CE Center for Effective Organizations

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by

Edward Lawler

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ABSTRACT

Identifies the likely outcomes of an effective reward system and points out the ways in which reward systems vary. Provides a way of thinking that can aid in making key strategic choices in reward system design.

The Strategic Design of Reward Systems[1]

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Reward systems are one of the most prominent and frequently discussed features of organizations. Indeed, the literature in organizational behavior and personnel management is replete with the examples of their functional as well as their dysfunctional role in organizations (See e.g. Whyte, 1955). All too often, however, a thorough discussion of how they can be a key strategic factor in organizations is missing. The underlying assumption in this chapter is that, when properly designed, the reward systems of an organization can be a key contributor to the effectiveness of organizations. However, for this to occur careful analysis needs to be made of the role that reward systems can and should play in the stratetic plan of the organization.

Objectives of Reward System

The first step in discussing the strategic role of reward systems is to consider what behavioral impact they can have in organizations. That is, we need to first address the outcomes that one can reasonably expect an effective reward system to produce. The research so far on reward systems suggest that potentially they can influence five factors which in turn influence organizational effectiveness.

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1. Based upon "Reward Systems in Organizations" a chapter to be published in Lorsch, J. (ed.) Handbook of Organizational Behavior. (Englewood Cliffs, Prentice-Hall in Press.) Partial financial support was provided by the Office of Naval Research under Contract 53 N00014-81-K-0048; NR 170-923.

1. Attraction and Retention - Research on job choice, career choice, and turnover clearly shows that the kind and level of rewards an organization offers, influences who is attracted to work for an organization and who will continue to work for it (see e.g. Lawler, 1973; Mobley, 1982). Overall, those organizations which give the most rewards tend to attract and retain the most people. Research also shows that better performers need to be rewarded more highly than poorer performers in order to be attracted and retained. Finally, the way rewards are administered and distributed influences who is attracted and retained. For example, better performing individuals are often attracted by merit based reward systems.

2. Motivation - Those rewards that are important to individuals can impact their motivation to perform in particular ways. People in work organizations tend to behave in whatever way they perceive leads to rewards they value (see e.g. Vroom 1964, Lawler, 1973). Thus, an organization which is able to tie valued rewards to the behaviors it needs to succeed is likely to find that the reward system is a positive contributor to its effectiveness.

3. Culture - Reward systems are one feature of organizations that contribute to their overall culture or climate. Depending upon how reward systems are developed, administered, and managed, they can cause the culture of an organization to vary quite widely. For example, they can influence the degree to which it is seen as a human resources oriented culture, an entrepreneurial culture, an innovative culture, a competence based culture, and a participative culture.

4. Reinforce and Define Structure - The reward system of an organization can reinforce and define the organization's structure (Lawler, 1981). Often this feature of reward systems is not fully considered in the design of reward systems. As a result, their impact on the structure of an organization is unintentional. This does not mean, however, that the impact of the reward system on structure is usually minimal. Indeed, it can help define the status hierarchy, the degree to which people in technical positions can influence people in line management positions, and it can strongly influence the kind of decision structure which exists. The key features here seem to be the degree to which the reward system is strongly hierarchical and the degree to which it allocates rewards on the basis of movements up the hierarchy.

5. Cost - Reward systems are often a significant cost factor. Indeed, the pay system alone may represent over 50% of the organization's operating cost. Thus, it is important in strategically designing the reward system to focus on how high these costs should be and how they will vary as a function of the organization's ability to pay. For example, a reasonable outcome of a well-designed pay system might be an increased cost when the organization has the money to spend and a decreased cost when the organization does not have the money. An additional objective might be to have lower overall reward system cost than business competitors.

In summary, reward systems in organizations should be looked at from a cost benefit perspective. The cost can be managed and controlled and the benefits planned for. The key is to identify the outcomes needed in order for the organization to be successful and then to design the reward system in a way that these outcomes will in fact be realized.

Relationship to Strategic Planning

Figure 1 presents a way of viewing the relationship between strategic planning and reward systems. It suggests that once the strategic plan is developed the organization needs to focus on the kind of human resources, climate, and behavior that is needed in order to make it effective. The next step is to design reward systems which will motivate the right kind of performance, attract the right kind of people, and create a supportive climate and structure.

Figure 2 suggests another way in which the reward system needs to be taken into consideration in the area of strategic planning. It suggests that before the strategic plan is developed in an existing organization it is important to assess a number of things including the current reward systems and to determine what kind of behavior, climate, and structure they are supportive of. This step is needed so that when the strategic plan is developed it is based on a realistic assessment of the current condition of the organization and the changes which are likely to be needed to implement the new strategic plan. This point is particularly pertinent to organizations that are considering going into new lines of business, developing new strategic plans, and acquiring new divisions.

