

The new pay doesn't necessarily mean implementing new reward practices or abandoning traditional ones; it means identifying pay practices that enhance the organization's strategic effectiveness.

The New Pay: A Strategic Approach

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The "new pay" is not alternative pay. It is not skill-based pay, gainsharing or any of the specific pay practices that have cropped up in recent years. Indeed, the new pay is not a set of compensation practices at all, but rather a way of thinking about the role of reward systems in a complex organization. The new pay argues in favor of a pay-design process that starts with business strategy and organizational design. It argues against an assumption that certain best practices must be incorporated into a company's approach to pay.

The fact is, pay systems play a critical role in an organization's design. How well they support its strategy and other systems has a significant impact on an organization's effectiveness and the quality of its employees' work life. For that reason, many companies have adopted new pay practices in the past decade to align reward systems with the important changes occurring in organizational design and management.¹ This is a natural and logical outgrowth of a greater focus on strategic organization design.

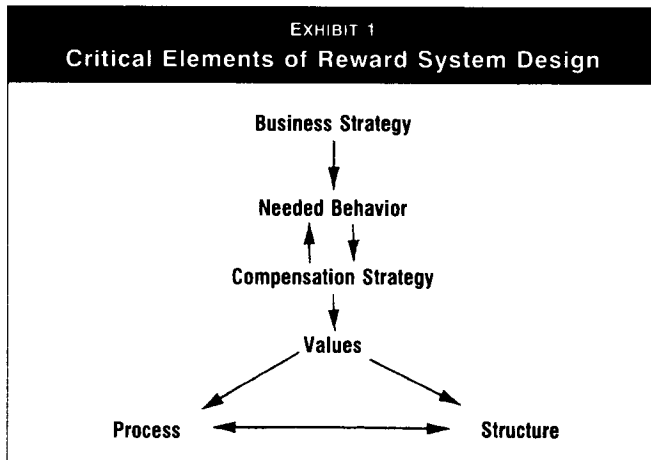
The overriding principle in these new systems is this: For a corporation to be effective, it must achieve congruency among all its op-

erating systems. Particular practices are neither good nor bad in the abstract. Instead, they must make sense within the context of the business strategy and other systems, such as those designed to manage information, human resources, production, finance and, of course, compensation.

The business strategy, in particular, serves as a critical guide in designing organizational systems because it specifies what the company wants to accomplish, how it wants to behave, and the kinds of performance and performance levels it must demonstrate to be effective. The strategy should strongly influence an organization's design and management style, both of which should drive the design of reward systems. These reward systems, in turn, help to drive performance by influencing important individual and organizational behaviors.

PAY-DESIGN PROCESS

Exhibit 1 depicts the design process an organization should use to create a pay system and test its effectiveness. As shown,



business strategy provides a foundation for identifying critical behaviors the organization must demonstrate, and this leads to the reward-system design. The challenge, of course, is to correctly identify the reward-system features that will produce the behaviors that make the strategy come alive. To that end, the exhibit identifies three critical elements of reward systems:

- *The organization's core values.* A corporation may state these principles outright or imply them in the way it operates. Examples of core values include a belief in pay for performance and a belief in secrecy regarding pay systems.

- *Process design features.* The communication policies, decisionmaking practices and related features of reward systems reflect the organization's management style. These elements also influence how well managers and employees accept, understand and commit to pay-system practices.

- *Pay-system practices and structures.* Managers usually devote the most attention to these reward-system features. They include the company's pay-delivery systems, such as gainsharing and profit-sharing plans, and its administrative policies and other organizational programs.

The stronger the alignment among core values, processes, and practices, the more effective pay systems will be (note the arrows connecting the three elements). This fit is critical because organizations must be consistent in what they say and what they do. Inevitably, any violations of consistency will create mis-

understandings about how the pay system works and fail to motivate the needed behaviors.

REWARD-SYSTEM OBJECTIVES

Before we consider the critical design decisions generated by core values, processes, and structures, let's look at how reward systems in general, and pay systems in particular, can affect individual and organizational behavior. Research on reward systems suggests that they influence a company's strategy implementation and overall effectiveness in six ways:

1. *Attracting and Retaining Employees.*

Studies on job choice, career choice and employee turnover clearly show that the types and level of rewards an organization offers influence the types of employees it attracts and retains. Overall, companies that offer the most rewards tend to attract and retain the most people. However, different types of rewards appeal to different types of people. For example, high levels of risk compensation may attract entrepreneurial personalities, while extensive, security-oriented benefits generally attract those who like to avoid risk.

