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Pay practices in Western countries appear to be changing more rapidly than at any time in recent decades. Companies are discovering that older pay systems fail to meet business needs, while new alternatives offer better options. The new systems are have been developed based on a new logic that matches the new logic of organization design that stresses employee involvement, lateral processes and teams.

This paper first examines organizational changes that are causing older pay systems to fail. Next, it offers a perspective on designing effective reward systems. It then considers major options in the design of base pay and pay for performance plans. Finally, it discusses how firms can plan for the continual evolution of pay systems to meet changing business needs.

Why Are Conventional Pay Systems Failing?

The pay practices that are now most widespread in Western countries arose in the decades after World War II. They fit the historical, social, and economic context in which they arose. Relatively favorable environmental conditions, such as steady market growth and moderate competition, fostered the rise of large, professionally managed, bureaucratic organizations during this period. Conventional pay systems embody good bureaucratic principles, emphasizing management hierarchy, the division of labor, a focus on the individual, and an emphasis on control and stability. Hierarchy and the division of labor are reflected in the use of numerous job titles and pay grades reflecting different types of work and different levels of authority. The focus on individuals is reflected in the emphasis on individual incentives such as “merit pay.”

Management typically maintains as much control over pay as possible. Human resource professionals, using salary surveys and sophisticated techniques, insure that the wages of the firm are not out of line with the labor market and that the firm’s practices are similar to those of labor market competitors.

The stability of pay practices is impressive; perhaps no other area of management practice has changed less in recent decades. However, pay systems that once were effective no longer meet the needs of many firms. Organizations of the 1990s face highly turbulent and extremely demanding environments. This has led to major organization design changes, and to pressure for pay system changes. The following changes have been particularly critical in stimulating change in pay practices.

1. <u>Globalization of labor markets.</u> The globalization of commerce has been accompanied by the globalization of labor markets. Millions of workers in less developed countries are willing to work for one-tenth to one-twentieth of the wages currently paid to workers in the developed economies of North America, Europe, and Asia. Increasingly, "second world" and "third world" economies compete for high-skilled knowledge work, not just the low-skilled manufacturing jobs they have won in the past. Countries such as Russia and India offer armies of unemployed but well-educated workers able to perform engineering, software development, and other high-skilled work. Modern communications technology makes it possible to upload orders or download finished products almost instantly over telephone lines linking contractors with customers located thousands of miles away.

The globalization of labor markets has several implications for pay systems. First, it creates severe pressure for wage stabilization or even wage cuts in developed economies. Second, wage inequality tends to increase. Low-skill workers, who compete most directly with those in less developed countries, have seen a drop in inflation-adjusted wages in the last two decades. The largest wage increases have gone to high-skill workers who are critical to their firms' ability to compete with advanced products and services. Third, corporations feel intense pressure to achieve the high productivity that enables them to continue paying wages that are high by world standards. Finally, firms are borrowing more pay practices that are used by successful foreign competitors. For example, the common Japanese practice of putting 30 percent or more of pay into semiannual bonuses that are tied to corporate profitability has encouraged U.S. firms to adopt profit sharing and gainsharing plans. This is especially true of firms in the auto and steel industries that compete directly with the Japanese.

2. Accelerating technological change. The rapid pace of technological change, and even the emergence of completely new technologies in such fields as electronics, information systems, advanced materials, and biotechnology, is a familiar story. It has become commonplace to predict that workers entering the labor market today will have to be completely reeducated at least twice during their lifetime to remain abreast of changing technologies and methods of work. This change has important but often unrecognized implications for pay systems. Firms are beginning to explore the use of pay systems that encourage employees to continually develop their skills, such as skill-based pay systems. In addition, conventional job classification and grading systems are becoming obsolete because they are too rigid and cumbersome when the work that employees do changes continuously. Even the job description is disappearing in many high technology companies. Firms are reducing the number of job categories, grades, and salary bands in part because conventional systems cannot be revised fast to meet organization needs.

3. Delayering. Information technology and increased employee self-management are increasingly replacing middle managers who previously performed monitoring and communication roles. As a result, most organizations are becoming permanently flatter with wider. Spans of control and fewer layers of management. Most large U.S. firms have eliminated more than one layer of management in the last ten years; Ford Motor Co. has eliminated eight.

The flattening of organizational hierarchies has profound implications for reward systems. Employees can no longer expect that their career will involve a continual vertical progression through the management ranks as a reward for good performance. Organizations need new types of careers for employees who may be promoted rarely regardless of how well they perform. Employees need to be rewarded for making lateral moves and for increasing their skills.

4. Downsizing. The basic model of organization that guides corporate executives has shifted. No longer do most companies wish to be vertically integrated and horizontally diversified. Instead, they want to be "lean and mean." They are choosing to do only those things that they can do better than anyone else, and to buy as many other services as possible on the open market. New information technology coupled with increasingly close relationships with suppliers has enabled companies to structure themselves in ways that would have been unthinkable only ten or twenty years ago. Most of the largest companies in Western economies have been getting permanently smaller. In some cases, this has happened through layoffs and the closure of unneeded plants and units; in other cases, through work force attrition.

