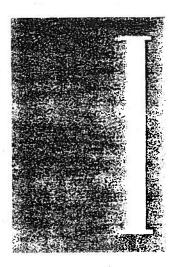Compensation

Pay Strategy: New Thinking for The New Millennium

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Three strategic considerations will shape the pay plans of the future.

I t is time for new thinking, new practices and more strategic direction in the pay systems of organizations. The simple fact is that organizations, the business environment and individuals are changing at a rate that is much faster than the rate of change with respect to the way organizations design and manage pay systems. There are a number of reasons for this. Pay practices are clearly hard to change. Pay system change is complex, in part because many individuals and organizations are comfortable with their existing pay practices and find it difficult to leave them behind. But this is not a sufficient reason to accept a slow rate of change and misaligned pay systems. It is simply too important to have a pay system that supports an organization's business strategy and contributes to organizational effectiveness.

All too often a misaligned pay strategy not only fails to add value, it produces high costs in the compensation area as well as inappropriate and misdirected behavior. Thus, organizations that fail to adapt their pay systems to today's business challenges operate with a significant handicap and at a tremendous disadvantage.

It is beyond the scope of this article to go into detail with respect to the major societal and busi-

ness changes that have implications for pay system change. But it is worth highlighting some of the key ones in order to underline the amount of change that has occurred.

More and more products and services are competing globally and this has lead to much greater competition. Organizations increasingly need to operate globally — moving products and people across national boundaries in seamless ways. In order to be successful, organizations increasingly have to get their products to market more quickly and improve their customer service. The Internet is creating new sales channels and changing the way information is distributed and managed within organizations.

In order to be competitive, organizations increasingly have to operate with lateral processes that are supported by advanced information technology systems. Increasingly, work in a number of areas requires advanced knowledge and skills.

Organizations can no longer afford extensive hierarchies with command and control management structures. More and more individuals do not have stable work activities that can be described as jobs. Instead, they have roles and general areas of responsibility that they flexibly perform. Individuals no longer have a traditional loyalty contract with organizations. Instead, they have a temporary relationship in which they try to maximize their rewards while adding to their skills and capabilities. Because individuals don't

see companies being loyal to them, they are not loyal to their employers and are increasingly willing to change jobs when better opportunities present themselves.

Key technical and management skills frequently have more demand than supply and as a result, certain individuals become "hot talent" and enjoy considerable leverage in negotiating for their working conditions. The work forces of many organizations are becoming more diverse and as a result, there are large, individual differences in what their employees want from work and how they want to be treated by reward systems. Individuals increasingly work in teams and are collectively responsible for producing products and services.

The challenge is to change pay systems at the speed of business.

There is no reason to believe that business will return to the way work was done when most of the current pay practices used by organizations were developed and fine-tuned. If anything, with the increased development of e-business and the Internet, the rate of change is likely to accelerate. The explosive growth of the Internet, for example, is likely to lead to greater globalization. Employee mobility and work force diversity will continue to increase. We are likely to see more cases of "hot talent," and the growth of businesses in which knowledge development is the key to organizational success.

The challenge, and it is a significant one, is to develop pay systems that fit the way organizations, individuals and society are changing and to change pay systems at the speed of business. No single pay system or set of pay practices is likely to provide the answer to how organizations should alter their pay systems. I do believe, however, that there are three major strategic positions that organizations should take with respect to pay systems that will allow them to develop pay practices that will be effective in the future. These three strategic approaches are described below.

Pay the Person

Historically, the pay systems of most large organizations have been based on jobs and job evaluation technology. This approach made sense in a world in which individuals had stable duties and the market value of individuals was largely determined by the way in which their jobs were designed and managed. In a world in which individuals do not have traditional jobs and are often able to add considerable value because of their high levels of knowledge and skill, it is very dangerous and misleading to pay them according to job worth rather than their individual worth. It ignores the difference-making value that is added by people with high levels of knowledge and performance. It also fails to encourage individuals to develop the right skills and knowledge.