To be effective, the reward systems must be designed to attract and retain those employees the strategy deems most important. That means the systems must distribute rewards in such a way that people will feel satisfied when they compare their rewards with those received by individuals doing similar jobs in other organizations. The emphasis here is on external comparisons, since turnover means employees have left for better situations elsewhere.

2. *Motivating Performance.* Reward systems can motivate performance when certain conditions exist.² What are those conditions?

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Employees must perceive that the company ties important rewards—in a timely fashion—to effective performance. People have their own mental maps of what the world is like, and they use these maps to choose the behaviors that will lead to outcomes that satisfy their needs. Employees are inherently neither motivated nor unmotivated to perform effectively; their motivation depends on the situation, how they perceive it, and what rewards they need and value.

In general, an individual is most motivated to behave in a certain way when he or she believes that the performance will lead to certain outcomes, that these outcomes are attractive, and that it's possible to perform at the desired level. These conditions have clear implications for pay systems: To be motivational, the systems must create a clear and achievable line of sight between an employee's behavior and the receipt of important amounts of pay.

3. Promoting Skills and Knowledge Development. Just as pay systems can motivate performance, they can encourage employees to learn and develop new skills. The same motivational principles apply, since individuals will focus on learning the skills a company rewards. Some organizations have implemented skill-based pay, a relatively new compensation approach, to capitalize on this very point. With skill-based pay, they can strategically target the types of learning they want employees to acquire. By contrast, many job-based systems accomplish this indirectly by tying increased pay and perquisites to higher-level jobs.

4. Shaping Corporate Culture. Along with other organizational features, reward systems help define culture. In fact, a company's approach to developing, administering and managing reward systems can cause its culture to vary widely from that of another organization. For example, these systems can influence the degree to which employees view a company as a human resources oriented culture, an entrepreneurial culture, an innovative culture, a competence-based culture, a fair culture, and a participative culture.

Reward systems can shape culture pre-

cisely because they have such an important effect on employees' skills, motivation, satisfaction, and sense of membership. The behaviors they promote become the dominant patterns of behavior in the organization and influence employees' perceptions and beliefs about what the company stands for, believes in, and values.

5. Reinforcing and Defining Structure. Pay systems can reinforce and define an organization's structure.³ Many executives do not consider this factor when designing pay systems. Thus, their impact on structure often is unintentional. But that doesn't mean the impact is minimal. Pay systems have a strong effect on the level of integration and differentiation, for example.⁴ People tend to unite when they are rewarded in the same way and divide when they are treated differently. In addition, pay systems can help define a company's status hierarchy and strongly influence the types of decisionmaking structures that exist.

6. Determining Pay Costs. Reward systems often represent a significant cost factor; pay alone makes up more than half of some companies' operating costs. Therefore, the system designer must focus on how high these costs should be and how they will vary with the organization's ability to pay. For example, a reasonable outcome of well-designed pay systems might be an increase in costs when the company has the money to spend and a decrease in costs when it does not. Another objective might be to have lower overall reward-system costs than do competitors.

DESIGN OPTIONS

Executives can design and manage pay systems in numerous ways, thanks to the wide variety of financial rewards and distribution methods available. A useful dichotomy in evaluating design options is the process/content one described earlier. In essence, a designer must align pay-system processes and content with the business strategy to create a "strategically correct" system. The most critical design options include the following:

Basis for Rewards

Many companies base their financial rewards on the types of jobs people do. Indeed, with the exception of bonuses and merit salary increases, most organizations take the approach of evaluating the job, not the person, to set a reward level. This approach assumes that job worth can be determined and that the person doing the job is worth only as much to the organization as the job itself.

That's a valid assumption in many respects, since companies can use job-evaluation programs and salary surveys to determine what other organizations pay for the same or similar work. Therefore, job-based pay has several advantages: It can assure an organization that its compensation costs are not dramatically out of line with those of competitors, and it gives the company a somewhat objective basis for its compensation practices.