Downsizing creates problems for pay systems. Companies that do not effectively manage downsizing may find themselves with a workforce that, on average, is more highly paid than before. This is because the employees who leave the company may be younger, less senior, more mobile, and less highly paid. Furthermore, increasing job insecurity can reduce employee feelings of loyalty and trust in their company. This can reduce their interest in rewards that depend on long-term membership in the organization, such as long-term incentives and traditional pension plans. Finally, the individual pay for performance relationships in merit pay plans tend to break down in part because managers can not award high pay raises even when individuals perform well. Workers whose salary is high for their salary grade often are unable to earn significant salary increases regardless of their performance rating.,

5. New strategic directions. Very few employees in Western economies are rewarded for the variety of behaviors that are relevant to the business initiatives that line managers regard as critical. The ability to work in cross-functional teams, a willingness to take on the responsibility

required for employee empowerment, and a focus on quality in the creation of products and services are examples of behaviors that most executives feel their organizations need. Yet very few pay systems reward employees for these skills and behaviors.

Designing Reward Systems for Competitive Advantage

As a direct results on the five changes we have reviewed a new logic for pay systems design is emerging. The goal of the new logic is to develop pay systems that support the business needs of a given firm. There is much less emphasis on simply copying the standard practices of other firms, and less emphasis on simply following the conventional wisdom. The pay systems that are emerging are simpler, more flexible, and more fluid than older pay systems. We begin our consideration of these systems by offering a perspective on the strategic design of reward systems.

An effective reward system accomplishes two complementary tasks. It reinforces the organization's strategic direction and motivates employees to engage in behaviors that the organization needs. Accomplishing the first task depends on an understanding of organization structure and functioning, while the second is rooted in individual psychology. Reward systems that accomplish these tasks go beyond adopting what other organizations have; they have the potential to provide a competitive advantage to the organization.

Strategic Design of Reward Systems. A key message of this chapter is that reward systems must be congruent with other key aspects of organization design to be effective. Pay practices are not good or bad in the abstract. They are only good or bad to the extent that they meet the organizational needs. This means that pay practices must be tailored to the organizational context. Specifically, reward practices must reinforce and support the desired business strategy, organizational structure, and the organizational culture to be effective (see Figure 1).

Business strategy examines the business realities facing the organization and asks how the organization can gain a competitive advantage given these realities. It considers market conditions, the unit's mix of products and services, the pace and direction of change in the market, the needs of customers, and the strengths and weakness of the organization and its competitors. A business strategy may emphasize the opportunity for competitive advantage through lower costs than competitors, higher quality products, better customer service, more rapid innovation in products and services, or other means.

All business strategies imply certain behaviors that exemplify the strategy or that the organization needs in order to achieve the strategy. Rewards can strongly influence whether a strategy, is carried out because they influence behavior. Thus, the strategy suggests that certain options in reward system design are desirable, while others are not. For example, Xerox's strategy emphasizes customer service, and sales and service employees receive incentives based in part on customer satisfaction surveys. Rubbermaid and 3M, two companies that emphasize innovation as their key competitive advantage, reward managers for deriving over 25 percent of sales from products that were introduced within the last five years. Entrepreneurial firms typically place a high percentage of employee pay at risk but provide high rewards for successful risk-taking. Conversely, organizations that value stability and long-term effort (such as universities and some R&D labs) tend to offer more job security than most.

Organizational structure is communicated to employees by the reward system. The pay system sends strong messages to employees about what units and levels of the organization are the most important to them. For example, if individuals are paid partly based on the performance of their team or plant, the pay system identifies team or plant performance as important concerns of employees. If pay for performance is only at the individual level, as in "merit pay" systems, the system sends a message that individual accomplishment is important, and that team and organizational performance have lower priority.

Matching the reward system to the structure of the organization requires analysis. A key concept is interdependence, that is the degree to which people work together to do their jobs. An interdependence analysis involves studying the work flow to find out how closely people must work together. Do they work mostly as independent contributors, or as members of small intact work teams, or as a whole unit? At which level of structure are the interdependencies strongest? Ignoring interdependencies can undermine reward system effectiveness. For example, research indicates that rewarding performance only at the individual level when employees are members of interdependent groups, as in product design teams, reduces team performance. Individuals attempt to stand out from the group to gain rewards, focusing on their own goals rather than the team's.

Another organizational structure issue concerns the level at which meaningful measures of performance are available. The pay system cannot appropriately reward performance unless that performance can be measured. This may push performance-related rewards to a higher organizational level. For example, employees may work in teams, but the teams may not be independent units that generate a discrete product or service. In such cases, it may be better to reward performance at the business unit level, where meaningful performance metrics reside.

Finally, practical issues may define the appropriate level for rewards. For example, in engineering organizations the typical employee may serve on multiple teams -- sometimes as many as ten to fifteen. Team-based rewards may be unnecessarily cumbersome in such a situation. It may be better to reward employees for the performance of a unit that includes all the teams. The employee is then motivated to do what makes sense for the organization, rather than to support the specific teams that present the greatest opportunities for a personal payout.

The *organizational culture* is the expression of the organization's most deeply rooted values, beliefs, and assumptions. The culture helps define for employees what is good, proper, and sensible. Employees typically understand many aspects of organizational culture very well, while other aspects may be unconscious or beyond awareness. Ideally, the culture that management is attempting to create should be consistent with the business strategy, but in some cases the culture of the organization may lag behind business needs.

Reward systems have the ability to shape culture because of their influence on communication, motivation, satisfaction, and membership. The behaviors that rewards cause become the dominant patterns of behavior in the organization and lead to perceptions and beliefs about what the organization stands for, believes in, and values. Reward systems can influence the degree to which the culture is seen as paternalistic, entrepreneurial, oriented toward developing human resources, innovative, fair, or participative. Management needs to explicitly identify the type of culture that it is trying to create and the patterns of behavior that are consistent with that culture. Pay system changes should reinforce positive elements of the existing culture and should support the culture that the organization is trying to establish.