Increasingly, human capital is the key capital for an organization. Human capital must earn a fair return or like any other capital it will search for a higher rate of return and it will frequently find it. Thus, organizations must be sure that their people are paid according to their market value. Pricing the job that they are doing at the moment is simply not a good enough way to value individuals. They must be valued for the knowledge, skills and competencies that they have. This evaluation must take into account not just the internal labor market within their organization, but the external labor market as well. Indeed, it must primarily take into account the external labor market. Placing too much focus on the internal labor market runs the great risk of either underpaying highly valued individuals or overpaying individuals who do not have the knowledge and skills that the most valuable employees have.

Developing an approach that pays individuals according to their market value requires a pay system which measures the knowledge, skills and competencies of individuals and prices them in the external market. At this time, the technology to do this is admittedly still under development and in a rudimentary form, but organizations still can begin to pay individuals according to their market value. They often can get a good idea of the market value of their key individuals simply by monitoring the actual hiring transactions that go on in the labor market. This, of course, is a far different approach from the traditional one of looking at salary survey data in order to gain information about what individuals doing particular jobs are paid.

Perhaps the greatest challenge in paying individuals for their skills, knowledge and competencies is developing good measures of them. Too often organizations that have tried to measure them have chosen to measure the degree to which individuals possess very generic compe-

tencies, such as leadership ability and communication ability. They have not written specific knowledge and skill descriptions for the roles that individuals need to perform and then developed measures of whether individuals have these specific skills and knowledge. As a result, they have not developed systems that are particularly good at rewarding individuals for developing the kinds of technical and business knowledge that individuals need in order to perform effectively.

I believe that in the future we will increasingly see organizations develop detailed, intranet-based descriptions of the kind of knowledge and skills individuals need to be effective in their roles. They will also have skill and knowledge profiles of their employees available on the intranet. These person descriptions will be supported by measures of skill and knowledge mastery and used as a basis for the market pricing of individuals, the assignment of work and the development of individuals.

By tying increases in pay to the development of the skills and knowledge that is called for in person descriptions, organizations will be able to accomplish two very important objectives. First, they will have a positive effect in motivating individuals to learn the skills and knowledge they need to perform in their current role, and second, they will raise the pay of individuals as they become more valuable in the external labor market. These two outcomes are clearly key to developing pay systems that create learning organizations and organizations that develop and retain valuable human capital.

Rewarding Excellence

There are a number of reasons why an intense focus on paying for performance is appropriate. It is an important way to attract and retain top performers and it is a potentially powerful motivator that can be a partial substitute for a traditional loyalty employment relationship.

The research literature on pay has for decades shown that although pay can be an effective motivator, often it is not. A few theorists have argued that, in fact, pay cannot be a motivator, but the research evidence does not support this view. Instead, it argues that pay motivates behavior when there is a clear relationship between a significant amount of pay and behavior, but it goes on to argue that often because of poor plan designs, pay winds up motivating dysfunctional behavior as well as functional behavior. It also has conclusively established that the traditional approach to pay for performance—merit pay—is

generally a failure. It is a failure for numerous reasons, including the fact that it is often based on poor measures and it usually delivers such small changes in compensation that it has no motivational impact. Further, it fails to pay good performers highly enough to retain them in a hot job market.

Perhaps the most important thing that we have learned from the research on pay for performance is that there is no silver bullet. No single plan fits all organizations nor is pay for performance an accomplishable objective in all organizations. Nevertheless, pay for performance needs to be an important part of most organizations' reward systems. The type of pay for performance that is utilized needs to very much reflect the strategy, structure, business processes and management style of the organization.

The pay for performance approach of an organization needs to effectively translate its business strategy into measures that can be used for reward system purposes and it needs to fit the characteristics of the organization's structure with respect to coordination and integration. It is unlikely that any one pay for performance plan or approach will be able to accomplish all the objectives that the reward system needs to accomplish. Thus, an effective pay for performance system for an organization is likely to have multiple pay for performance plans.