One alternative to job-based pay is to pay individuals for the skills they possess.⁵ This approach can generate important changes in corporate culture and employee motivation. Rather than reward people for scaling the corporate hierarchy or "growing" their jobs, the company rewards them for increasing their skills. Skill-based pay helps to create a culture of concern for personal growth and development and a highly talented workforce. In factories that use this system, it typically means that many people can perform multiple tasks, resulting in a highly knowledgeable and flexible laborforce.

In most cases, skill-based pay tends to produce somewhat higher pay levels for individuals, but these costs usually are offset by greater workforce flexibility and performance.⁶ Flexibility often leads to lower staffing levels and less absenteeism or turnover, both of which may drop because employees appreciate the opportunity to utilize and be paid for a wide range of skills. On the other hand, skill-based pay can be a challenge to administer. To date, there are no well-developed systems for determining the worth of individual skills in the marketplace.

In general, skill-based pay seems to fit well in companies that want a flexible, relatively permanent workforce oriented toward learn-

ing, growth, and development. Many plant startups use this approach, as do plants that are moving toward high-involvement management methods.⁷ In addition, more companies are applying skill-based pay to knowledge workers, managers, and service situations where the strategy calls for one-stop service and a high level of customer satisfaction.

Performance-Based Pay

Two of the most strategic decisions a company must make about its reward systems are these: Will pay be based on performance? If so, how will this link be established? Once these decisions are made, a number of other reward-system features tend to fall into place. (One alternative is seniority-based pay, frequently used by government agencies. Many Japanese companies also base pay on seniority, although they often give bonuses tied to corporate performance.)

Most U.S.-based businesses say they reward individual performance through a merit system. But creating a true merit pay system is easier said than done. In fact, some observers have concluded that many organizations would be better off if they didn't try to relate pay to performance and relied on other bases to motivate performance.⁸ The reason: Companies find it difficult to specify the types of performance they desire and determine whether or not employees have demonstrated them.⁹

Organizations face a lot of choices in relating pay to performance.¹⁰ They must determine what kinds of rewards they will give (such as stock, cash and a variety of other options); how often they will give them (ranging from time periods of a few minutes to many years); and whether performance will be measured at the individual, group or organizational level. Finally, they must determine what kinds

What kinds of performance will you reward and how will you measure performance?

of performance will be rewarded. For example, managers might be rewarded for sales increases, productivity volumes, cost-reduction ideas, the ability to develop subordinates, and so on.

Rewarding some behaviors and not others has a major effect on performance, so a company must pay close attention to its strategic plan in deciding what to reward. Once it fully develops the strategic plan, it can define key performance objectives and design the reward systems to motivate the appropriate performance. In the process, pay-system designers should consider issues such as short-term versus long-term performance, risk taking versus risk aversion, division performance versus total corporate performance, and ROI maximization versus sales growth. However, an organization can only make decisions about any given issue, such as whether to use stock options, after it has carefully considered whether it supports the desired behaviors.

Market position is a critical aspect of pay-system design.

A few general points about relating pay to performance bear mentioning here. For one, bonus plans generally do a better job of motivating employees than do pay raises and salary increase plans. The reason is that, with them, an individual's pay can vary substantially from time period to time period, while a raise usually becomes an annuity.

Second, objective performance measures are better motivators than subjective measures. In general, employees assign higher credibility to objective measures, such as sales volume or units produced. Thus, they often accept the validity of these measures when they will not accept a boss's rating. A company that ties rewards to objective measures often creates a much more credible link between pay and performance than does one that bases pay on subjective, nonverifiable measures, such as a supervisor's rating.

Third, group and organizational bonus plans generally work best in creating integration and teamwork. Under these plans, it is usually to everyone's advantage that each person work effectively because all share in the financial results of higher performance. When people feel they can benefit from another's actions, they are likely to support and encourage good performance by others. This is not true under individual plans, which tend to produce differentiation and competition.

Market Position

Many companies have well-developed policies about how their reward levels should compare with those of competitors. For example, some companies want to be a pay leader and consciously set their pay rates at above-market levels. Other companies are much less concerned about being leaders and are content to target their pay at or below market rates. If many of an organization's jobs require a low level of skills and enjoy a large labor supply, then a strategy of high pay may not be appropriate. In this case, increasing labor costs may produce a minimum number of benefits.

