TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 3, 2007

MEMORANDUM FOR CHIEF HUMAN CAPITAL OFFICER

FROM: *(for)* Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders (Audit # 200510030)

This report presents the results of our review of the Internal Revenue Pay-for-Performance System. The overall objective of this review was to determine whether the Internal Revenue Pay-for-Performance System effectively links compensation to individual performance. We focused our efforts on how the Internal Revenue Service (IRS) implemented the new System for managers and whether the IRS complied with the Personnel Flexibilities provisions of the IRS Restructuring and Reform Act of 1998[1] and the *Office of Personnel Management Criteria for IRS Broadbanding System*. We also evaluated potential risks to ongoing human capital initiatives to recruit, retain, and motivate future IRS leaders.

Impact on the Taxpayer

The structure and methods of pay progression included in the redesigned Internal Revenue Pay-for-Performance System may not support the positive impacts of Human Capital Office (HCO) initiatives to recruit, retain, and motivate future IRS leaders. In addition, the new System was not adequately communicated to the managers before it was implemented, causing opposition and decreasing morale. As a result, the IRS risks reducing its ability to provide quality service to taxpayers because the Internal Revenue Pay-for-Performance System potentially hinders the IRS' ability to recruit, retain, and motivate highly skilled leaders.

[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Synopsis

Over the next few years, the IRS faces significant challenges because of the potential for substantial loss of highly skilled technical managers and employees due to pending retirements. To maintain the continuity of its leadership and workforce, the IRS must ensure its managerial compensation system effectively attracts and retains high-performing individuals from both inside and outside the IRS and provides greater flexibility to reward and motivate high levels of performance. The current Internal Revenue Pay-for-Performance System may not accomplish this. On the contrary, the current System may discourage both managers as well as nonmanagers from applying for management positions.

The HCO implemented the Internal Revenue Pay-for-Performance System in three phases: the Senior Manager Payband[2] was implemented in March 2001, the Department Manager Payband for the newly designed Campuses[3] was implemented in November 2001, and the Frontline Manager Payband was implemented in September 2005. The Senior Manager and Department Manager Paybands were revised in March 2006 to incorporate the pay elements of the Frontline Manager Payband.

We identified several areas in which the System can be improved to better support the IRS' desire to attract and retain talented individuals for its management positions.

- Although the IRS used the IRS Restructuring and Reform Act of 1998 authority to proceed with the implementation of the Internal Revenue Pay-for-Performance System, it does not appear the System fully implements all of the Act's provisions, which were designed to help facilitate pay and classification adjustments necessary to restructure the IRS' organization.

  For example, the Frontline Manager Payband did not improve the IRS' existing manager classification system, which was considered to be especially problematic. Instead, the HCO acknowledged that the frontline manager single-grade band design was implemented to reflect the existing frontline management structure, which had a wide variety of occupations and grades that were difficult to group into common levels of work. Although the HCO recognized the advantages of grouping positions into broad, occupational paybands, after several attempts, the Human Capital Advisory Council failed to reach an organizational consensus on how to design multigrade, occupational bands for the frontline managers because of differing career paths among the business units. As a result, the HCO did not group job positions and related ranges of pay but

[2] Payband means a pay level or work level within a career path containing one or more General Schedule Pay System grades and related ranges of pay.
[3] Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

instead retained the General Schedule (GS) Pay System grades as separate bands and simply removed the incremental steps within each grade.

- In addition, the HCO did not establish pay policies and procedures that ensured managers are compensated comparably with IRS employees in the GS Pay System or that the performance-based increases are commensurate with the managers' performance.

  This is important given that, at the discretion of the IRS Commissioner each year, the IRS may withhold from its managers the annual across-the-board pay adjustment that is provided to all other IRS employees and all other Federal Government employees compensated under the GS Pay System. If this happens, managers compensated under the Internal Revenue Pay-for-Performance System in future years may not be paid comparably with other IRS employees under the GS Pay System, who automatically receive the annual across-the-board pay adjustment.

  In addition, because the Office of Personnel Management guidelines require the salary range in a payband to be equivalent to the comparable GS Pay System salary range, it is possible that managers at the high and low end of their respective payband salary ranges will not receive a pay raise commensurate with their performance. For example, a manager at the high end of the payband cannot receive more than the high end of the corresponding GS Pay System grade even if he or she is rated as Outstanding. However, a manager at the low end of the payband who is not meeting standards will automatically receive the same percentage increase in salary as a manager rated as Outstanding because of the requirement for the payband salary ranges to increase in accordance with the GS Pay System increase.

- Finally, the HCO did not sufficiently communicate the details of the Internal Revenue Pay-for Performance System to the affected managers, which decreased morale and increased opposition to some of the provisions of the System.

  In September 2005, the IRS expedited the implementation of the Frontline Manager Payband by at least a year in an effort to "minimize the impact of the conversion costs [from the GS Pay System to paybanding] in Fiscal Year 2005." With its immediate goal of meeting the accelerated deadline for implementation, the IRS did not allow sufficient time for the executives to communicate the details of the new pay system or attempt to seek support from the affected managers, which caused speculation and apprehension about how the new System would affect managers' pay. In addition, the IRS waited until October 2006 to announce that all managers who received a Met, an Exceeded, or an Outstanding performance rating would receive a salary increase that was at least equal to the annual across-the-board pay adjustment. Therefore, the managers remained uncertain throughout their entire Fiscal Year 2006 rating period as to how much salary increase they would receive, if any at all. The two major Associations that represent IRS managers reported significant frustration among their members with the lack of communication by the HCO. In addition, an overwhelming majority of the Associations' members, who responded to a survey, opposed any plans to reallocate the annual across-the-board pay adjustment (e.g., give higher performing managers an additional increase by taking some of the across-the-board increase from the managers performing at a satisfactory level).

Recommendations

We recommended the Chief Human Capital Officer (CHCO):

- Reconsider the structure of the Internal Revenue Pay-for-Performance System for the Frontline Manager Payband by streamlining job classifications to be more broadly based on the nature of the work performed and competencies.
- Reinstate the policy of providing managers who receive a satisfactory (Met) or higher rating with the annual across-the-board pay adjustment that is provided to IRS employees in the GS Pay System.
- Consider alternate sources of funding for the performance-based salary pools and ensure the amounts dedicated for increases are sufficient to both reward top performers and compensate other managers equitably, based on their performance.
- Offer employees an opportunity to express concerns and questions about the new pay system directly to the HCO experts and make an effort to communicate more openly and timely with employees before implementing any new changes to employee compensation and benefits.

Response

IRS management agreed with three of our four recommendations and disagreed with one recommendation. The IRS has initiated a third-party evaluation of the Internal Revenue Pay-for-Performance System in its entirety, including an assessment of the Frontline Manager Payband and a review of the performance-based salary pools. This evaluation will be conducted in 3 phases over 5 years; will determine whether, and how strongly, the current Internal Revenue Pay-for-Performance System supports the human capital organizational goals to recruit, retain, and motivate future leaders; and will provide recommendations to strengthen the System. In addition, the CHCO plans to take efforts to more effectively communicate with employees and to develop a communication strategy that considers any third-party recommendations in this area.

