidays.[11]

Accounting for the value of such benefits, the average federal employee receives a total compensation package worth 30 percent to 40 percent more than a comparable private-sector worker. Taxpayers bear this cost. Reducing federal compensation to market rates would cut $47 billion from the deficit in 2011.[12]

Automatic Promotions

What factors inflate federal pay? My research found that much of the unexplained federal wage premium came from greater returns to experience.[13] In other words, federal employees receive raises and promotions more rapidly than do private-sector workers.

This is a consequence of the General Schedule, which primarily bases raises and promotions on time served—not employee performance. Federal employees on the General Schedule start at the first step of their assigned job grade. As long as they receive a 3 out of 5 rating in their performance evaluation they will automatically receive "within grade" or "step" increases in pay every one, two, or three years until they reach step 10 of their job grade. If their position has a career ladder then they will automatically advance grades in the General Schedule as well.

The system assumes that federal employees perform competently. A manager who wishes to give an employee a lower rating bears the burden of proving that the employee underperforms. The federal government gives employees many procedural tools to defend themselves against low performance rankings. Consequently federal managers rarely use performance ratings below 3.[14]

Workers in the General Schedule have little monetary incentive to put in anything more than a minimally acceptable level of effort. As long as they do this, the law guarantees them frequent pay increases. Additional effort has little effect on their pay. Federal managers may award "quality step increases," but these are a small component of federal pay. Less than one-quarter of the money spent on annual federal pay increases is

---

[10]Sherk, "Inflated Federal Pay," pp. 9–12.
[11]WorldatWork, "Paid Time Off: Programs and Practices," May 2010, at *http://www.worldatwork.org/waw/adimLink?id=38913* (March 4, 2011).
[12]*Ibid.*, pp. 12–15.
[13]*Ibid.*, Appendix D.
[14]Silvia Montoya and John Graham, "Modernizing the Federal Government: Paying for Performance," Pardee RAND Graduate School *Occasional Paper*, 2007, p. 21.

meaningfully tied to employee performance.[15] The federal pay system gives automatic raises to almost all federal employees, but does not reward those who truly exert themselves. This inflates federal pay without motivating performance.

Not All Pay Inflated

The federal government pays, on average, above-market compensation. However, this is only an average. The President's Pay Agent does a very poor job of measuring market pay. The President's Pay Agent attempts to determine what level of work a private-sector job entails and what General Schedule grade that would translate to in the private sector. The Pay Agent then averages pay across the jobs it determines belong in each General Schedule grade. This effectively imposes the General Schedule system onto private-sector payrolls.[16]

In actuality, private-sector employers do not base pay on anything resembling the General Schedule. Market forces, such as relative supply and demand for different skills, specialties, and occupations determine private-sector pay rates. Employees in different occupations performing similar "levels of work" often earn very different salaries. Additionally, private-sector employers reward performance and productivity, not time served.

These differences between private pay systems and the General Schedule cause federal pay to vary—both higher and lower—wildly from market rates. Some federal employees experience a pay penalty. Other federal employees receive cash wages 40 percent to 50 percent above what similar private-sector workers earn.[17] The same research that shows that federal employees enjoy higher average pay also shows that this premium is a small part of the differences in individual jobs between federal pay and market rates.[18]

Generally speaking, highly skilled and specialized employees are less likely to receive significantly inflated pay in the federal government. My research finds that software engineers, lawyers, physical scientists, and economists do not receive statistically higher pay in the federal government.[19] It is simultaneously true that the federal government pays higher average compensation than the private sector and that many federal employees are not overpaid.

Conclusion

The federal pay system is broken. Economic research consistently shows that federal employees earn more than they would in the private sector. My research shows that federal employees earn total compensation 30 percent to 40 percent greater than

[15]United States Office of Personnel Management, "A Fresh State for Federal Pay," p. 22.
[16]*Ibid.*, p. 48.
[17]Sherk, "Inflated Federal Pay," Table 6.
[18]Dale Belman and John Heywood, "Public Sector Wage Comparability: The Role of Earnings Dispersion," *Public Finance Review*, Vol. 32, No. 6 (2004), pp. 567–587.
[19]Sherk, "Inflated Federal Pay," Table 6.

comparable private-sector workers. Reducing their compensation to market rates would save taxpayers $47 billion in 2011. The only major study to show federal employees are underpaid is the President's Pay Agent report, which questions the accuracy of its own methodology.

Federal employees themselves demonstrate that the Pay Agent is incorrect: They quit their jobs far less frequently than do private-sector workers. This would not happen if they felt mistreated and underpaid.

The problems with the federal pay system extend beyond inflated pay. The federal government financially rewards its employees for time served, not for performance. High performing federal workers do little better than their mediocre peers. As long as federal employees put in minimally acceptable levels of effort they receive automatic raises. The government gives its workers little incentive to work.

However, not all federal workers receive above-market pay. The flaws with the Pay Agent's methodology cause federal pay to diverge wildly from market rates. Many skilled federal employees do not earn inflated pay. Consequently, Congress should not look to pay freezes or across-the-board cuts to bring federal pay in line. This would unfairly penalize those federal employees who are not overpaid while still leaving others with premium wages. Instead, Congress should scrap the General Schedule and move to a pay for performance system with pay more closely tied to market rates. Congress should also contract out as much federal work as possible to the competitive private sector. These steps would equitably bring the wages of federal workers in line with those of the private-sector workers whose taxes fund their salaries.

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(c)(3). It is privately supported and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2010, it had 710,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2009 income came from the following sources:

Individuals	78%
Foundations	17%
Corporations	5%

The top five corporate givers provided The Heritage Foundation with 2.0% of its 2010 income. The Heritage Foundation's books are audited annually by the national accounting firm of McGladrey & Pullen. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own and do not reflect an institutional position for The Heritage Foundation or its board of trustees.

James Sherk is a Senior Policy Analyst in Labor Economics at the Heritage Foundation. He researches ways to promote competition and mobility in the workforce instead of erecting barriers preventing workers from getting ahead.

Sherk joined Heritage in 2006. His recent writings address why joblessness rose in the recession, the federal pay premium, and why unionization had declined in the private sector.

Sherk's commentary and analysis has appeared in such publications as the *Washington Post*, *New York Post*, *Business Week* and *Roll Call*. He has been a guest expert on such networks as CNN, CNBC and PBS.

Before coming to Heritage Sherk completed graduate studies at the University of Rochester, where he received a master of arts in economics with a concentration in econometrics and labor economics. He earned a bachelor's degree in economics and mathematics at Hillsdale College in Hillsdale, Mich.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name:

---

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

None

---

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

The Heritage Foundation
Senior Policy Analyst in Labor Economics

---

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

None

I certify that the above information is true and correct.
Signature: James Sherk

Date: 3/7/11