Two aspects of organizational culture are highly relevant to pay innovations: employee involvement or empowerment, and teamwork. A high level of employee involvement is associated with greater success in both skill-based pay and variable pay systems, because these systems depend on employee initiative for success. Both skill-based pay and variable pay systems also facilitate greater employee involvement as well because they reward employee initiative. A high level of teamwork is important for and is reinforced by variable pay plans that pay out at the group or organization level. In a very individualistic culture, employees may not cooperate in ways that allow team bonuses or gainsharing bonus plans to work.

Motivation of Performance. The strategic design of reward indicates the types of behavior that the organization needs, but we are still left with the problem of how to motivate those behaviors through the reward system. Considerable research indicates that a reward systems can motivate performance. If it meets several conditions. It must deliver important rewards in a timely fashion. The rewards must be tied to the desired behaviors. Employees must understand the connection between their behaviors and the rewards.

The approach that researchers use most widely to understand employee motivation is known as expectancy theory. Three concepts are the key building blocks of this theory.

1. *Effort to performance expectancy*. This is the employee's expected probability that a given level of effort will lead to a given level of performance. It is the individual's perception of how hard it will be to achieve a given behavior. For example, employees may feel nearly certain that they can produce ten units per day but perceive only a fifty-fifty chance that they can produce fifteen units per day.

2. *Performance to outcome expectancy*. This is the employee's expected probability that performing at a certain level will lead to a specific reward. It is the individual's perception of the likelihood that a given level of performance is connected to certain outcomes. For example, employees may feel certain that they will receive their salary for performing at a normal rate of ten units per day. If employees do not see a connection between performance and pay, however, they may see no additional reward for producing fifteen units per day.

3. *Attractiveness of the reward*. Outcomes such as promotion opportunities, recognition, and pay vary in their attractiveness to individuals. The most motivating rewards for a given employee are those that are the most attractive to that individual. Although money is not an attractive outcome to everyone and a given amount of money may be more attractive to some people than others, pay is one of the most widely desired rewards that organizations can offer. Its attractiveness is significantly related to the size of the rewards.

Putting these concepts together, an employee's motivation to perform in a certain way is greatest when the employee believes that performance at a desired level is possible (effort to performance expectancy); the employee believes that the behavior will lead to certain outcomes (performance to outcome expectancy); and the employee feels that the outcomes are attractive. An employee will choose the level of performance that has the greatest motivational force associated with it, as indicated by its combination of expectancies, outcomes, and values.

Figure 2 presents the expectancy model of motivation.. It depicts motivation as the force on an individual to expend effort. Performance results from a combination of the effort that the individual exerts and his or her level of ability. The employee attains certain outcomes as a result of performance. The feedback loop in the model indicates that employee motivation is shaped in part by the individual's perceptions about whether performance actually results in valued outcomes.

In order for employees to believe that performance is related to pay, the connection between performance and reward must be visible and a climate of trust and credibility must exist in the organization. Visibility is critical to establishing a clear line of sight from effort to reward. Trust is important in order for employees to believe that they will be rewarded for future performance. A high level of openness and employee participation in pay system decisions can help establish trust.

In summary, an effective reward system is one that motivates the behavior performance that is needed by the organization, and that the type of performance that the organization needs is defined by its business strategy, structure, and culture. What reward system design options appear to be effective in motivating employees to do the things that contemporary organizations need? We first consider options in base pay, that pay which is fixed or guaranteed.

Base Pay Options

Two major options in base pay design that are currently receiving very widespread attention are "broad banding" systems and skill-based pay systems. Broad banding systems greatly simplify job grading systems by revising the overall architecture of the pay system. Skill-based pay systems revise the basis for allocating pay within the overall architecture.

Broad banding. Most large organizations have increased pay grade distinctions over time. The use of many grades has permitted firms to offer relatively frequently promotions in the form of grade increases, to create pay distinctions that mirror the hierarchical and status distinctions in the organization, and to control salary inflation within grades. Large companies often have dozens of pay grades between the lowest paid employee and the top executives.

Broad banding radically reduces the number of grades in the organization. Companies such as General Electric and Northern Telecom recently have combined grades until only as few as six remain in the entire corporation or a large business unit. As grades are combined, the spread between the bottom and the top of the range increases from perhaps 35 to 50 percent to as much as 150 percent. In addition, firms using broad banding are usually eliminate traditional pay tools, such as point factor job evaluation and range controls.

Broad banding may fit the firm's business strategy, structure, and culture. A company that has radically delayered in favor of promoting flexible, lateral, team-oriented structures for managing the business of the firm may find numerous grades to be an anachronism. Broadening bands can also have a positive impact on motivation because it can give managers more flexibility with respect to how much money they have to reward performance. Decreasing grades may also increase employee flexibility, by reducing instances in which employees are reluctant to take assignments that are not associated with opportunities for promotion to another pay grade. Some firms adopting broad banding expect that most employees will remain within one band, such as an engineering band or middle manager band, during their entire career. Companies adopting broad banding often hope to reduce the time, effort, and energy currently needed in order to manage their complex pay grade systems.

Broad banding may create a variety of problems. Once more familiar methods of cost control have been abandoned, it may not be clear how pay costs will be controlled and pay equity will be maintained. Line managers typically assume a critical role in controlling compensation costs in broad banding, and they may need to be evaluated partly on the basis of the effectiveness with which they perform this role. Extensive communication is needed in broad banding to help employees understand how the new system works and how they can advance in it. Broad banding is incompatible with hierarchical, bureaucratic company cultures. Finally, companies may overpromise in adopting broad banding. This is particularly a problem in companies that adopt control techniques such as pay zones or "shadow ranges" within broad bands. It may appear to employees that little has changed except the nomenclature.