Individual pay for performance systems accomplish different objectives than do team and organization-wide pay for performance systems. Bonus systems have different impacts than do stock-based plans. Thus, organizations need to carefully design a combination of pay for performance plans that covers all the objectives they need to accomplish with their plans.

The point has already been made that merit pay increases are poor motivators. Part of the

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problem with them is that they create an annuity payment which employees receive as long as they are employed regardless of their future performance. This ties up a considerable amount of an organization's payroll in an inflexible base pay commitment. One of the major effects of this is that few salary dollars are left to reward present performance. Thus, one key recommendation is

that in the future, organizations should rely on variable pay plans in order to reward performance.

Every organization needs to carefully consider the use of stock. Stock ownership and stock options are powerful ways to reward performance. They can be given to individuals based on performance and, of course, their value changes as an organization's performance changes. They do suffer from one major weakness, however. The

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line of sight from an individual's behavior to the value of stock is often poor, thus for many members of an organization they may not have a powerful, motivational impact. Nonetheless, when organizations are trying to integrate everyone toward a common set of goals and a mission, broad-based stock plans can be quite useful because they give everyone a common fate. Stock option plans also can be a powerful way to retain individuals if they require individuals to remain with an organization in order to exercise them.

One of the most difficult decisions in pay system design concerns whether to reward individuals, groups, business units or the organization as a whole. Plans that reward individuals clearly accomplish different objectives than plans that reward the organization as a whole. The former are a much more powerful motivator of individual behavior. Plans that reward the organization as a whole are good at integrating individuals and encouraging them to understand the business and develop effective lateral relationships, but poor at directly motivating individuals. Team bonus plans can be extremely powerful in motivating team performance and cause individuals to work together to accomplish the team's goals and objectives. On the other hand, they do little to encourage teams to work together.

Given the different impacts of individual, team, and business-based pay for performance plans, they may all have a place in a single organization's approach to paying for performance. For example, individuals may be paid based on their individual performance, their team's performance, as well as on their businesses' performance. This makes good sense in situations where individual performance can be measured;

individuals are part of a team whose performance is well measured and the organization is practicing employee involvement in a way that encourages individuals to understand the business and participate in decisions affecting the entire organization. Under this set of conditions, it makes sense for an organization to have three different types of pay for performance plans.

If individual performance is not measurable because highly interdependent teams are used and the major focus should be on team performance, a system that rewards team performance and organizational performance may be most appropriate. Finally, in situations where individual performance is all that counts and the organization does not practice employee involvement, an individual pay for performance system that is highly leveraged with variable pay may be all that is appropriate.

Given the trends in organization design toward lateral organizations, employee involvement roles, rather than jobs, and the lack of loyalty, it is possible to make some general statements about what pay for performance approaches are likely to become more popular. Clearly broad-based stock plans are likely to become much more popular. They fit the idea of employee involvement and they support the development of lateral thinking in organizations. They also do not require the kind of individual performance metrics that are difficult to collect in a role-based organization. Team based pay for performance plans are also likely to become much more popular. The increasing use of teams and the difficulty in measuring individual performance makes this particularly likely. Team based cash bonus plans have the potential to develop a good line of sight and can be a direct motivator of individual performance.

The use of profit sharing plans and plans which pay bonuses based on business unit and operating unit performance is also likely to increase significantly. Particularly in small business units and in operating units such as plants, they have the potential to create a reasonably strong line of sight, and research on gainsharing and goalsharing suggests that they therefore can be quite effective motivators. With education and employee involvement, a reasonable line of sight can often be developed so that individuals see how their performance impacts performance measures and therefore the bonus that they receive. Particularly if the bonus offered is of a significant size it can be an effective motivator of performance.