Often, the new lines of business require a different behavior and therefore a different reward system. Simply putting the old reward system in place in the new business is often not good enough and indeed, can lead to failure in the new business. On the other hand, developing a new reward system for the new business can cause problems in the old

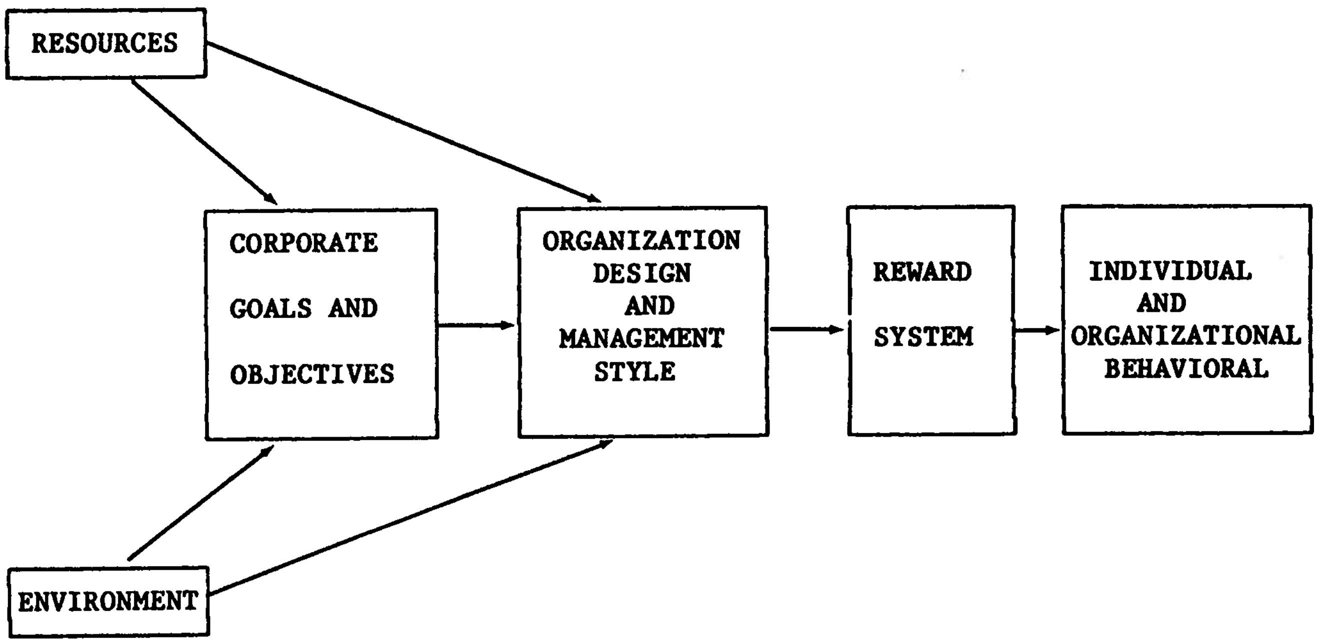
RESOURCES
CORPORATE GOALS AND OBJECTIVES
ORGANIZATION DESIGN AND MANAGEMENT STYLE
REWARD SYSTEM
INDIVIDUAL AND ORGANIZATIONAL BEHAVIORAL
ENVIRONMENT