Market position is a critical aspect of pay-system design because it can strongly influence the types of people an organization attracts and retains. It also affects the turnover rate and selection ratio. Of course, a company does not have to be a high payer for all of its jobs. It can pay above-market rates for certain key skills and pay average or below-market rates for others. This approach has obvious advantages, since the company can attract the critical skills it needs to succeed and still control labor costs.

The reward systems' market position can have a noticeable impact on organizational culture as well. For example, a policy that calls for above-market pay can contribute to the feeling that the organization is elite, that people must be competent to work there, and that they are indeed fortunate to be on board. By contrast, a policy that puts certain skill groups in a high-pay position and relegates the rest to a lower level may contribute to the creation of elite employee groups and cause tensions.

Finally, it is interesting to note that some companies use above-average forms of non-cash compensation to compete for the talent they need. For example, they may stress that employees will have excellent working conditions and the opportunity to do interesting and challenging work. This stance has the potential to be quite effective because it gives companies a competitive edge in attracting people who value noncash compensation.

Centralized/Decentralized Rewards

With a centralized pay strategy, a corporate staff group usually takes responsibility for maintaining consistent pay practices. These often include standardized pay grades and ranges, job-evaluation systems, and promotion systems. With a decentralized approach, a company may establish broad pay guidelines or principles it wishes to stand for, but then it leaves the day-to-day design and administration of reward systems to local units.

A centralized structure promotes the development of pay expertise at the central level and creates pay homogeneity throughout the organization. This homogeneity helps give employees a clear image of the corporate culture, feelings of internal equity, a belief that the company stands for something, and a sense of organization-wide integration that may facilitate career moves and cooperation. It also eases the job of understanding activities in different parts of the organization and communicating them to other units. A decentralized strategy, for its part, allows for local innovation in pay practices that suit particular businesses and strategies.

As with most pay-design options, there is no "right" choice between a centralized and decentralized approach. Overall, a decentralized system makes the most sense when a company has many businesses in different markets and perhaps at different levels of maturity. It allows unique practices to surface that give one business a competitive advantage but pose a real handicap for another. For example, perquisites such as company cars may be standard operating procedure in one business but unnecessary in another. Similarly, a startup firm may need to offer extensive bonuses and stock

to attract and to motivate individuals, while a more mature company does not.

Degree of Hierarchy

Often, companies never make a formal decision to create either hierarchical or egalitarian reward systems. In many cases, a hierarchical approach simply develops over time because it is consistent with the general way in which organizations operate. To wit, they usually offer bigger salaries and more perquisites and status symbols as people rise in the organization. The effect is to strongly reinforce traditional hierarchical relationships and create a climate of different status and power levels. In steeply hierarchical reward systems, the reward system itself usually has more levels than does the formal organization chart. As a result, it creates additional status differences.

With an egalitarian approach, a company dramatically downplays differences in rewards and perquisites that are based strictly on hierarchical level. For example, large corporations that adopt an egalitarian stance may create a few broad bands in their pay systems and eliminate such perquisites as private parking spaces and executive restrooms. This less-hierarchical approach tends to encourage decisionmaking by expertise rather than by position. It also supports teamwork and vertical integration.

Again, there is no right or wrong answer as to how hierarchical a system should be. In general, a steeply hierarchical approach works best when an organization needs relatively rigid bureaucratic behavior, solid top-down authority, and a strong motivation for people to move up the organizational ladder. A more egalitarian approach fits with a participative management style and a need to retain technical specialists in nonmanagement or lower-level management roles. Indeed, many com-

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panies that emphasize egalitarian rewards compete in high-technology and knowledge-based industries.

Communication Policy

Organizations differ widely in their approach to reward-systems communication, and the policies they create in this area can have a big impact on corporate culture. Some are extremely secretive, particularly with regard to pay. They forbid employees to talk about their pay, provide minimal information on how rewards are allocated, and do not have public policies about factors such as market position, the methods used to gather market data, and the size of salary increase budgets.

At the other extreme, some companies communicate so openly that everyone's pay is a matter of public record, along with the organization's overall pay philosophy. These firms list promotions in open job postings and, in some cases, allow peer groups to assess an employee's eligibility for promotion.