IRS management disagreed with our recommendation to reinstate the policy of providing managers who receive a satisfactory or higher rating with the annual across-the-board pay adjustment that is provided to IRS employees in the GS Pay System. The authority to provide managers with the annual across-the-board pay adjustment rests with the IRS Commissioner, who will consider exercising this discretion in the future. To date, the Commissioner has granted these managers a minimum increase equivalent to the GS Pay System across-the-board pay adjustment. IRS management stated that instituting a mandatory minimum increase in policy is not fiscally practicable at this time due to budgetary implications and restraints. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment

We recognize the flexibility provided to the Commissioner to set pay increases under the *Office of Personnel Management Criteria for IRS Broadbanding System* and are not suggesting this authority be removed. We also recognize the Commissioner's desire to grant pay raises with meaningful distinctions for managers rated as Outstanding, Exceeded, and Met. We believe the Commissioner can do both. Although the Commissioner granted managers who received a Met or higher performance rating with a minimum increase equivalent to the annual across-the-board pay adjustment in January 2007, this was intended to apply only to that year. In 2006, the IRS changed its prior policy of granting the across-the-board pay adjustment to all managers with satisfactory performance and stated future pay adjustments would be decided on a year-by-year basis by the current Commissioner. However, the across-the-board pay adjustment is not tied to an employee's level of performance; it is a measure of the increase in the cost of labor. As a result, if in the future this flexibility results in some managers not receiving the across-the-board adjustment, there are indications that it could come at the expense of the morale and employee satisfaction of managers performing at the Met rating level. We believe the IRS should consider all of the implications of such a decision in allocating pay raises to its managers.

Further, we believe that some adjustments to the Frontline Manager Payband may be necessary to improve managers' morale and to enhance the IRS' ability to recruit qualified employees into manager positions. In addition, efforts to create an effective pay-for-performance compensation system may be undermined if the performance-based salary pools are not adequately funded. We agree that a comprehensive evaluation is needed to determine the adequacy of the funding for the performance-based salary pools and to assess the effectiveness of the methodology used to calculate future salary increases.

Copies of this report are being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have any questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Abbreviations

CHCO	Chief Human Capital Officer
GS	General Schedule
HCO	Human Capital Office
IRS	Internal Revenue Service
OPM	Office of Personnel Management
RRA 98	IRS Restructuring and Reform Act of 1998

Background

Broadbanding–commonly referred to as paybanding–is a system for grouping positions for pay, job evaluation, and other purposes that is different from the General Schedule (GS) Pay System.[1] Paybanding is a result of combining grades and related ranges of rates of pay in one or more occupational series, such as tax compliance, law enforcement, and Counsel.[2] In general, occupations are assigned to one or more related job series, and the grades are grouped into bands that reflect the career paths associated with the occupational job series.[3] The Personnel Flexibilities provisions of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998[4] (RRA 98) authorized the Secretary of the Treasury to establish one or more paybanding systems covering all or any portion of the IRS workforce under the GS Pay System, subject to guidance to be issued by the Office of Personnel Management (OPM). In December 2000, the OPM prescribed criteria for IRS paybanding systems that followed certain principles specified by the RRA 98.[5]

Congress realized the IRS needed the ability to recruit and retain high-quality leadership to transform the agency into an efficient, modern, and responsive organization designed around the needs of taxpayers. The workforce classification and pay provisions of the RRA 98 offered the IRS the flexibility to design its salary and incentives structures to support mission accomplishment and to base pay decisions on performance rather than length of service.

The current Internal Revenue Pay-for-Performance System has three components: Senior Manager, Department Manager, and Frontline Manager Paybands. Figure 1 describes the

[1] The GS Pay System is established by Chapter 51 and subchapter III of Chapter 53, 5 U.S.C. Section 9509(a).
[2] Occupational series means positions similar as to specialized work and qualification requirements.
[3] Career path means a grouping of one or more occupational series into broad occupational families or career tracks for job evaluation, pay, or other purposes. A career path may contain one or more bands.
[4] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.). The authority to establish one or more broadbanding systems is in Section 9509 of the statute.
[5] 5 U.S.C. Section 9509(b)(1)(B)(4) - The criteria to be prescribed by the OPM shall, at a minimum, (A) ensure the structure of any broadbanded system maintains the principle of equal pay for substantially equal work; (B) establish the minimum and maximum number of grades that may be combined into paybands; (C) establish requirements for setting minimum and maximum rates of pay in a payband; (D) establish requirements for adjusting the pay of an employee within a payband; (E) establish requirements for setting the pay of a supervisory employee whose position is in a payband or who supervises employees whose positions are in paybands; and (F) establish requirements and methodologies for setting the pay of an employee upon conversion to a broadbanded system, initial appointment, change of position or type of appointment (including promotion, demotion, transfer, reassignment, reinstatement, placement in another payband, or movement to a different geographic location), and movement between a broadbanded system and another pay system.

positions and shows the number of managers included in each component of the Internal Revenue Pay-for-Performance System as of June 2006.

Figure 1: Components of the Internal Revenue Pay-for-Performance System

Payband	Converted Positions	Number of Managers	Percentage of Managers
Senior Manager	GS-14 and 15 managers who report directly to an executive or who manage one or more subordinate managers.	1,503	18%
Department Manager	GS-11 through 13 second-level managers in the campus[6] functions: Accounts Management, Submission Processing, and Compliance.	400	5%
Frontline Manager	GS-5 through 15 managers not covered by Senior and Department Manager Paybands	6,630	77%
Totals		**8,533**	**100%**

Source: The Agency-Wide Shared Services function Human Resource Reporting Center.

In contrast, the GS Pay System covers most positions in the Federal Government. It consists of 15 grades, each broadly defined in terms of work difficulty, responsibility, and the qualifications required for performance. Each grade consists of a salary range divided into 10 steps. In general, pay progression to the next step is based on length of service. If employees demonstrate an acceptable level of competence for a specified amount of time, they will advance to the next higher step.[7] Except for career-ladder promotions, advancement to a higher grade is usually a competitive promotion, and employees must have successfully completed qualifying work experience at the lower grade.[8]

In the past, individual Federal Government agencies have obtained approval to introduce pay-for-performance systems. However, the transition of the Federal Government from the traditional GS Pay System was accelerated when the Department of Defense and the Department of Homeland Security obtained approval to implement performance-based pay systems. Congress approved these new pay systems in response to the President's request for more

[6] Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[7] A within-grade increase or step increase is a periodic increase in a GS Pay system employee's rate of basic pay from one step of a grade of his or her position to the next higher step of that grade. Within-grade advancement is scheduled after each 52 weeks of service in steps 1, 2, and 3; after 104 weeks in steps 4, 5, and 6; and after 156 weeks in steps 7, 8, and 9. Grade advancement generally requires 1 year of qualifying experience at the next lower grade in the job series.
[8] A career ladder consists of the grades ranging from the lowest level at which an employee can be hired as a trainee to the journeyman grade level, also known as the full performance level.

flexibility in how civil service employees are paid and managed. Under this new approach, the decades-old GS Pay System, which provided predictable pay raises, could now be replaced with compensation based on merit and market-rate conditions.