The loser is individual pay for performance. Not just merit pay, which has already been dismissed, but variable individual pay. It simply does not fit as well in lateral team-based organizations as does team and organization-based pay for performance.

When the practice of paying individuals for their skills and knowledge is combined with a system which rewards performance, organizations can use pay systems as an effective substitute for loyalty. The pay system can encourage people to develop the skills the organization needs to have and it can motivate them to stay with the organization. It can also motivate them to perform well. Thus, it can do much more than the loyalty system, because seniority-based loyalty systems are primarily effective at encouraging individuals to stay with an organization. Because loyalty systems do not reward skill development or performance effectiveness, they do not motivate individuals to improve their skills or perform effectively. Thus they fail to do a good job at developing the human capital of an organization and retaining the most valuable employees.

Individualizing the Pay System

Traditionally the pay programs of organizations have adopted a one-size-fits-all approach to rewards. Individuals are given little choice with respect to how they are rewarded and what rewards they receive. The differences that exist within organizations are usually the result of the type of work individuals do rather than their needs and desires. This approach generally fits a homogeneous work force but does not fit a diverse work force. With a diverse work force it runs a tremendous risk of giving individuals rewards that they do not value while failing to reward them with things that they value highly. This can obviously have negative consequences for both the attraction and retention of individuals as well as for motivation.

The obvious alternative to a one-size-fits-all reward system is one that gives individuals a significant amount of choice. In the United States, some organizations have taken one step in this direction with the installation of cafeteria or flexible benefit plans, but in most cases it is a small step. Individuals are given little choice and as a result, these plans are not very effective. With a diverse work force it may make sense to give individuals a considerable amount of choice in the reward packages that they are offered. This can include individuals being given options with respect to working simply for cash, having exten-

sive benefit packages, and even choosing the type of pay for performance system that they are covered by. The advantages of greater flexibility include tailoring rewards to employee preferences and thus, greater effectiveness in attracting and retaining a diverse work force. The potential negative of this approach is that it may create too diverse a work force for a company that wants to establish a strong unified culture.

Because the reward system is a powerful tool for attracting and retaining individuals, a one-size-fits-all reward system tends to lead to a homogenous internal population of employees. This can be a real negative if it leads to not enough individuals wanting to work for an organization and/or a homogenous culture that lacks adaptability and flexibility, as well as the ability to understand diverse markets. On the other hand, it can be a positive if the organization has a very specialized niche and the kind of performance capabilities that it needs are best developed by having an internally homogenous work force.

Organizations need to think through the consequences of having a diverse versus a homogenous work force and then pick the reward profile that fits the degree and type of diversity they desire. Given that many organizations are moving towards a more diverse work force and becoming more global, it is likely that organizations will increasingly choose to have flexibility and individualization in their reward system. This simply makes sense with respect to optimizing the impact of the dollars organizations spend, particularly organizations which are dealing with diverse markets and multiple national cultures.

Creating the Strategic Reward System

What should the pay systems of organizations look like in the future? Based on how organizations are changing and the impact of reward systems, I have suggested that three strategic thrusts are appropriate:

● Person-based pay should be used to reward individuals for their skills, knowledge and competencies relative to their external market value.

● Multiple pay for performance approaches should be used, with variable pay and stock as rewards.

● Reward systems should be individualized to fit the characteristics of individuals that an organization wishes to attract and retain. In most cases, this can best be done by allowing individuals a choice in the rewards that they receive.

Compensation

Although these strategic thrusts are widely applicable, they clearly do not fit all situations and they are only the first step in developing an actual reward system for an organization. The next step is to develop actual pay practices that follow them and fit with the management style, structure, and strategy of the organization. This step involves developing a good understanding of the business strategy, the appropriate measures of organizational effectiveness, and of course, an understanding of the kinds of relationships and communication patterns that are needed in order for an organization's structure to be effective. In short, the three approaches are the basic building blocks upon which an effective pay system can be built for tomorrow's organizations.

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