Skill-based pay. The most common base pay system is job-based pay, which rewards employees for the job they currently hold. By contrast, skill-based pay (also termed pay for skills, knowledge-based pay, and competency-based pay) rewards employees for their repertoire of knowledge and skill. Typically, employees receive formal certification to show that they have obtained the skill before they receive additional pay. This differs from job-based pay, where the pay is attached to the job and employees receive immediate pay increases when they move to a new job even if they are not capable of performing it. Skill-based pay systems usually de-emphasize seniority and other factors unrelated to skill. This contrasts with the common use of maturity curves for engineers. These systems assume without proof that an employee becomes more valuable with greater experience. Often, advancement opportunities for employees are broader in skill-based pay systems than in job-based pay systems.

Three types of skills in a skill growth are usually identified in skill-based pay system:

- **Depth of skill** is increased knowledge of one technical specialty. Examples include the "technical ladder" for engineers, which provides opportunities for promotion based on expertise rather than hierarchical advancement, and apprenticeship systems for skilled trades workers.

- **Breadth of skill** is increased knowledge of a variety of different tasks or jobs. For example, engineers might be rewarded for learning more than one engineering discipline; factory workers may be rewarded for learning all jobs in their work team or factory.

- **Vertical skill** is self-management skill. For example, the Volvo Kalmar plant gave all team members a raise when they proved they could operate with a supervisor.

A skill-based pay plan can reward one, two, or all of these types of increased skill. In the typical plan, manufacturing employees or rewarded for learning breadth skills so that they can participate in self managing work teams. Most U.S. companies now use one form or another of skill-based pay in at least some organizational units.

The success rate for skill-based pay plans appears to be relatively high. The available research suggests that organizations with skill-based pay experience increases in productivity, quality, output, safety, attendance, and employee-management relations. Employees tend to earn above-market wages because they become more valuable to their employers. For this and other reasons, most employees tend to have favorable attitudes about such plans.

The benefits do not appear simply because the organization adopts skill-based pay, however. The plan must be designed so that it makes one or more of the following things happen:

- **Employee flexibility**. Skill-based pay may enable cross-trained employees to more effectively control and eliminate production or service delivery bottlenecks. It also may permit leaner staffing.

- **Support for high involvement**. Skill-based pay systems are found more often and work more effectively in organizations with high levels of employee involvement. This type of pay system gives employees incentives to learn the technical and social skills they need to manage themselves effectively. This may bring advantages such as reduced need for management positions, more effective employee problem solving, and better cooperation among different departments.

- **Acquisition of critical skills**. Certain types of employees may be attracted to join the organization and remain in it because of skill-based pay. This is one impetus for the

> extensive development of skill-based pay plans in information technology groups, where the plan appeals to technically oriented employees.

Even when successful, skill-based pay plans can run into many problems. In some cases these are so serious that the plans fail. The most serious concern to managers is the potential for higher costs. At the outset, higher costs are almost a certainty, due to the cost of wage incentives, increased training, and certification-related expenditures. The organization adopting skill-based pay must bet that these higher costs will be offset by benefits to the organization. Unless the benefits are realized, the plan will cost more than it is worth to the organization.

Skill-based pay plans often face a variety of problems. They can be confusing because employees must understand the range of skill blocks for which the are eligible, the training and certification requirements for the blocks, the pay rates for each block, and so on. This means that skill-based pay systems require considerable communication for success. Certification processes may be time-consuming, and employees may object to the certification criteria as unfair or inappropriate. If the skill-based pay system rewards employees for learning skills that they do not use, either because of the work they are assigned or because the technology changes and some skill blocks become obsolete, the plan will escalate wages for no benefit. Increasingly, firms are requiring annual recertification of skills to insure that the company is receiving value in the form of increased skill for the increased wages employees receive. Not all employees have the ability or desire to learn new skills. If there are too many in the workforce who do not want skill-based pay, it will not succeed.

Pricing skill blocks in the labor market may be difficult if few other organizations in the same market use a skill-based pay approach. The logic of market pricing may shift, from pricing each step in the pay system (analogous to how each job in a job-based system is priced to the market) to pricing the overall system. The starting wage is determined by what is needed to obtain the right kind of employee; it may be possible to find a logical top level by finding a job rate in the market for cross-trained or highly skilled employees.

One common concern of manages is that employees will become disgruntled if they “top out” and cannot continually earn increases in a skill-based pay system. Research has convincingly indicated that this is not a serious problem, perhaps because employees realize that they are better off under most skill-based pay systems than they would be in other systems.

The most common type of skill-based pay system is a base pay system. It is typically found in manufacturing plants and similar environments. These systems usually attempt to represent cover all the important skills needed to do the work of employees covered by the system. Skills and knowledge are organized into skill “blocks” that each require perhaps four to twelve months to learn. Training requirements and certification standards are identified for each block. The design often is complex and careful, since employees receive permanent base pay rewards for increases in skill.

A new but increasingly important approach to skill-based pay uses bonuses instead of base wage increases to reward skill acquisition. It is appropriate in situations where the base of knowledge is changing quickly or is difficult to specify. It makes sense in certain kinds of high technology work, including the work of engineers and information systems professionals, for whom the knowledge base may become obsolete in as little as five to seven years. It may not make sense to make permanent increases to salary for obtaining knowledge that will soon be obsolete. The bonus approach can be combined with performance management systems. All employees can have learning objectives that are similar to performance objectives, and they can receive bonuses that vary in size depending on the importance and difficulty of the learning objectives. Although this approach makes a great deal of sense in the right situation there is little research to inform the design of the plans.