This review was performed at the IRS National Headquarters in the Office of the Chief Human Capital Officer (CHCO), the Pay-for-Performance Program Office, and the One-Stop Service and Customer Relations Program Office in Washington, D.C.; the embedded Human Resources Offices for the Agency-Wide Shared Services function and the Small Business/Self-Employed Division in Washington, D.C.; and the Wage and Investment Division in Atlanta, Georgia, during the period September 2005 through January 2007. We also obtained information from the Department of the Treasury Office of Human Resources Strategy and Solutions; the Office of Management and Budget Department of the Treasury Representatives; the OPM, Strategic Human Resources Policy Division, and the Human Capital Desk Officer for the Department of the Treasury in Washington, D.C.; the Government Accountability Office in Washington, D.C., and San Francisco, California; the Professional Managers Association in Washington, D.C.;[9] and the Federal Managers Association in New York, New York.[10] The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[9] The Professional Managers Association represents about 2,000 IRS managers ranging in grade from GS-5 to GS-15.
[10] The Federal Managers Association represents about 1,400 IRS managers ranging in grade from GS-5 to GS-15.

Results of Review

The Internal Revenue Pay-for-Performance System May Not Reward and Motivate High Levels of Performance for Managers

There are several areas in which the Internal Revenue Pay-for-Performance System can be improved to better support the IRS' desire to attract and retain the highest performing talent for its management positions. For example, the IRS did not use its RRA 98 authority to improve the existing manager classification system, which was considered to be especially problematic. In addition, the IRS did not establish pay policies and procedures to ensure managers were paid comparably to their GS Pay System counterparts and commensurate with their individual performance. Finally, the CHCO did not allow sufficient time to address workforce classification and pay issues that should have been resolved before making changes to managers' salaries and pay systems. As a result, the structure and methods of pay progression included in the redesigned Internal Revenue Pay-for-Performance System may not support the positive impacts of Human Capital Office (HCO) initiatives to recruit, retain, and motivate future IRS leaders. On the contrary, the current System may discourage both managers as well as nonmanagers from applying for management positions.

The IRS is facing significant operational challenges, including budget shortfalls and high performance expectations for both service and enforcement. Its ability to meet program requirements and the expectations of external and internal customers depends largely on recruiting and maintaining a highly skilled and motivated workforce. Over the next few years, the IRS faces significant challenges in this area because of the potential for substantial loss of highly skilled technical experience in mission critical occupations.[11] For example, the Small Business/Self-Employed Division and the Large and Mid-Size Business Division reported in their Fiscal Year 2006 strategic assessments that the human capital crisis continues to intensify as managers and employees in key occupational series increasingly become eligible for retirement or migrate to other areas.

As of January 2004, 76.6 percent of IRS executives, 48.9 percent of IRS managers, and 20 percent or more of all other employees in mission critical occupations were eligible for either early or optional retirement. Within the divisions, 30.3 percent of managers in the Large and Mid-Size Business Division were eligible for optional retirement in January 2004. In the Wage and Investment Division, 22 percent of the current management team is projected to retire by

[11] Mission critical occupations are those series or occupations critical to frontline enforcement and direct support to frontline operations needed to meet the stated IRS goals.

2007. The productivity of these employees and their collective ability to deliver quality service is critical to the successful accomplishment of the IRS' goals.

Strategic recruitment and succession planning efforts are underway throughout the IRS to ease the potential effects of managers who may retire. It is essential that the Internal Revenue Pay-for-Performance System aligns with and reinforces recruitment and succession planning efforts. To maintain the continuity of its leadership and workforce, the IRS must ensure its managerial compensation system effectively attracts and retains high-performing individuals from both inside and outside the IRS and provides greater flexibility to reward and motivate high levels of performance.

The current Internal Revenue Pay-for-Performance System consists of three components

The first payband for senior managers was implemented in March 2001. When it was implemented, the Senior Manager Payband had 10 steps ranging in salary from the equivalent of a GS-14 Step 1 through a GS-15 Step 10. The managers received the same annual increases to their basic pay,[12] including locality pay,[13] as those provided to GS Pay System employees. However, the GS Pay System entitlement to step increases was removed. Basic pay was reviewed every 2 years, and managers progressed from step to step within the Payband only if their performance rating met or exceeded certain standards.

In November 2001, a similar payband structure was extended to managers in the new IRS campus functions: Accounts Management, Submission Processing, and Compliance. Salary grades GS-11 through GS-13 were consolidated into a single 16-step Department Manager Payband.

Varying in-house opinions regarding the structural design, as well as budget constraints, delayed the IRS from implementing paybanding for the remaining IRS managers who occupied frontline positions. In addition, the Department of the Treasury and the CHCO have been working with the OPM since early 2004 to revise the paybanding criteria for the IRS. The proposed changes include a wider variety of paybands and the elimination of all salary increases, including locality pay, for paybanded managers and employees who receive an Unacceptable rating. In September 2005, the IRS Commissioner decided to implement a Frontline Manager Payband using the *OPM Criteria* of 2000, which are the same criteria used for the Senior Manager and Department Manager Paybands. The IRS plans to review the Internal Revenue

[12] Basic pay is a rate of pay that is continuing and is set by law or administrative action before any additional payments or deductions of any kind. Basic pay does not include locality pay.
[13] Locality pay adjustments are based on salary surveys in the area where an employee works. Employees paid under the GS Pay System receive an annual pay increase that is equal to the GS Pay System across-the-board pay adjustment plus the locality pay adjustment.

Pay-for-Performance System for all managers when the OPM completes its paybanding regulations.

The Frontline Manager Payband was fundamentally different from the earlier Senior Manager and Department Manager Paybands in terms of structure and methods of pay progression. It consists of 11 single-grade bands (5 through 15) with open-rate ranges of pay (no steps) that are the same as the minimum and maximum rates in the GS Pay System for the correlating grade. Under the Frontline Manager Payband, managers are eligible for a performance-based increase to their salary each year. The performance-based increase replaces the GS Pay System within-grade step increase, quality step increase,[14] and annual across-the-board pay adjustment.

In March 2006, the CHCO revised the Senior Manager and Department Manager Paybands to incorporate the stepless design and pay elements of the Frontline Manager Payband. These Paybands, however, retained their multigrade consolidated structure.

The Frontline Manager Payband did not streamline job classification

The Frontline Manager Payband does not provide relief from the rigidity of the current GS Pay System. The IRS indicated that it needed the ability to streamline job classification, which was found to be especially problematic in the managerial ranks. The *OPM Criteria* provided the IRS with broadbanding authority to reduce management layering by offering the flexibility to group job positions into broad paybands based on the nature of work and competencies needed. Although the IRS used the RRA 98 authority to proceed with the implementation of the Frontline Manager Payband, it does not appear that the single-grade band design will help to facilitate pay and classification adjustments necessary to respond to changing organizational priorities, as envisioned by the RRA 98. Paybanding generally expands an organization's ability to hire more quickly and offer competitive salaries, as well as provide flexibility to assign new or different work to support mission accomplishment. In addition, this type of structure may provide employees with better opportunities to diversify their knowledge and advance their careers.