FIGURE 1

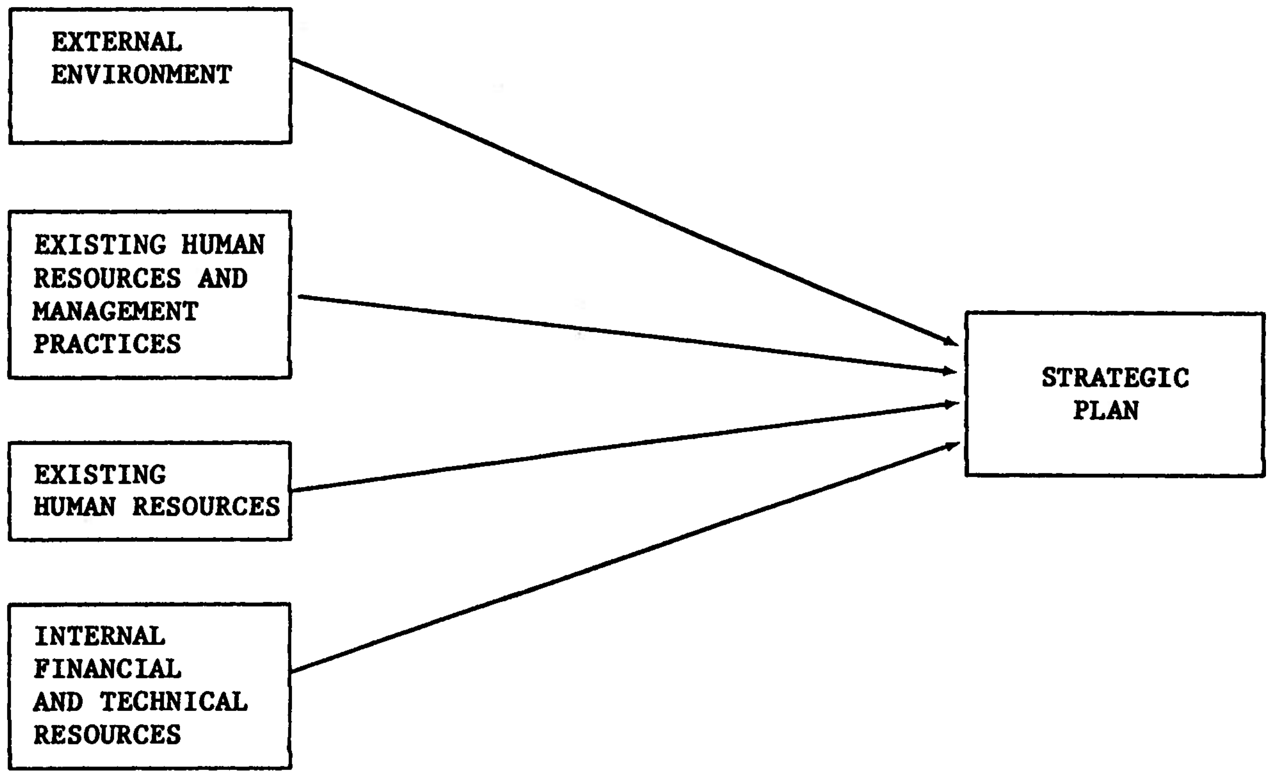
EXTERNAL ENVIRONMENT
EXISTING HUMAN RESOURCES AND MANAGEMENT PRACTICES
EXISTING HUMAN RESOURCES
INTERNAL FINANCIAL AND TECHNICAL RESOURCES
STRATEGIC PLAN

FIGURE 2

business because of the type of comparisons which are made between different parts of the same organization. This is not to say that organizations should avoid venturing into new businesses, it is merely to say that a careful assessment of the kinds of reward system changes that are needed should take place before organizations enter into new business sectors.

Design Options

There are almost an infinite number of ways to design and manage reward systems in organizations. This is because there are a host of rewards that can give, and of course a large number of ways that they can be distributed. The focus in the remainder of this chapter will be on the visible extrinsic rewards that an organization controls and that can as a matter of policy and practice be allocated to members on a targeted basis. Included will be pay, promotion, status symbols, and perquisites, little attention will be given to such intrinsic rewards as feelings of responsbility, competence, and personal growth and development.

A useful dichotomy in thinking about options in the design of reward systems is the process/content one. All organizational systems have a content or structural dimension as well as a process dimension. The structural or content dimension of a reward system refers to the formal mechanisms, procedures, and practices (e.g. the salary structures, the performance appraisal forms), in short, the nuts and bolts of the system. The process side refers to the communication and decision process parts of the system. A key issue here involves the degree of openness with respect to information about how the reward system operates and how people are rewarded. A second issue is the degree of participation that is allowed in the design of the reward system and the ongoing administration of it. Many organizations without ever choosing to, administer rewards in a top down secretive way. As will be discussed further, this is not the only way that rewards can be administered. The discussion of design choices will begin by looking at some key structural choices and then turn to a consideration of some key process choices.

Structural Decisions

Basis for Rewards

Traditionally, in organizations such rewards as pay and perquisites are based on the type of jobs that people do. Indeed, with the exception of bonuses and merit salary increases, the standard policy in most organizations is to evaluate the job, not the person, and then to set the reward level. This approach is based on the assumption 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 is worth. This assumption is in many respects valid since through such techniques as job evaluation programs it is possible to determine what other organizations are paying people to do the same or similar jobs. Among the advantages of this system is that it assures an organization that its compensation costs are not dramatically out of line with those of its competitors and it gives a somewhat objective basis to compensation practices.

An alternative to job based pay which has recently been tried by a number of organizations is to pay individuals for the skills that they possess. In many cases this will not produce dramatically different pay rates than are produced by paying for the nature of the job. After all, the skills people have usually match reasonably well with the jobs they are doing. It can, however, produce some different results in several respects. Often people have more skills than the job uses and in such cases these individuals are paid more than they would be paid under a job based system. In other cases individuals don't have the skills when they first enter a job and do not deserve the kind of pay that goes with the job. In these cases individuals have to earn the right to be paid whatever it is the job related skills are worth.

Perhaps the most important changes that are introduced when skill based or competence based pay is used occur in the kind of climate and motivation it produces in an organization. Instead of people being rewarded for moving up the hierarchy, people are rewarded for increasing their skills and developing themselves. This can create, in the organization, a climate of concern for personal growth and development, and of course it can produce a highly talented work force. In the case of factories where this system has been used, it typically means that many people in the organization can perform multiple tasks and thus, the work force is highly knowledgeable and flexible.