Pay for Performance Options

Paying for performance is a critical and complex issue. The starting point for any pay for performance system needs to be an analysis of the business strategy, organizational structure, and organizational culture. This will indicate (1) the types of performance that the organization needs to reward; and (2) the level of analysis at which rewards should be located (individual, team, unit, or corporation).

Merit pay. The most common method of paying for performance in Western countries is individual "merit pay." Merit pay increases salaries on the basis of changes both in labor market conditions, as assessed by salary surveys, and individual performance, as assessed by performance appraisals. An individual's position in their salary grade often is used to modify this relationship. Employees high in the range become "topped out" and receive lower increases or no increases, regardless of their level of performance. In merit pay plans, increases become compounded annuities; employees enjoy the fruits of one year's merit increase for the rest of their career.

In many organizations, individual "merit pay" and pay for performance are synonymous. This is unfortunate, because merit pay systems are seriously flawed as a means of motivating performance in most organizations. Their annuity feature requires organizations to award relatively conservative increases. There is rarely much difference between the raises of high performers and low performers in any one year. This, as well as the reliance on subjective appraisals that may be poorly performed by supervisors, can destroy the perception of a relationship between pay and performance. Also, the modification of pay increases based on position in the pay grade means that in reality, these systems often do not award larger raises to high performers.

Payment based on individual performance may interfere with team or unit performance in interdependent organizational units, as individuals compete at the expense of the group. Finally, merit pay systems are becoming increasingly difficult to administer because of management delayering. Performance appraisals can be difficult to conduct well when each supervisor has just six to ten subordinates. In many organizations today, the average supervisor has fifty or even 100 subordinates, and no supervisor can intimately know the performance of all subordinates under such conditions.

In the U.S., many companies are experimenting with them merit pay systems in order to strengthen the connection between pay and performance. Some firms are giving the same percentage increase to all those at a given performance level; those high in their pay range receive some or all of it in the form of bonuses, while others receive the increase as a base pay raise. Some are paying increases to all employees in bonuses. This increases the potential for paying large bonuses to high performers, thus strengthening the pay to performance connection, and reducing the permanent annuity cost of merit raises.

Many firms are greatly simplifying the appraisal process by using three-point rating scales that only attempt to separate very high and very low performers from typical performers. Valid identification of performance outliers is easier than make the fine distinctions required to rate every employee on a five, seven, or nine point rating scale.

Perhaps the most common innovation in merit pay systems today is some variation on the “360 degree” appraisal. This type of appraisal makes use of ratings from those whose experience allows them to rate an employee’s performance, whether they are subordinates, supervisors, peers, or internal or external customers. Thus, the rating may come from any direction on the organization chart. The use of automated packages that are installed on computer networks makes it possible to conduct these appraisals efficiently. The 360 degree appraisal automatically reduces the individual performance focus of merit pay, because the employee must expect that peer and customer ratings will reflect his or her cooperation with others. It also increases the chances that the employee will accept feedback from a performance appraisal, since the feedback of multiple raters is harder to dismiss than feedback from the supervisor only. Finally, it may be the only practical way to appraise performance of employees in an organization with very high spans of control.

Variable pay. There are many forms of variable pay, and variable pay plans have many names: gainsharing, profit sharing, team bonuses, Scanlon plans, and so on. The variable pay plans we will discuss here have two key characteristics. They pay for performance through bonuses that are paid near the time that the performance occurs, and they pay for the performance of collectivities rather than individuals. These systems are used by about 40 percent of large U.S. and many Swedish firms as well. The bonus money that employees potentially can make in a variable pay plan represents "pay at risk," meaning that it is not guaranteed. Pay varies with performance, so that the organization pays out more when it can afford to and less when performance does not justify high payment. A high level of pay at risk can create an entrepreneurial culture in the organization.

Here, we make no sharp distinction between plans at the team and organizational levels. The design issues are the same. The major caution when considering team bonuses is that an inappropriate plan may create competition among teams that need to cooperate. If the teams are not highly interdependent and are relatively self-contained -- for example, two self-contained product lines under one roof -- it may be appropriate to reward team performance.

The two key elements in variable pay plans that lead to increased organizational effectiveness are:

- A *formula* by which employees share monetarily in the performance gains of the organization.

- *Structures and processes* by which employees share in the creation of organizational performance gains.

If only the first element is present, the plan will not motivate improved performance because there will not be clear connection behavior performance and reward. It is simply a fringe benefit that pays some times and not others. The second element is the means by which employees help create improved performance, generating a pool of money in which they share. Without it, employees will not be motivated because they will have no way to influence the size of their bonuses.

Variable pay plans have a relatively high success rate. Reviews of the literature and large-scale studies suggest that variable pay plans result in increased organizational performance in perhaps two cases out of three. Typical benefits reported for variable pay include increased productivity, better quality, lower costs, lower absenteeism and turnover, and more favorable employee attitudes. Cost-benefit analyses indicate that there is a good positive return to the organization for the increased wages that are paid out in the form of bonuses.

In order for the plan to succeed in improving performance, it must change patterns of behavior that can in turn lead to increased performance. Increased performance may result from increased employee suggestions for improvement; greater employee effort; better and more persistent problem solving; cooperation within and between groups in the organization, since groups have an incentive to cooperate in order to achieve common goals; greater demands on management for improved performance; and better relations between management and employees.