The only structural difference between the Frontline Manager Payband and the GS Pay System is the elimination of the "steps" within each grade in the Frontline Manager Payband.[15] Figure 2 shows an example of the structure of the Frontline Manager Payband compared with the GS Pay System for one payband.

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[14] A quality step increase is an increase in an employee's rate of basic pay from one step of the grade to the next higher step of that grade. Any non-Senior Executive Service employee who occupies a permanent GS Pay System position, is paid less than the maximum rate of his or her grade, receives an Outstanding performance rating of record, and is not compensated under the Internal Revenue Pay-for-Performance System or an incentive pay system is eligible for a quality step increase.

[15] Differences in how employees' salaries change within the Payband are discussed later in this report.

Figure 2: Frontline Manager Payband Compared to GS Pay System (in Dollars)

GS-9[16]	**Step 1** 38,175	**Step 2** 39,448	**Step 3** 40,721	**Step 4** 41,994	**Step 5** 43,267	**Step 6** 44,540	**Step 7** 45,813	**Step 8** 47,086	**Step 9** 48,359	**Step 10** 49,632
FM-9[17]	**Minimum** 38,175									**Maximum** 49,632

Source: IRS HCO Policy Number 85 and GS Pay System Salary Table for 2006.

When the Frontline Manager Payband was implemented, all frontline managers were placed into the payband that corresponded to their GS Pay System grade level. For example, all GS-9 managers were converted to FM-9 managers.

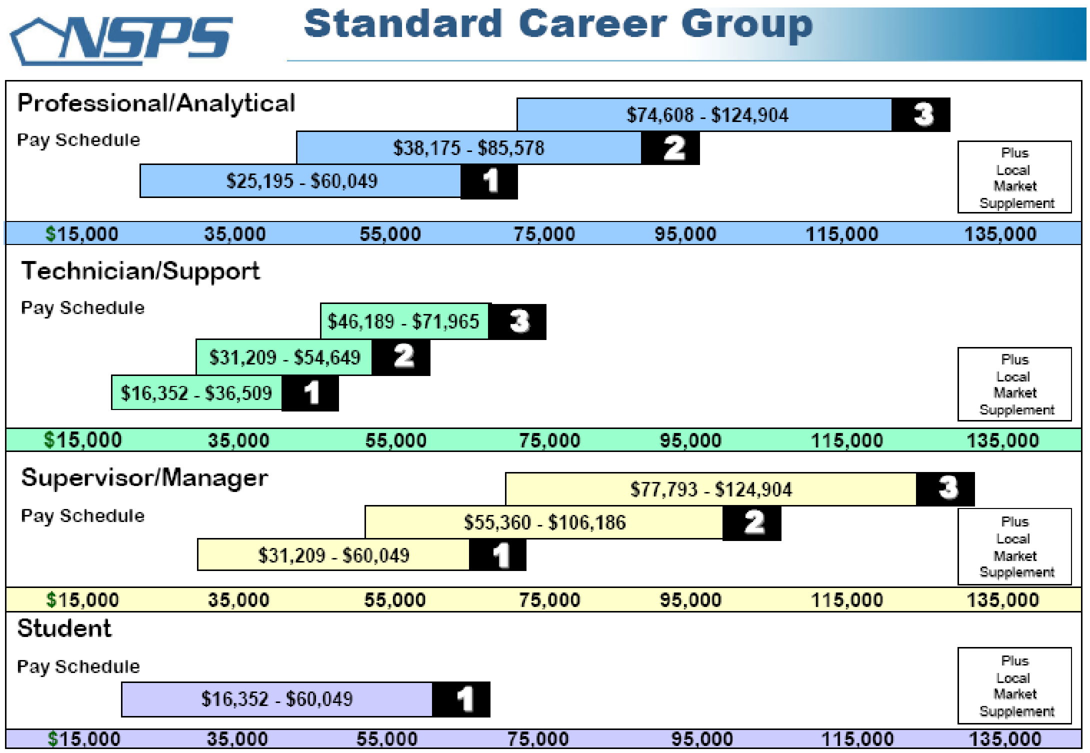
Use of a payband system that streamlines job classification based on the nature of the work performed and level of competencies has been attempted at other Federal Government agencies. For example, the Department of Defense National Security Personnel System was designed to consolidate all GS Pay System employees into one of four career groups:

- Standard.
- Investigative and Protective Services.
- Scientific and Engineering.
- Medical.

Each of these career groups included pay schedules comprised of paybands that allow employees to progress during their careers. For example, the Standard Career Group includes four pay schedules: professional/analytical, technician/support, supervisor/manager, and student. Each of these pay schedules included three paybands that combined GS Pay System grades and provided the employees with the opportunity to progress based on their performance and complexity of the work, as well as promoting broader skill development and advancement opportunities within and across paybands. Figure 3 shows the pay schedules and the associated paybands for the Standard Career Group.

[16] Fiscal Year 2006 Base Pay.
[17] Frontline Manager Payband 9.

Figure 3: Example of the Paybanding Structure for One of the Four Department of Defense Career Groups



Source: Department of Defense National Security Personnel System Town Hall Briefing, May 2006.

The HCO recognized the advantages of grouping positions into broad, occupational paybands. However, after several attempts, the Human Capital Advisory Council failed to reach an organizational consensus on how to design multigrade, occupational bands for the frontline managers because of differing career paths among the business units. Because of the difficulty encountered, the HCO decided to preserve the current classification framework and shifted its focus to one primary objective: the implementation of a pay-for-performance system for managers. The HCO acknowledged that the frontline manager single-grade band design was implemented to reflect the IRS' existing frontline management structure, which had a wide variety of occupations and grades that were difficult to group into common levels of work. A payband structure that groups occupations into broader classifications would improve the flexibility needed to reassign employees for management. In addition, this structure would help achieve a reduction in classification determinations, thereby alleviating pressure on the existing classification system.

The Internal Revenue Pay-for-Performance System does not ensure managers are compensated comparably with IRS employees in the GS Pay System

In response to the growing need for pay reform in the Federal Government, Congress enacted the Federal Employees Pay Comparability Act of 1990.[18] This Act provides for a two-part annual pay adjustment for workers in the GS Pay System: an across-the-board pay adjustment that is tied to the Employment Cost Index and a locality pay adjustment that varies by pay locality.[19] From Calendar Years 2000 through 2006, the annual across-the-board pay adjustment varied from 2.1 percent to 3.8 percent. Congress intended that these annual pay adjustments would achieve comparability between Federal and non-Federal Government jobs for the same levels of work within the same local pay area. These pay adjustments are not tied to performance. However, for supervisory employees paid under the Internal Revenue Pay-for-Performance System, the OPM provided the IRS with the flexibility to withhold a portion or all of the annual across-the-board pay adjustment as long as the manager's salary does not fall above or below the range of salaries in the comparable GS Pay System grade.