In most cases where skill based pay has been tried it tends to produce an interesting mix of positive and negative features as far as the organization is concerned (Lawler, 1981). Typically, it tends to produce somwhat higher pay levels for individuals, but this is usually offset by greater work force flexibility. This flexibility often leads to lower staffing levels, fewer problems when absenteeism or turnover occur, and indeed, it often leads to lower absenteeism and turnover itself because people like the opportunity to utilize and be paid for a wide range of skills. On the other hand, skill based pay can be rather challenging to administer because it is not clear how one goes to the outside marketplace and decides, for example, how much skill is worth. Skill assessment can also often be difficult to accomplish. There are a number of well developed systems for evaluating jobs and comparing them to the marketplace, but there are none which really do this with respect to the skills an individual has.

There are no well established rules to determine which organizational situations fit job based pay and which fit skill or competence based pay. In general, skill based pay seems to fit those organizations that want to have a flexible, relatively permanent work force that is oriented toward learning, growth, and development. It also seems to fit particularly well with new plant startups and other situations where the greatest need is for skill development. Despite the newness and the potential operational problems with skill based pay, it does seem to be a system that more and more organizations will be using.

Performance Based

Perhaps the key strategic decision that needs to be made in the design of any reward system is whether or not it will be based on performance. Once this decision is made, a number of other features of the reward system tend to fall into place. The major alternative to basing pay on performance is to base it on seniority. Many government agencies, for example, base their rates on the job the person does and on how long they have been in that job. In Japan, individual pay is also often based on seniority, although individuals often received bonuses based on corporate performance.

Most business organizations in the United States say that they reward individual performance, and they call their pay system and their promotion system merit based. Having a true merit pay or promotion system is often easier said than done, however. Indeed, it has been observed that many organizations would be better off if they didn't try to relate pay and promotion to performance, and relied on other bases for motivating performance (Kerr 1975). The logic for this statement stems from the difficulty of specifying what kind of performance is desired, and then determining whether, and in fact, it has been demonstrated. There is ample evidence that a poorly designed and administered reward system can do more harm than good (see e.g. Whyte, 1955, Lawler, 1971). On the other hand, there is evidence that when pay is effectively related to the desired performance, it can help to motivate, attract, and retain outstanding performers. Thus, when it is feasible it is usually desirable to relate pay to performance.

There are numerous ways to relate pay to performance, and often the most important strategic decision that organizations make is how they do this. The options open to organizations are enormous. The kind of pay reward that is given can vary widely and include such things as stock and cash. In addition, the frequency with which rewards are given can vary tremendously from time periods of a few minutes to many years. Performance can be measured at the individual level so that each individual gets a reward based on his or her performance. Rewards also can be given to groups based on the performance of the group, and rewards can be given based on the performance of total organizations. This gives the same reward to everyone in an organization. Finally, there are many different kinds of performance which can be rewarded. For example, managers can be rewarded for sales increases, productivity volumes, their ability to develop their subordinates, their cost reduction ideas, and so on.

Rewarding some behaviors and not others has clear implications for performance, and thus, decisions about what is to be rewarded need to be made carefully and with attention to the overall strategic plan of the business (see, for example, Galbraith and Nathanson, 1978, Salscheider, 1981). Consideration needs to be given to such issues as short vs. long term performance, risk taking vs. risk aversion, division performance vs. total corporate performance, ROI maximization vs. sales growth, and so on. Once the strategic plan has been developed to the point where key performance objectives have been defined, then the reward system needs to be designed to motivate the appropriate performance. Decisions about such issues as whether to use stock options (a long term incentive), for example, should be made only after careful consideration of whether they are supportive of the kind of behavior that is desired (see e.g. Crystal, 1978, Ellig, 1982).

It is beyond the scope of this chapter to go into any great detail about the pros and cons of the many approaches to relating pay to performance. Table 1 gives an idea of some of the design features which are possible in a reward system and some of the pluses and minuses associated with them.

First, eash plan is evaluated in terms of its effectiveness in creating the perception that pay is tied to performance. In general, this indicates the degree to which the approach ties pay to performance in a way that leads employees to believe that higher pay will follow good performance. Second, each plan is evaluated in terms of whether or not it resulted in the negative side effects that often are produced by performance-based pay plans. These include social ostracism of good performers, defensive behavior, and giving false data about performance.

Third, each plan is evaluated in terms of the degree to which it encourages cooperation among employees. Finally, employee acceptance of the plan is rated. The ratings range from 1 to 5; a 5 indicates that the plan is generally high on the factor and a 1 indicates it is low. The ratings were developed based on a review of the literature and on my experience with the different types of plans (see for example, Lawler 1971).