Of course, there are many variable pay failures. Plans may fail either because the formula is poorly designed or because the gainproducing structures are inadequate. There are many potential problems with variable pay formulas. The hurdle for achieving a payout may be too high, especially early in the life of the plan. Employees tend to give up on plans that do not pay out in the first year or two. Conversely, if the formula makes it is too easy to achieve a payout, the plan may fail because it does not cause employees to change their behavior. There may not be enough money available in the plan to incent a change in behaviors. The research evidence suggests that bonus opportunities must represent at least five to ten percent of base pay to be motivating. The more money available, the more motivating the plan; some plans make it possible for employees to earn 25 percent or more of base pay in bonuses, although a much lower amount is typical.

The plan may be designed to reward the wrong behaviors, or may not cover all the relevant behaviors and metrics. For example, a formula that only rewards increased labor productivity may lead employees to work harder but increase scrap and waste materials and supplies.

Payouts also may be too infrequent. From a motivational point of view, frequent payouts are desirable, although this may not be practical for an organization's accounting system or performance cycles.

Omitting key groups from the plan can create other problems. For example, if the plan covers only direct labor employees, support employees such as maintenance workers and material handlers may resist changing their behavior in order to make it possible for others to earn a bonus.

Finally, the formula can be too inflexible. Because the formula is tailored to a particular context, the formula needs to change as the things it is designed to fit also evolve. This suggests the need for periodic changes to the variable pay plan.

The structures needed to support performance improvement may be absent or poorly implemented. Most variable plans requires a participative system that generates and processes employee ideas for improvement. This may be a separate system of variable pay committees, or participation may be integrated into the role of existing work teams. Whatever the particular structure, unless employees have the opportunity to suggest improvements, they are left in the position of only being able to work harder to achieve a payout.

Inadequate training and communication about the plan and organizational performance is another common source of problems. Employees are not motivated by the plan unless they understand it and unless they know the direction of organizational performance and how it is changing.

Another key variable is trust. Employees must trust that the formula is fair, that they will receive a payout for their efforts, and that their ideas will lead to organizational changes. If trust is very low, adoption of variable pay should be reconsidered.

Finally, management may be a barrier to success. Employees question why things have been done in certain ways in the past, and challenge management to adopt changes faster. Some managers see this as a desirable aspect of variable pay, while others are threatened by such behavior.

The design of variable pay plan formulas is complex, and indeed it has been the subject of numerous books. Here we will highlight some of the most important issues.

Formula Design. There are several key principles of variable pay design. First, such plans usually are designed to be *self-funding*, so that the money paid out in bonuses is derived from savings that the plan itself generates. Another principle is *line of sight*, or the ability of employees to see how their effort leads to higher performance and ultimately a bonus. There are many ways of increasing line of sight in variable pay plans. Simpler measures and formulas tend to produce greater line of sight; so do more frequent payouts. Paying out to smaller units (such as a teams) creates greater line of sight than paying out in a large plant (say, 1000 employees) or an entire company. Support processes can be critical to creating line of sight. A simple formula and team-level bonuses may be inappropriate, which means that considerable training and information sharing must help employees understand a plan that is not obvious to them.

A variety of variable pay formulas are illustrated in Figure 3. This figure indicates that a key design choice is the metrics that will serve as criteria for the formula; another is the threshold for payment.

Many different performance measures can be used as the basis for a variable pay formula. These range from very concrete behavioral measures (accidents, absenteeism, safety inspection ratings, etc.) to measures of unit performance (productivity, cost, quality, on-time delivery, cycle time, etc.) to measures of financial performance (return on sales or investment, profit, economic value added, etc.). The best measure for a given organization can only be discovered through analysis. The advantage of behavioral measures is that they have strong line of sight, meaning that employees can see that changing their behavior leads to a payout. For example, employees are motivated to reduce absenteeism because there is a clear connection between attendance and bonuses.

Financial performance metrics are more closely tied to the organization's ability to pay. If the organization is doing well, it can afford to pay bonuses; if it is not doing well, no bonuses are paid out. This often makes financially oriented plans attractive to managers. However, most employees often have modest control over financial performance. Whether the organization makes a high profit or achieves a high rate of return depends on market conditions, competitor behavior, capital equipment purchases, and accounting decisions that employees cannot influence. Unit performance metrics are in the middle on these criteria. Employees can influence them more easily than financial performance measures, but not as easily as behavior measures. An organization that shows good performance on productivity tends to make a higher rate of return over the long run, but the relationship is not perfect. A plan based on unit performance or behavioral measures may pay out handsomely even when the total organization is losing money, or may not pay out at all when the organization is making high profits.

Many organizations attempt to realize the best of both worlds by combining different types of metrics in the same formula. For example, there may be a requirement that the organization is making a profit before it makes payouts on unit performance or behavioral measures. These and other options protect against payouts in bad times, but at the risk of making the plan more complex and difficult to understand. The plan also may inadvertently include so many safeguards that it cannot pay out.

Figure 1 also highlights the design choice of whether to pay out when the organization does better than in the past (gainsharing when performance exceeds historical levels), versus when the organization reaches targets that are defined by management (goal sharing). Gainsharing based on historical performance usually appears fair to employees. It also avoids employee fears of a “speedup,” a common problem in individual incentive plans such as piecework. Goal sharing may be a more practical approach in some situations. Historical data may be unavailable, as in a new plant, or may be irrelevant, as in the case of an organization that must perform at a much higher level than in the past to stay in business. Management-set targets are very flexible, and can change annually to reflect new business directions and emphases. Also, managers tend to accept targeted plans in part because of their role in setting the targets.