Under the current Internal Revenue Pay-for-Performance System, all managers are eligible to receive a performance-based salary increase commensurate with their annual evaluation ratings.[20] For example, managers who receive an Outstanding performance rating will receive a higher performance-based increase than managers who receive an Exceeded rating, and managers who receive an Exceeded rating will receive a higher performance-based increase than managers who receive a Met rating. The performance-based increase replaces the GS Pay System within-grade step increase, quality step increase, and annual across-the-board pay adjustment. A performance-based salary increase is different from a performance bonus (award); a manager who receives a performance-based increase to basic pay may also receive a performance bonus in the same year.[21]

"Why . . . would we [IRS] be able to attract the best and brightest for management when there is less and less financial incentive . . .?"

". . . to deliver what is expected only to lose real compensation would be demoralizing and an incentive to get out of management . . "

Professional Managers Association

Prior to implementation of the Frontline Manager Payband, the IRS' policy was to provide the annual across-the-board pay adjustment to all managers in the Senior and Department Manager Paybands. However, the IRS decided to discontinue this policy for its redesigned Internal Revenue Pay-for-Performance System. As a result, managers compensated under the Internal Revenue Pay-for-Performance System could

[18] Pub. L. No. 101-509, title V, Sec. 529 ((title I, Sec. 101(a)(1)), Nov. 5, 1990, 104 Stat. 1427, 1429).
[19] The across-the-board pay adjustment is generally tied to the Employment Cost Index, a measure of the change in the cost of labor. The locality pay adjustment is based on salary surveys in an area where an employee works.
[20] Annual evaluation ratings are as follows: Outstanding, Exceeded, Met, Minimally Satisfactory, or Not Met.
[21] A performance bonus is a lump-sum payment based on an annual performance evaluation rating.

receive smaller pay adjustments than the approximately 90,000 IRS employees who remain in comparable GS Pay System grades and who will continue to receive the annual across-the-board pay adjustment. As a result, the IRS may have difficulty recruiting and retaining managers because of the impact this policy has on the managers' compensation.

The decision to provide the minimum increase equivalent to the annual across-the-board pay adjustment to managers is at the discretion of the IRS Commissioner and not required by law. Only the approximately 9,000 managers in the Internal Revenue Pay-for-Performance System are affected by the discretion. The remaining 90 percent of IRS employees are not affected by the uncertainty of whether they will receive the annual across-the-board pay adjustment.

In October 2006, the IRS Deputy Commissioner for Operations Support announced that, for Calendar Year 2007, a performance-based increase that is at least equal to the annual across-the-board pay adjustment would be given to all managers who received a Met, an Exceeded, or an Outstanding performance rating. In January 2007, the Deputy Commissioner publicized the specific performance-based increases[22] for managers who received the following performance ratings:

- Outstanding – 6.5 percent of their basic pay.
- Exceeded – 3.6 percent of their basic pay.
- Met – 1.7 percent of their basic pay.[23]
- Not Met or Minimally Satisfactory – 0 percent of their basic pay.

Therefore, the managers remained uncertain throughout their entire Fiscal Year 2006 rating period as to how much raise they might receive, if any at all. In addition, the IRS has not provided assurance for future years that the minimum increase will be comparable to the annual across-the-board pay adjustment provided to GS Pay System employees. Without this protection, it is possible that a paybanded manager who meets minimally acceptable standards may receive a percentage increase that is less than an employee performing at the same level in the GS Pay System. The GS Pay System employees who meet minimum performance expectations are also eligible for within-grade step increases that are based on longevity and equal to approximately 3 percent for each step.[24] The paybands in the Internal Revenue Pay-for-Performance System do not have steps, so managers may not receive the equivalent of within-grade increases.

The IRS performance-based increase is allocated from a resource pool based on the amounts previously expended for within-grade step increases, quality step increases, and the annual

[22] The 2007 performance-based increase did not include locality pay.
[23] For Calendar Year 2007, the GS Pay System across-the-board pay adjustment was 1.7 percent.
[24] The IRS estimated the average annual increase was approximately 1.5 percent, based on the waiting periods. There are 10 steps for each GS Pay System pay grade. The within-grade increase for Calendar Year 2005 ranged from 3.3 percent at the Step 1 level to 2.6 percent at the Step 10 level. The waiting periods for each step are shown in Footnote 7.

across-the-board pay adjustment approved for the next calendar year. The HCO calculated a 1.5 percent annualized yield for the within-grade and the quality step increases. The funding for the performance-based increase pool will be determined annually and on an IRS-wide basis. For example, the January 2007 performance-based increase pool was 3.2 percent of the managers' salaries (1.5 percent for the within-grade and the quality step increases plus 1.7 percent for the annual across-the-board pay adjustment). However, the United States Merit Systems Protection Board recently reported that a pay-for-performance system funded by money earmarked for the annual across-the-board pay adjustment and within-grade step increases may create resistance among those who perceive that their incomes are falling behind and heighten competition among employees in a negative way.[25]

There are two reasons for this possible resistance. First, the annual across-the-board pay adjustment is not performance-based; it is tied to market conditions for comparable salaries. Therefore, it should not be included with the performance-based increase pool in the future. The IRS should dedicate a portion of its budget to provide paybanded managers performing at a satisfactory level with a minimum annual salary increase equal to the annual across-the-board pay adjustment. Second, it is possible that, in the future, managers who receive a Met rating would not get an increase equivalent to the full annual across-the-board pay adjustment in order to pay for the higher performance-based increases that could be given to managers who received a higher rating.

Under the current policy, it is also possible that some IRS managers could receive a smaller annual pay adjustment than their equally performing equivalent GS Pay System counterparts. In addition, the IRS' efforts to create an effective pay-for-performance compensation system may be undermined if the performance-based increase pool is not adequately funded. This could serve as a disincentive for top-performing IRS employees to seek positions in management, as well as negatively affect recruiting and retention efforts.

Performance-based increases may not be commensurate with the managers' performance

The OPM requires IRS salaries in its paybanding systems to have the same dollar range as salaries paid in the GS Pay System. For example, the salary range for each Frontline Manager Payband matches the salary range for each pay grade from GS-05 through GS-15. Although the paybands do not include steps, the minimum and maximum salaries for each payband are equal to the minimum and maximum salaries for the GS Pay System pay grade. Each year, if Congress authorizes an across-the-board pay adjustment for GS Pay System employees, the minimum and maximum salaries in the IRS paybands will increase by the same amount as the corresponding GS Pay System pay grade.

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[25] United States Merit Systems Protection Board, *Designing an Effective Pay for Performance Compensation System* (dated January 2006) xiv, 21.