A number of trends appear in the ratings. Looking only at the criterion of tying pay to performance, we see that the individual plans tend to be rated highest; group plans are rated next; and organizational plans are rated lowest. This occurs because in group plans, to some extent, and in organizational plan, to a great extent, an individual's pay is not directly a function of his or her behavior. An individual's pay in these situations is influenced by the behavior of many others. In addition, when some types of performance measures (e.g. profits) are used, pay is influenced by external conditions which employees cannot control.

Table 1
Ratings of Various Pay Incentive Plans*

		Tie Pay to perfor-	Negative Side	Encourage Cooperation	Employee Acceptance
Salary Reward					
Individual plan	Productivity	4	1	1	4
	Cost effectiveness	3	1	1	4
	Superiors' rating	3	1	1	3
Group plan	Productivity	3	1	2	4
	cost effectiveness	3	1	2	4
	Superiors' rating	2	1	2	3
Organizational plan	Productivity	2	1	3	4
	Cost effectiveness	2	1	2	4
Bonus Reward					
Individual plan	Productivity	5	3	1	2
	Cost effectiveness	4	2	1	2
	Superior's rating	4	2	1	2
Group plan	Productivity	4	1	3	3
	Cost effectiveness	3	1	3	3
	Superiors' rating	3	1	3	3
Organizational plan	Productivity	3	1	3	4
	Cost effectiveness	3	1	3	4
	Profit	2			

* On a scale of 1 to 5, 1 = low and 5 = high

Bonus plans are generally rated higher than pay raise and salary increase plans. This is due to the fact that with bonus plans it is possible to substantially vary an individual's pay from time period to time period. With salary increase plans, this is very difficult since past raises tend to become an annuity.

Finally, note that approaches that use objective measures of peformance are rated higher than those that use subjective measures. In general, objective measures enjoy higher credibility; that is, employees will often accept the validity of an objective measure, such as sales volume or units produced, when they will not accept a superior's rating. When pay is tied to objective measures, therefore, it is usually clearer to employees that pay is determined by performance. Objective measures are also often publicly measurable. When pay is tied to them, the relationship between performance and pay is much more visible than when it is tied to a subjective, nonverifiable measure, such as a supervisor's rating. Overall, the suggestion is that individually-based bonus plans that rely on objective measures produce the strongest perceived connection between pay and performance.

The ratings of the degree to which plans contribute to negative side effects reveal that most plans have little tendency to produce such effects. The notable exceptions here are individual bonus and incentive plans at the nonmanagement level. These plans often lead to situations in which social rejection and ostracism are tied to good performance, and in which employees present false performance data and restrict their production. These side effects are particularly likely to appear where trust is low and subjective productivity standards are used.

In terms of the third criterion - encouraging cooperation - the ratings are generally higher for group and organizational plans than for individual plans. Under group and organizational plans, it is generally to everyone's advantage that an individual work effectively, because all share in the financial fruits of higher performance. This is not true under an individual plan. As a result, good performance is much more likely to be supported and encouraged by others when group and organizational plans are used. If people feel they can benefit from another's good performance, they are much more likely to encourage and help other workers to perform well than if they cannot benefit, and may be harmed.

The final criterion--employee acceptance--shows that, as noted earlier, most performance-based pay plans have only moderate acceptance. The least acceptable seems to be individual bonus plans. Their low acceptance, particularly among nonmanagement employees, seems to stem from their tendency to encourage competitive relationships between employees and from the difficulty in administering such plans fairly.

It should be clear that no, one, performance-based pay plan represents a panacea. It is therefore unlikely that any organization will ever be completely satisfied with the approach it chooses. Furthermore, some of the plans that make the greatest contributions to organizational effectiveness do not make the greatest contributions to quality of work life, and vice versa. Still, the situation is not completely hopeless. When all factors are taken into account, group and organizational bonus plans that are based on objective data, and individual level salary increase plans, rate high.

Many organizations choose to put individuals on multiple or combination reward systems. For example, they may put individuals on a salary increase system which rewards them for their individual performance, while at the same time giving everybody in the division or plant a bonus based on divisional performance. Some plans measure group or company performance and then divide up the bonus pool generated by the performance of a larger group among individuals based on individual performance. This has the effect of causing individuals to be rewarded for both individual and group performance in the hope that this will cause individuals to perform all needed behaviors.

A common error in the design of many pay for performance systems is the tendency to focus on measurable short-term operating results because they are quantifiable and regularly obtained anyway. Many organizations reward their top level managers in particular, on the basis of quarterly or annual profitability. This can have the obvious dysfunctional consequence of causing managers to be very short-sighted in their behavior and to ignore strategic objectives which are important to the long-term profitability of the organization. A similarly grievous error can be the tendency to depend on completely subjective performance appraisals for the allocation of pay rewards. Considerable evidence exists to show that these performance appraisals are often biased and invalid, and instead of contributing to positive motivation and a good work climate that improves superior subordinate relationships, they lead to just the opposite (see e.g. Devries, Morrison, Shellman and Gerlach, 1981; Latham and Wexley, 1981). These are just two of the most common errors that can develop in the administration of performance reward systems. Other common errors include the giving of too small rewards, failure to clearly explain systems, and poor administrative practices.