The challenge is to pick a position on the continuum from "open" to "secret" that supports both the culture and the behaviors needed for organizational effectiveness. An open system tends to encourage people to ask questions, share data, and ultimately be involved in decisions. Conversely, a secret system tends to put people in more dependent positions and concentrate power at the top, which allows the organization to keep its options open. Secret systems cause some negative side effects, including a considerable distortion of the actual rewards people receive and a low-trust environment in which people have trouble understanding the relationship between pay and performance. Thus, strict secrecy policies may cause a structurally sound pay system to be rather ineffective.

Open systems create considerable pressure to do an effective job of administering rewards. Therefore, if a company has merit pay or another policy that may be difficult to defend, it must invest considerable time and effort in pay administration. If this is done poorly, employees may create strong pressure to eliminate the policies and pay everyone the same. Ironically, then, secrecy may be the

best policy if a firm wants to base pay on merit but spend little time administering rewards. However, secrecy also may limit the effectiveness of a merit pay plan.

Decisionmaking Practices

Closely related to the communication issue are the decisionmaking processes for reward systems. Open communication encourages a wide range of people to participate in the process. Further, if individuals are to be actively involved in decisions concerning reward systems, they must have information about pay policy and practices.

It is important to distinguish between decisions regarding the design of reward systems and their administration. A company may have different decisionmaking styles in these two areas. Typically, top management designs reward systems with the help of support staff and then relies on the chain of command to administer the systems. These companies assume that such a set-up will provide the proper checks and balances in the reward systems and place decisionmaking where the expertise rests.

This approach certainly fits well with a management style that emphasizes hierarchy, bureaucracy, and control through the use of extrinsic rewards. It does not fit well, however, in an organization that believes in more open communication, higher levels of employee involvement, and control through individual commitment to policies. Nor does it fit when expertise is broadly spread throughout the organization.

A number of organizations have begun using employee involvement in pay-system design. For example, some have involved employees in creating their own bonus and gain-sharing systems, with generally favorable results.¹¹ Typically, employees can identify important pay issues and provide expertise that is not normally available to pay-system designers. Perhaps more importantly, their understanding and acceptance of the system tend to be quite high when they participate in designing it, allowing for a rapid start-up of the system and a commitment to its survival.

In addition, some companies have exper-

EXHIBIT 2
Pay and Management Style

<u>Design Options</u>	<u>Traditional Management</u>	<u>Employee Involvement</u>
Communication	Secret	Open
Decisionmaking	Top Down	Wide Involvement
Structure	Centralized	Decentralized
Pay for Performance	Merit Pay	Business Success Based
Base Pay	Job Based	Skill Based
Degree of Hierarchy	Steep Level Effect	Egalitarian

imented with having peer groups and lower-level supervisors handle workaday decisions about the distribution of pay increases, the job-evaluation process and the placement of jobs within pay structures. The most visible examples of this experimentation come from team-based plants that use skill-based pay. Typically, a work group reviews an individual's performance and decides whether he or she has acquired new skills. Interestingly, the evidence to date suggests that this process usually works well. Peers often have the best information about performance and thus are in a good position to make performance assessments.

PAY SYSTEM INTEGRATION AND FIT

As these points illustrate, the first step in creating strategic reward systems is to design pay elements that fit the business strategy. But once a company has developed a clear picture of the appropriate pay practices, it must then view them as an integrated unit to determine if they are aligned with one other. It's also important to see how they fit with the company's management style and systems for information management, communications, and decisionmaking. Ultimately, the alignment of these features will determine whether the organization can effectively implement its strategy.

Exhibit 2 presents a basic alignment model for two sets of pay practices. In the center column, the business strategy calls for a traditional management style, which leads to reward-system practices that support hierarchy, bureaucratic control, and top-down authority. On the right, a set of involvement-oriented pay practices emphasizes teamwork, lateral processes, and knowledge-based decisionmaking.

In sum, the "new pay" presents a fundamental challenge: aligning organizational elements, including the various features of reward systems, to produce the behaviors that support business strategy. The new pay does not necessarily mean implementing new reward practices or abandoning the traditional pay model. It means identifying the pay practices that enhance the organization's strategic effectiveness, and then evaluating their success in terms of this contribution.

ENDNOTES

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