Because the increase in the maximum salary of each payband is limited to the GS Pay System maximum salary in the comparable pay grade, high-performing managers at the highest end of the payband will be limited to an annual increase equivalent to the annual across-the-board pay adjustment, regardless of their performance rating. This is due to the limitation that their compensation cannot be higher than the maximum GS Pay System salary for that pay grade. For example, using the salaries of the Frontline Manager-9 band in Figure 2 and the performance-based increases approved in January 2007, a manager making $38,175 and rated as Outstanding could receive a performance-based increase of $2,481; however, a manager making $49,632 and rated as Outstanding could receive a performance-based increase of only $838. Combining more than one GS Pay System grade into the payband would reduce the number of managers who would be affected by this limitation.

In addition, because the minimum salary in the payband must keep pace with the equivalent minimum salary for the corresponding GS Pay System grade, minimally successful managers at the lowest end of the payband must receive the equivalent of the annual across-the-board pay adjustment. Therefore, minimally performing managers at the low end of the payband would receive the same percentage salary increases as high-performing managers at the high end of the payband and could receive a higher percentage increase than equally performing managers in the middle of the band. Providing all managers who meet performance expectations with the annual across-the-board pay adjustment would minimize this inequity.

Recommendations

***Recommendation 1*:** The CHCO should reconsider the structure of the Internal Revenue Pay-for-Performance System for the Frontline Manager Payband by streamlining job classifications to be more broadly based on the nature of the work performed and competencies.

> ***Management's Response:*** IRS management agreed with this recommendation, stating that the single-grade structure implemented in September 2006 met the diverse needs of the IRS workforce and mission and that the *OPM Criteria* provided the IRS with this flexibility. The IRS has initiated a third-party evaluation of the Internal Revenue Pay-for-Performance System in its entirety, including an assessment of the Frontline Manager Payband. This evaluation will be conducted in 3 phases over 5 years; will determine whether, and how strongly, the current Internal Revenue Pay-for-Performance System supports the human capital organizational goals to recruit, retain, and motivate future leaders; and will provide recommendations to strengthen the System. The CHCO agreed to consider our recommendation along with the recommendations from the third-party assessment to determine the need for System modifications. Management did not include an expected completion date in their response.
>
> ***Office of Audit Comment:*** We disagree that the frontline manager single-grade band design met the diverse needs of the IRS workforce and mission. We believe some

adjustments may be necessary to improve managers' morale and enhance the IRS' ability to recruit qualified employees into manager positions. In addition, some adjustments may be necessary when the OPM finalizes changes to the regulations governing the IRS Pay-for-Performance Systems. To allow the IRS an opportunity to complete its evaluation of the current System and implement changes, we will report an expected completion date of December 31, 2008.

***Recommendation 2*:** The CHCO should reinstate the policy of providing managers who receive a satisfactory (Met) or higher rating with the annual across-the-board pay adjustment that is provided to IRS employees in the GS Pay System.

Management's Response: IRS management disagreed with this recommendation, stating that, under current IRS policies, all managers except those that receive a Minimally Satisfactory and Not Met rating receive an annual performance-based increase. The authority to provide managers who receive a satisfactory or higher rating with a minimum increase equivalent to the annual GS Pay System across-the-board pay adjustment rests with the IRS Commissioner, who will consider our recommendation to exercise this discretion in the future. To date, the Commissioner has granted managers who received a satisfactory or higher rating under the Internal Revenue Pay-for-Performance System a minimum increase equivalent to the GS Pay System across-the-board pay adjustment. However, instituting a mandatory minimum increase in policy is not fiscally practicable at this time due to budgetary implications and restraints.

Office of Audit Comment: We recognize the flexibility provided to the Commissioner to set pay increases under the *OPM Criteria* and are not suggesting this authority be removed. We also recognize the Commissioner's desire to grant pay raises with meaningful distinctions for managers rated as Outstanding, Exceeded, and Met. We believe the Commissioner can do both. The money set aside for salary increases includes the total estimated amounts that would have been given for within-grade and quality step increases, as well as the across-the-board adjustment. The money for the first two components (within-grade and quality step increases) can be allocated to the managers who are rated higher on their annual performance ratings. Considering this, it is unclear why it would be fiscally impracticable to reinstate the policy of providing managers who receive a Met or higher rating with the annual GS Pay System across-the-board pay adjustment.

Although the Commissioner granted managers who received a Met or higher performance rating a minimum increase equivalent to the annual across-the-board pay adjustment in January 2007, this was intended to apply only to that year. In 2006, the IRS changed its prior policy of granting the across-the-board pay adjustment to all managers with satisfactory performance and stated future pay adjustments would be decided on a year-by-year basis by the current Commissioner. However, the across-the-board pay adjustment is not tied to an employee's level of performance; it is a measure of the increase in the cost of labor. As a result, if in the future this flexibility results in some managers not receiving the across-the-board adjustment, there are indications that it could come at the expense of the morale and employee satisfaction of managers performing at the satisfactory level. We believe the IRS should consider all of the implications of such a decision in allocating pay raises to its managers.

Recommendation 3: The CHCO should consider alternate sources of funding for the performance-based salary pools and ensure the amounts dedicated for increases are sufficient to both reward top performers and compensate other managers equitably, based on their performance.

Management's Response: IRS management agreed with this recommendation, stating that budget neutrality is one of the principles guiding the design of the Internal Revenue Pay-for-Performance System. The CHCO has initiated a third-party evaluation of the Internal Revenue Pay-for-Performance System in its entirety, including a review of the performance-based salary pools. The CHCO agreed to consider our recommendation along with the recommendations of the third-party assessment to determine the need for System modifications. Management did not include an expected completion date in their response.

Office of Audit Comment: IRS efforts to create an effective pay-for-performance compensation system may be undermined if the performance-based salary pools are not adequately funded. We agree that a comprehensive evaluation is needed to determine the adequacy of the funding for these pools and to assess the effectiveness of the methodology used to calculate future salary increases. To allow the IRS an opportunity to complete the study and implement changes, we will report an expected completion date of December 31, 2008.

Inadequate Communication Increased Opposition and Decreased Morale

In January 2006, the United States Merit Systems Protection Board provided guidance on designing an effective pay-for-performance compensation system. The guidance recommends that communication, training, and transparency are essential to facilitate pay system integrity. Specifically, buy-in is promoted by involving those employees most affected by the new pay system early in the development process rather than trying to pull everyone on board after the plan is finalized. The guidance states that supervisors and managers need to be trained in the mechanics of the pay-for-performance process and that the first aspect of transparency is systemic–how the pay system operates. Some Federal Government agencies that have implemented, or are in the process of implementing, a pay-for-performance system have attempted to involve employees prior to implementation. For example, the Department of Defense has provided for its employees extensive training and workshops that give specific details about the system and encourage employees to ask questions and express concerns.

However, the IRS HCO did not adequately attempt to seek support or buy-in from affected managers before implementing the Frontline Manager Payband in September 2005. The IRS had initially planned to implement this Payband at the beginning of Fiscal Year 2007, which would have allowed more time for structure design, planning, and communications with affected employees. However, it later reconsidered this schedule and decided to expedite the implementation of the Payband in an effort to "minimize the impact of the conversion costs [from the GS Pay System to paybanding] in Fiscal Year 2005." With its immediate goal of meeting the accelerated deadline for implementation, the HCO did not allow sufficient time to communicate the details of the new System to the affected managers, which increased opposition and apprehension. Approximately 1 month prior to implementation, the HCO provided managers with information about the System, but the communication and training was essentially one-way (video training tapes) and did not allow the affected managers an opportunity to express preferences or concerns about the System before it was imposed.