We wish to emphasize again that managers can determine the suitability of any particular formula only through an analysis of the needs of the organization. Different plans are appropriate to different settings. Also, we again emphasize that the support processed and structures are probably more important to success than the specifics of the formula.

Organization Learning and Pay System Change

We have argued that pay systems need to be custom tailored to their context, specifically the organization’s business strategy, structure, and culture. Because each of these things is constantly evolving, no pay system can remain static and continue to be effective. Over time, any pay system will fall out of alignment with other aspects of organization design. Management needs to expect this and plan for it. To know whether the pay system is out of alignment with other organizational changes, management must periodically assess the effectiveness of the pay system and consider changes in the system. Managers also need to conduct a systematic assessment because of the limitations of design knowledge. No one can say for certain that any particular constellation of design characteristics is working as intended. Only by conducting a systematic assessment can the organization learn whether a pay system change, like any major organizational change, is working as intended and is having a positive effect on performance.

Conclusion: Reward Systems and Organizational Change

Our analysis has portrayed reward system design as a matter of matching pay changes with the organizational context. In reality, the context is continually changing in most organizations. If the organization design is changing, should reward system changes wait until other changes have been made, or should they be used to help drive other changes?

In most major organizational changes, pay system change lags other changes. Only after other practices have been put in place does the organization consider reward system changes that are needed to support the new practices. For example, changes toward a more participative management style usually begin with job redesign, quality circles, team building, or other changes. Pay changes usually are made later. Managers often feel that pay is too contentious an issue to raise early, and may not be comfortable designing new pay systems until the outline of other changes becomes clear.

Although it happens more rarely, pay system change can precede or even help drive other changes. In fact, variable pay plans such as the Scanlon plan have long been used to help move an organization toward a greater emphasis on participative management. Participative systems may be installed to make the pay system work effectively under such plans. Changing the reward system may reduce the tendency of the organization to resist change and it may reduce the investment of employees in the status quo. Unless this is done, employees may fear the effect of organizational changes on their salary, their pay for performance opportunities, their pay grade, and so on. All the changes we have discussed in this chapter present some degree of threat to vested interests in bureaucratic organizations.

Organizations can also use the pay system to help manage the transition toward a new organizational state. They can provide rewards to employees who engage in the behaviors needed to install the changes and make their work effectively. For example, one-time bonuses may help the organization achieve specific goals (deadlines, etc.) in a new plant or business startup. In our view, managers have underused reward systems as a positive force for helping to create organizational change.

Additional Readings

Lawler, Edward E. III. (1990). Strategic Pay: Aligning Organizational Strategies and Pay Systems. San Francisco: Jossey-Bass.

Lawler, Edward E. III., Mohrman, Susan A., & Ledford, Gerald E. Jr. (1992). Employee Involvement and Total Quality Management: Practices and Results in Fortune 1000 Companies. San Francisco: Jossey-Bass.

Ostman, Lena. (1987). Payment by Results: 13 Case Studies from Sweden. Stockholm: Swedish Employers' Federation (SAF).

Schuster, Jay R., & Zingheim, Patricia K. (1992). The New Pay: Linking Employee and Organizational Performance. New York: Lexington Books/ MacMillan.