In summary, the decision of whether or not to relate pay to performance is a crucial one in any organization. The error of automatically assuming that they should be related can be a serious one. Admittedly, the advantages of doing it effectively are significant and can greatly contribute to the organizational effectiveness. What is often overlooked is that doing it poorly can have more negative consequences than positive ones. Specifically, if performance is difficult to measure, and/or rewards are difficult to distribute based on performance, the effect of the pay for performance system can be the motivation of counter-productive behaviors, law suits charging discrimination, and the creation of a climate of mistrust, low credibility, and managerial imcompentence. On the other hand, total abandonment of pay for performance means that the organization gives up a potentially important motivator of performance, and as a result, may condemn itself to a reduced level of performance. The ideal, of course, is to increase conditions where pay can be effectively related to performance, and as a result, have it be an important contributor to the effectiveness of the organization.

Market Position

The reward structure of an organization influences behavior partially as a function of how the amount of rewards given compare to what other organizations give. Organizations frequently have well developed policies about how their pay levels should compare with the pay levels in other companies. For example, some companies (e.g. IBM) feel it is important to be a leading payer, and they consciously set their pay rates at a level higher than any of the companies they compete with. Other companies are much less concerned about being in the leadership position with respect to pay, and as a result, are content to target their pay levels at or below the market for the people they hire. This structural issue in the design of pay systems is a critical one, because it can strongly influence the kind of people that are attracted and retained by an organization. It also influences turnover rate and selection ratio. Simply stated, those organizations that adopt a more aggressive stance with respect to the marketplace end up attracting and retaining more individuals. From a business point of view this may pay off for them, particularly if turnover is a costly factor in the organization, and if a key part of the business strategy demands attracting and retaining highly talented individuals.

On the other hand, if many of the jobs in the organizations are low-skilled and people are readily available in the labor market to do them, then a corporate strategy of high pay may not pay off. It can increase labor costs and produce a minimum number of benefits. Of course, organizations don't have to be high payers for all the jobs. Indeed, some organizations identify certain key skills they need, and adopt the stance of being a high payer for them, and an average or below average payer for other skills. This has some obvious business advantages in terms of allowing organizations to attract the critical skills that it needs to succeed, and at the same time to control costs.

Although it is not often recognized, the kind of market position that a company adopts with respect to its reward systems can also have a noticeable impact on organization climate. For example, a policy which calls for above market pay can contribute to the feeling in the organization that it is elite, that people must be competent to be there, and that they are indeed fortunate to be there. A policy which splits certain skill groups into a high pay position and leaves the rest of the organization at a lower pay level, can on the other hand contribute to a spirit of elite groups within the organization and cause some devisive social pressures.

Finally, it is interesting to note that some organizations try to be above average in non-cash compensation as a way of competing for the talent they need. They talk in terms of producing an above-average quality of work life, and stress not only hygiene factors but interesting and challenging work. This stance potentially can be a very effective one, because it puts organizations in the position of attracting people who value these things, and could give them a competitive edge at least with these people.

In summary, the kind of market position that an organization has with respect to its total reward package is crucial in determining the behavior of the members as well as the climate of the organization. It needs to be carefully related to the general business strategy of the organization, and in particular, to the kind of human resources and organization climate which are called for.

Internal - External Pay Comparison Oriented

Organizations differ in the degree to which they strive toward internal equity in their pay and reward systems. Those organizations that are highly internal equity oriented work very hard to see that individuals doing similar work will be paid the same even though they are in very different parts of the country, and in different businesses. Some corporations (e.g. IBM) set the national pay structure for their organization based on the highest pay that a job receives anywhere in the country. Those organizations that do not stress internal equity typically focus on the labor market as the key determinant of what somebody should be paid, and although this does not necessarily produce different pay for people doing the same job, it may. For example, the same job in different industries, electronics and auto, for example, may be paid quite differently.

There are a number of advantages and disadvantages to the strategy of focusing on internal pay comparisons and paying all people in similar jobs the same, regardless of where they are in the organization. It can make the transfer of people from one location to another easier since there won't be any pay differences to contend with. In addition, it can produce an organizational climate of homegeneity, the feeling that everyone working for the same company is treated well or fairly. It also can reduce or eliminate the tendency of people to want to move to a higher paying division or location, and the tendency for rivalry and dissatisfaction to develop within the organization because of poor internal pay comparisons.