> ***"I have never seen an issue that has raised as much heat as the performance-based increase pool. Managers are vehemently opposed to the concept."***
>
> ***Federal Managers Association***

We contacted the two Associations representing IRS managers, the Professional Managers Association and the Federal Managers Association, to obtain an indication of the managers' perspective on the way in which the IRS developed its pay-for-performance system. Both Associations reported a significant number of questions and concerns from their members about how the HCO decided on the structure and pay adjustment policies for the Frontline Manager Payband. The majority of the comments expressed frustration about the lack of communication from the HCO about how the managers would be affected. Members of both

Associations were also concerned that it appeared the Frontline Manager Payband was not as fair a compensation system as the GS Pay System. The IRS National Conference Chairman of the Federal Managers Association noted that a survey found an overwhelming majority (93 percent) of members who were frontline managers responding to the survey were opposed to the concept of the performance-based increase pool. The opinions expressed in this survey indicated a perception that the HCO changed IRS managers' compensation without considering the legitimate concerns and opinions of the affected managers.

In August 2006, both Associations surveyed their memberships to determine if their views of the new Internal Revenue Pay-for-Performance System, in particular the performance-based increase pool concept, had changed since the System was first introduced in September 2005. This was done in anticipation of meeting with the IRS Commissioner before the final decision on how the pool would be distributed to the managers. Over 92 percent of the 1,019 respondents from the Federal Managers Association remained opposed to including the annual across-the-board pay adjustment in the pool. This majority believed all managers who meet performance expectations should receive, at a minimum, the full annual across-the-board pay adjustment approved by Congress. The main reason for their opposition stems from the fact that other IRS employees in the GS Pay System will continue to receive the increase. Consequently, managers who meet expectations may receive a lower percentage increase to their basic salaries than the employees they supervise.

Some members of the Professional Managers Association agreed that managers who are rated as Exceeded and Outstanding should be appropriately rewarded for their performance. However, survey respondents overwhelmingly disagreed that the higher compensation should be made at the expense of those who are rated as satisfactory (Met). For example, 466 (96 percent) of the 483 respondents agreed that managers who receive a satisfactory (Met) or better rating "should receive the full annual adjustment approved by Congress and signed by the President." Eighty-nine percent of respondents disagreed with the statement that "managers receiving a 'met' rating should receive less compensation [less than the annual across-the-board pay adjustment] so that an outstanding manager can get a substantial base pay increase and bonus." Finally, a few managers also expressed the desire to return to a nonmanagement position.

Additional survey responses included:

- Ninety-two percent of respondents answered "no" when asked if the current performance management system accurately identifies the truly 'outstanding' managers. This is important because the performance management system now ties in directly to managers' annual salary adjustments.[26]

[26] Ratings from the performance evaluation system may also be used as a basis for providing performance awards.

- Ninety-two percent of respondents also stated that receiving no annual increase based on a Met rating under the current Pay-for-Performance Systems would not hurt their performance. However, many respondents reported this would decrease morale.

Although the CHCO has provided managers with some information since the implementation, there was no disclosure of how the performance-based increase pool would be allocated among the managers. Consequently, managers did not know how much their basic pay would increase as a result of their Fiscal Year 2006 performance (the first rating period under the new pay system) until January 2007. The business divisions and management organizations informed us that this lack of communication caused speculation and widespread opposition.

As stated earlier, the HCO plans to review the Internal Revenue Pay-for-Performance System when the OPM completes its paybanding regulations. In addition, the IRS may decide in the future to include all of its employees (not just managers) in a pay-for-performance system. With each of these situations, the IRS has an opportunity to solicit input from the affected employees prior to implementing any new pay system.

Recommendation

Recommendation 4: The CHCO should offer employees an opportunity to express concerns and questions about the new pay system directly to the HCO experts. In addition, the CHCO should make an effort to communicate more openly and timely with employees before implementing any new changes to employee compensation and benefits.

> ***Management's Response:*** IRS management agreed with this recommendation and plans to continue partnering with the management Associations on pay-for-performance issues; work with the division/function stakeholders and communication representatives to determine the best means to communicate information; reinforce the effectiveness of the channels to submit questions and concerns; and more effectively communicate with employees before, during, and after implementing any new changes to the Internal Revenue Pay-for-Performance System. Management expects a strategy for communication to be developed by September 30, 2007.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Pay-for-Performance System effectively links compensation to individual performance. We focused our efforts on how the IRS implemented the new System for managers and whether the IRS complied with the Personnel Flexibilities provisions of the RRA 98 and the *OPM Criteria for IRS Broadbanding System.* We also evaluated potential risks to ongoing human capital initiatives to recruit, retain, and motivate future IRS leaders. To accomplish this objective, we:

I. Determined if the Senior Manager, Department Manager, and Frontline Manager Paybands[1] established links between pay and individual performance.

A. Reviewed current laws, regulations, policies, and procedures governing the Internal Revenue Pay-for-Performance System. We requested advice from the Treasury Inspector General for Tax Administration Office of Counsel on specific areas of concern related to the IRS' compliance with the RRA 98 and the *OPM Criteria for IRS Broadbanding System.*

B. Interviewed key Office of Management and Budget, OPM, National Treasury Employees Union, Department of the Treasury, and IRS personnel involved in the development, implementation, and evaluation of the Internal Revenue Pay-for-Performance System.

C. Analyzed historical documents, communications available on the HCO Intranet web site "Payband Resource Center for Managers," and minutes and briefings of Human Capital Board meetings to determine how the IRS' managerial paybands evolved from their original design in 2001 to the current Internal Revenue Pay-for-Performance System.

D. Contacted the Government Accountability Office, researched the new Department of Defense and Department of Homeland Security pay systems, and reviewed the United States Merit Systems Protection Board's Report to the President to determine if the structure and pay adjustment policies of the Internal Revenue Pay-for-Performance System are aligned with current practices and implementing guidance for alternative pay-for-performance systems.

[1] Payband means a pay level or work level within a career path containing one or more GS Pay System grades and related ranges of pay.

II. Identified the potential risks posed by the new System to the IRS' ongoing human capital initiatives to recruit, retain, and motivate future IRS leaders.

A. Reviewed the IRS Human Capital Strategic Plan for 2005 – 2009 and Implementation Plan for 2006 and 2007.

B. Contacted the Professional Managers Association and the Federal Managers Association[2] to obtain the current perspective and opinions of their membership regarding the policies and implementation of the new Internal Revenue Pay-for-Performance System.

[2] The Professional Managers Association represents about 2,000 IRS managers ranging in grade from GS-5 to GS-15. The Federal Managers Association represents about 1,400 IRS managers ranging in grade from GS-5 to GS-15.