Figure 1
Strategic Compensation Design

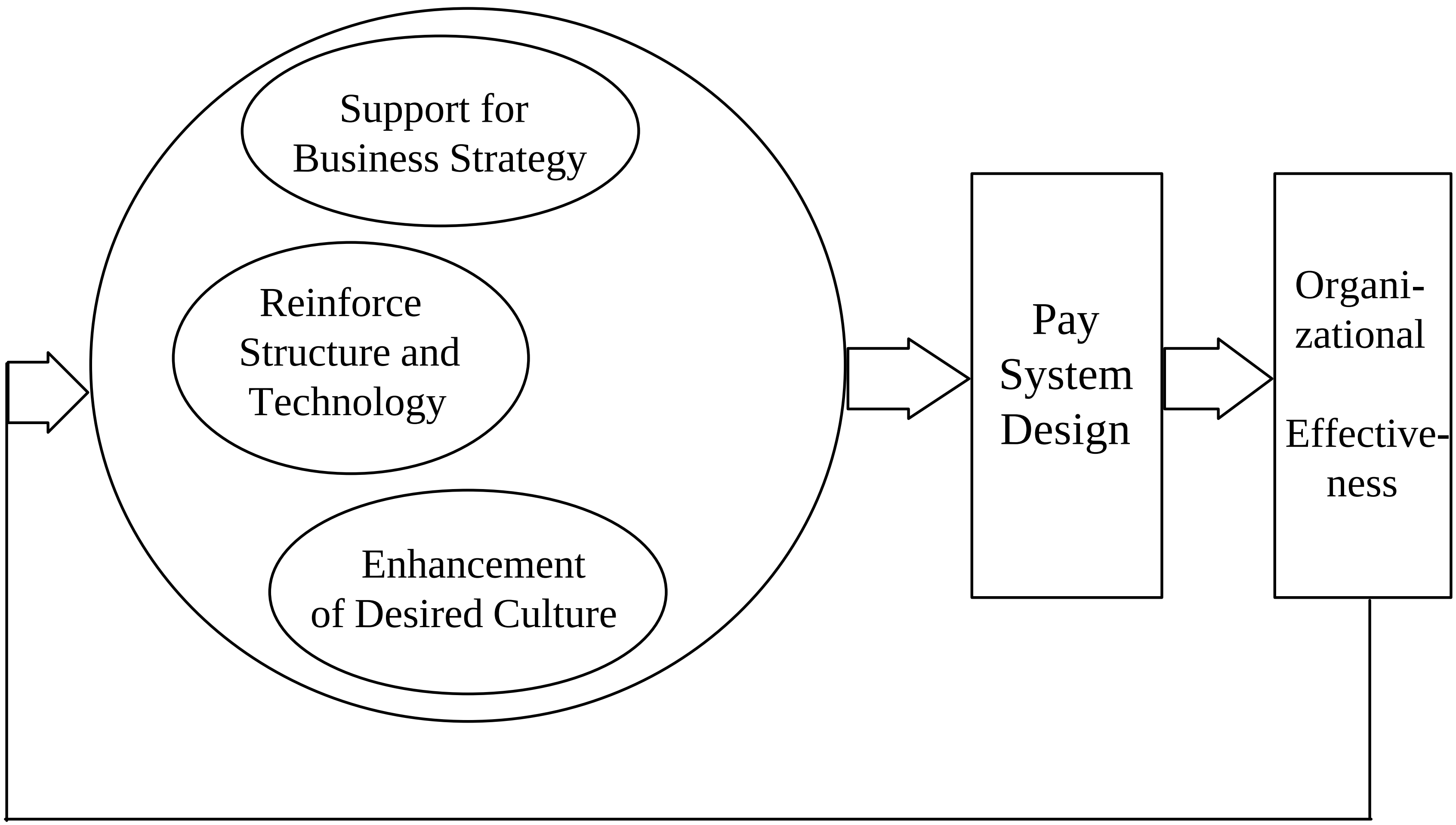

Figure 2
Expectancy Model of Motivation

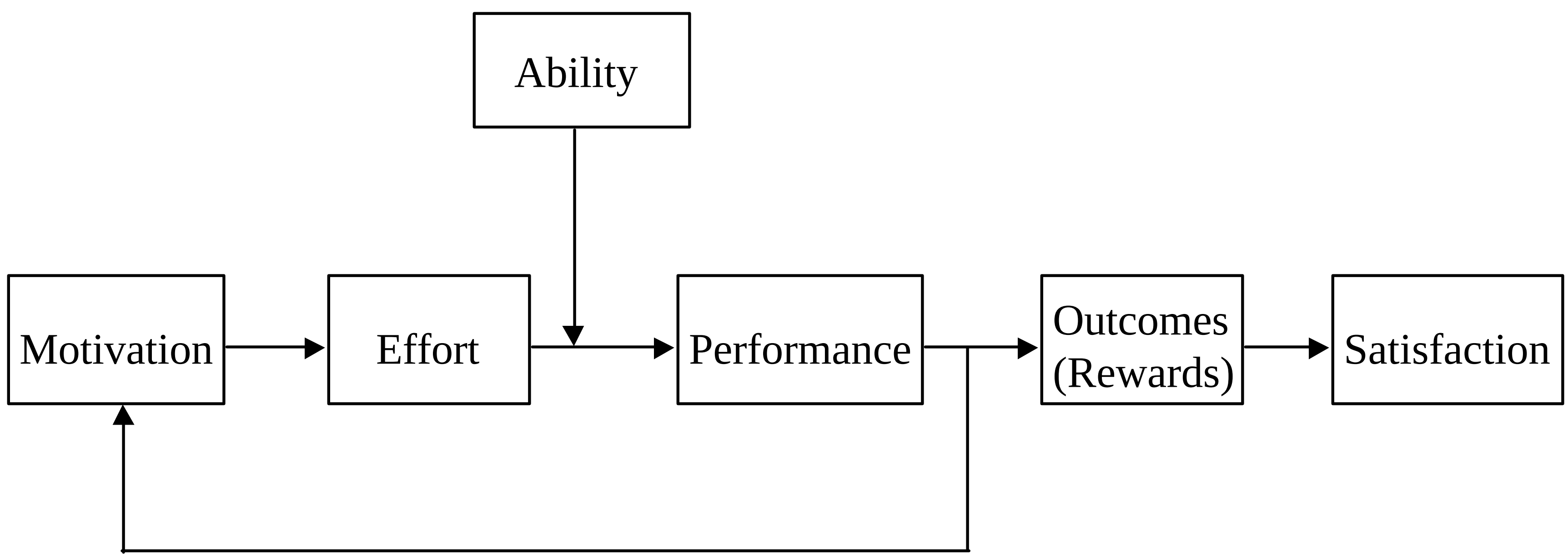

Figure 3
Varieties of Variable Pay

	Behavioral (e.g., safety, absenteeism)	**Unit Performance** (e.g., cost, quality)	**Financial Performance** (e.g., ROI, EVA, profit)
History (*Gain* Sharing)			
Targets (*Goal* Sharing)			

Change Mechanisms should encourage clear goal alignment across functions, the ability to integrate a change into existing systems, accountability for results, and reward systems that reinforce desired change behaviors. This contextual focus is critical to the ability to implement desired change with no interruption to daily operation. Are your structures and systems flexible enough to adapt and support the implementation of change? Does your organization have the structures and systems in place to support the successful implementation of change? Is change readiness is the new change management Organizational Change: Managing the Human Side. Based on ndings from the American Productivity & Quality Centerâ€™s 1997 Organizational Change consortium benchmarking study.Â Organizations that successfully implement signicant change reinforce and reward desirable behaviors of leaders and managers with appropri-ate changes to corporate infrastructure such as performance appraisal, performance management, and compensation systems. Managers and leaders who cannot or will not contribute positively to the change process are encouraged to leave the organization.Â Likewise, performance management and compensation systems will require change as well. International Benchmarking Clearinghouse 7 American Productivity & Quality Center.