On the other hand, a focus on internal equity can be very expensive, particularly if the organization is diversified, and as usually happens, pay rates across the corporation get set at the highest level that the market demands anywhere in the corporation (Salscheider, 1981). The disadvantage of this is obvious. It causes organizations to pay a lot more money than is necessary in order to attract and retain good people. Indeed, in some situations it can get so severe that organizations become non-competitive in certain businesses and industries, and find they have to limit themselves to those businesses where their pay structures make labor costs competitive. Overly high labor costs, for example, often have made it difficult for auto, oil, and gas companies to compete in new business areas.

In summary, the difference between focusing on external equity and internal equity is a crucial one in the design of pay systems. It can determine the cost structure as well as the climate and behavior of organizations. The general rule is that highly diversified companies find themselves pulled more strongly toward an external market orientation, while organizations that are single industry or single technology based typically find themselves more comfortable with an internal equity emphasis.

Centralized/Decentralized Reward Strategy

Closely related to the issue of internal versus external equity is the issue of a centralized versus decentralized reward system strategy. Those organizations that adopt a centralized strategy typically assign to corporate staff groups the responsibility for seeing that pay practices are similar throughout the organization. They typically develop standard pay grades and pay ranges, standardized job evaluation systems, and perhaps, standardized promotion systems. In decentralized organizations policy and practice in the area of pay, promotion, and other important reward areas, is left to local option. Sometimes the corporations have broad guidelines or principles they wish to stand for, but the day to day administration and design of the system is left up to the local entity.

The advantages of a centralized structure rest primarily in the expertise that can be accumulated at the central level and the degree of homogeneity which is produced in the organization. This homogeneity can lead to a clear image of the corporate climate, feelings of internal equity, and the belief that the organization stands for something. It also eases the job of communicating and understanding what is going on in different parts of the organization. The decentralized strategy allows for local innovation, and of course, closely fitting the practices to the particular business.

Just as is true with many other of the critical choices, there is no right choice between a centralized and decentralized approach to reward system design and administration. Overall, the decentralized system tends to make the most sense when the organization is involved in businesses that face different markets, and perhaps, are at different points in their maturity (Greiner, 1972; Galbraith and Nathanson, 1978). It allows those unique practices to surface which can give a competitive advantage to one part of the business but may prove to be a real hindrance or handicap to another. For example, such perquisites as cars are often standard operating procedure in one business while they are not in another. Similarly, extensive bonuses may be needed to attract one group of people, e.g., oil exploration engineers, while it makes little sense in attracting other groups, e.g. research scientists. Overall, an organization needs to carefully examine its mix of businesses and the degree to which it wants to stand for a certain set of principles or policies across all its operating divisions. Then, it must decide whether a centralized or decentralized reward strategy is likely to be most effective.

<u>Degree of Hierarchy</u>

Closely related to the issue of job-based versus competence based pay, is the strategic decision concerning the hierarchical nature of the reward systems in an organization. Often, no formal decision is ever made to have relatively hierarchical or relatively egalitarian approachs to rewards in an organization. A hierarchical approach simply happens because it is so consistent with the general way organizations are run. Hierarchical systems usually pay people greater amounts of money as they move higher up the organization ladder, and give people greater perquisites and symbols of office as they move up. The effect of this approach is to strongly reinforce the traditional hierarchical power relationships in the organization and to create a climate of different status and power levels. In steeply hierarchical reward systems, the reward system may have more levels in it than the formal organization chart and as a result, create additional status differences in the organization.

The alternative to a hierarchical system is one in which differences in rewards and perquisites that are based only on hierarchical level are dramatically downplayed. For example, in those large corporations (e.g., Digital Equipment Corporation) that adopt a egalitarian stance to rewards, such things as private parking spaces, executive restrooms, and special entrances are eliminated. People from all levels in the organization eat together, work together, and travel together. Further, individuals can be relatively highly paid by working their way up a technical ladder, and do not have to go into a management ladder in order to gain high levels of pay. This less hierarchical approach to pay and other rewards produces a quite different climate in an organization than does the hierarchical one. It tends to encourage decision making by expertise rather than by hierarchical position, and draws fewer status differences in the organization.

As with all reward system strategic choices, there is no right or wrong answer as to how hierarchical a system should be. In general, a steeply hierarchical system makes the most sense when an organization needs relatively rigid bureaucratic behavior, strong top down authority, and a strong motivation for people to move up the organizational hierarchy. A more egalitarian approach fits with a more participative management style, and the desire to retain technical specialists and experts in non-management or lower level management roles. It is not surprising, therefore, that many of the organizations which have emphasized egalitarian perquisites are in high technology and knowledge based industries.

Reward Mix

The kind of rewards that organizations give to individuals can vary widely. For example, the money that is given can come in many forms varying all the way from stock to medical insurance. Organizations can choose to reward people almost exclusively with cash, downplaying fringe benefits, perquisites, and status symbols. The major advantage of paying cash is that the value of cash in the eyes of the recipient is universally high. When the cash is translated into fringe benefits, perquisites, and other trappings of office, it may lose its value for some people and as a result, be a poor investment (see e.g., Nealey, 1963; Lawler, 1971). On the other hand, certain benefits can best be obtained through mass purchase and therefore, many individuals want the organization to buy them. In addition, certain status symbols or perquisites may be valued by some individuals beyond their actual dollar cost to the organization and thus, represent good buys. Finally, as was mentioned earlier, there often are some climate and organizational structure reasons for paying people in the form of perquisites and status symbols.