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
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Appendix III

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Audit Liaison: Chief Human Capital Officer OS:HC

Appendix IV

Management's Response to the Draft Report

CHIEF
HUMAN CAPITAL OFFICER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
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MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Robert Buggs

SUBJECT: Response to Draft Audit Report – The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders (Audit #200510030)

Thank you for the opportunity to review the draft audit report dated April 19, 2007. The IRS is committed to ensuring that the Internal Revenue Pay-for-Performance System (IR Pay System) complies with the IRS Restructuring and Reform Act of 1998 and represents an equitable and effective means of compensating managers. The IRS initiated a third party evaluation and analysis in order to assess the effectiveness of the IR Pay System and to establish a baseline for ongoing program review. In addition, we have conducted numerous managerial/employee focus groups in various geographic locations to obtain valuable feedback regarding the design and application of the system. On April 17, 2007, the Office of Personnel Management (OPM) also issued proposed regulations in the *Federal Register* to revise the criteria for IRS broadbanding systems.

The IRS is committed to providing ongoing communication regarding the IR Pay System and concurs with recommendation #4 that our communication efforts can be improved. With respect to recommendation #2, the authority to provide managers who receive satisfactory or higher ratings with a minimum increase equivalent to that received by employees in the General Schedule (GS) pay system rests with the Commissioner, and the Commissioner will consider TIGTA's recommendation #2 to exercise this discretion in the future. To date, the Commissioner has granted employees under the IR Pay System with a rating of Met or higher a minimum increase equivalent to the GS across-the-board increase. Finally, in light of the ongoing third party evaluation and the fact that the Frontline Manager Payband and the revised Senior Manager and Department Paybands had the first performance based pay adjustment in January 2007, we believe that more time is warranted to evaluate the effectiveness of the existing IR Pay System before significant revisions to the program are implemented. Therefore, we will consider recommendations #1 and #3, which may warrant further action(s) at a future date, alongside the recommendations of the third party evaluation once it has been completed. Attached is a detailed response to recommendations #1, #2, and #3, and our corrective action for recommendation #4.

If you have any questions, please call me at (202) 622-7676 or Deborah E. Thompson, Director, Pay for Performance Program Office at (202) 283-9122.

Attachment

RECOMMENDATION 1: The CHCO should reconsider the structure of its Internal Revenue Pay-for-Performance System for the Frontline Manager Payband by streamlining job classifications to be more broadly based on the nature of the work performed and competencies.

CORRECTIVE ACTIONS: The OPM criteria for the IRS Broadbanding System provide the IRS the flexibility to design a payband that consists of single or multiple GS grades. The IRS implemented the Frontline Manager (FM) Payband in September 2005 and the single grade structure met the diverse needs of the IRS workforce and mission. The IRS has initiated a third party evaluation of the IR Pay System, which includes an assessment of the FM Payband. This program evaluation will evaluate the effectiveness of the IR Pay System in its entirety in three phases over a five-year period. This assessment will determine whether, and how strongly, the current IR Pay System supports the Human Capital organizational goals to recruit, retain, and motivate future leaders, and will provide recommendations to strengthen the IR Pay System. The evaluation includes quantitative data collection and analysis, focus group and executive interview feedback, and an analysis of linkages to supporting programs such as the performance management system. TIGTA's recommendation #1 will be considered alongside the recommendations of the third party evaluation once it has been completed to determine the need for program modifications.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

RECOMMENDATION 2: The CHCO should reinstate the policy of providing managers who receive satisfactory or higher ratings with the annual across-the-board pay adjustment that is provided to IRS employees in the GS Pay System.

CORRECTIVE ACTIONS: IRS policies establish five rating levels, Outstanding, Exceeded, Met (which is the satisfactory rating), Minimally Satisfactory, and Not Met. Under IRS policies, all ratings except Minimally Satisfactory and Not Met ratings receive a performance based increase. The authority to provide managers who receive satisfactory or higher ratings with a minimum increase equivalent to that received by employees in the GS pay system rests with the Commissioner, and the Commissioner will consider TIGTA's recommendation #2 to exercise this discretion in the future. To date, the Commissioner has granted employees under the IR Pay System with a rating of Met or higher a minimum increase equivalent to the GS across-the-board increase. Instituting a mandatory minimum increase in policy is not fiscally practicable at this time due to budgetary implications and restraints. The Human Capital Office will evaluate communications (see Corrective Actions to recommendation #4) so that such decisions will be communicated to managers as soon as practicable.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

RECOMMENDATION 3: The CHCO should consider alternate sources of funding for the performance-based salary pools, and ensure the amounts dedicated for increases are sufficient to both reward top performers and compensate other managers equitably, based on their performance.

CORRECTIVE ACTIONS: One of IRS' guiding principles in designing the IR Pay System is the principle of budget neutrality. Funding for performance-based increase (PBI) is based on the amount of money previously expended for within-grade increases and quality step increases, plus the annual base pay adjustment as provided under the GS pay system. This funding, along with the current methodology for determining the PBI values, allows the IRS to make meaningful distinctions in pay. As discussed in our response to recommendation #1, the IRS has initiated a third party evaluation of the IR Pay System, including reviewing performance-based salary pools, and recommendation #3 will be considered alongside the recommendations of the third party evaluation once it has been completed to determine the need for program modifications.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

RECOMMENDATION 4: The CHCO should offer employees an opportunity to express concerns and questions about the new pay system directly to the HCO experts. In addition, the CHCO should make an effort to communicate more openly and timely with employees before implementing any new changes to employee compensation and benefits.

CORRECTIVE ACTIONS: The IRS is committed to providing on-going IR Pay System communications, and agrees that our communication efforts can always be improved. The IRS plans to continue (a) partnering with the Federal Managers Association and the Professional Managers Association on pay-for-performance issues, (b) partnering with the division/function stakeholders and communication representatives to determine the best means to communicate information, and (c) reinforcing the effectiveness of the channels to submit questions and concerns. The IRS will make efforts to more effectively communicate with employees before, during, and after implementing any new changes to the IR Pay System. The third party evaluation of the IR Pay System also entails a comprehensive assessment of IR Pay System communications, including the Manager's Payband Resource Center website, which is available to employees as the primary resource for policies, processes and guidance about the IR Pay System. The current process allows all questions to be submitted through the Employee Resource Center. As with other Servicewide programs, this process allows for proper assignment, tracking, and resolution of inquiries. The evaluation is to be completed by the end of the fourth quarter of FY07. In collaboration with the third party evaluation recommendations and communication strategy, IR Pay System communications will be revised accordingly.

IMPLEMENTATION DATE: Communications is an on-going process. By the end of fourth quarter FY07, recommendations from the third party assessment are to be complete and a strategy for communications is to be developed.

RESPONSIBLE OFFICIAL: Director, Pay for Performance Program Office

CORRECTIVE ACTION(S) MONITORING PLAN: Status updates will be provided to the IRS Human Capital Officer on the progress of the communication aspect of the program evaluation.