One interesting development in the area of compensation is the flexible or cafeteria style benefit program (see e.g. Lawler, 1981). Here, individuals are allowed to make up their own reward package to fit their needs and desires. The theory is that this will lead to organizations getting the best value for their money because they will give people only those things they desire. It also has the advantage of treating individuals as mature adults rather than as dependent people who need their welfare looked after in a structured way. At the moment, this approach has been tried in only a few organizations. The results so far have been favorable, thus, there is reason to believe that others may be adopting it in the near future because it can offer a strategic cost benefit advantage in attracting and retaining certain types of employees.

Overall, the choice of what form of rewards to give individuals needs to be driven by a clear feeling of what type of climate the organization wishes to have. For example, the idea of a flexible compensation package is highly congruent with a participative, open organization climate that treats individuals as talented, mature adults, and wants to attract such people. A high status symbol, non-cash-oriented approach may appeal to people who are very status oriented and value positional power with the need for a high level of visible reinforcement for their position. This would seem to fit best in a relatively bureaucratic organization that relies on position power and authority in order to carry out its actions.

Process Issues and Reward Administration

A number of process issues with respect to reward system design and administration could be discussed here. In some respects process issues come up more often than do structure and content issues because organizations are constantly having to make reward system management, implementation, and communication decisions while structures tend to be relatively firmly fixed in place. However, rather than discussing specific process issues here, the focus will be on broad process themes that can be used to characterize the way reward systems are designed and administered.

Communication Policy

Organizations differ widely in how much information they communicate about their reward systems. At one extreme, some organizations are extremely secretive, particularly in the area of pay. They forbid people from talking about their individual rewards, give minimal information to individuals about how rewards are decided upon and allocated, and have no publicly disseminated policies about such things as market position, the approach to gathering market data, and potential increases and rewards for individuals. At the other extreme, some organizations are so open that everyone's pay is a matter of public record, as is the overall organization pay philosophy (many new high involvement plants operate this way, (see e.g., Lawler, 1978; Walton, 1980). In addition, all promotions are subject to open job postings, and in some instances peer groups discuss the eligibility of people for promotion.

The difference between an open and a closed communication policy in the area of rewards is enormous. Like all the other choices that must be made in structuring a reward system, there is no clear right or wrong approach. Rather, it is a matter of picking a position on the continuum from open to secret that is supportive of the overall climate and types of behavior needed for organizational effectiveness. An open system tends to encourage people to ask questions, share data, and ultimately be involved in decisions. On the other hand, a secret system tends to put people in a more dependent position to keep power concentrated at the top, and to allow an organization to keep its options open with respect to commitments to individuals. Some negative side effects of secret systems are the existence of considerable distortion about the actual rewards that people get and creation of a low trust enviornment in which people have trouble understanding the relationship between pay and performance (see e.g., Lawler, 1971; Steele, 1975). Thus, a structurally sound pay system may end up being rather ineffective because it is misperceived if strong secrecy policies are kept in place.

Open systems put considerable pressure on organizations to do an effective job of administering rewards. Thus, if such difficult to defend policies as merit pay are to be implemented, considerable time and effort needs to be invested in pay administration. If they are done poorly, strong pressures usually develop to eliminate the policies and pay everyone the same (see e.g., Burroughs, 1982). Ironically, therefore, if an organization wants to spend little time administrating rewards, but still wants to base merit pay, secrecy may be the best policy, although secrecy in turn may limit the effectiveness of the merit pay plan.

Decision Making Practices

Closely related to the issue of communication is the issue of decision making. Open communication makes possible the involvement of a wide range of people in the decision-making process concerning compensation. Further, if individuals are to be actively involved in decisions concerning reward systems, they need to have information about policy and actual practice.

In discussing the type of decision-making processes that are used in organizations with respect to reward systems, it is important to distinguish between decisions concerning the design of reward systems and decisions concerning the ongoing administration of reward systems. It is possible to have different decision-making styles with respect to each of these two types of decisions. Traditionally, of course, organizations have made both design and ongoing administration decisions in a top down manner.

Systems typically have been designed by top management with the aid of staff support, and administered by strict reliance on the chain of command. The assumption has been that this provides the proper checks and balances in the system, and in addition locates decision-making where the expertise rests. In many cases this is a valid assumption and certainly fits well with an organizational management style that emphasizes hierarchy, bureaucracy, and control through the use of extrinsic rewards. It does not fit, however, with an organization that believes in more open communication, higher levels of involvement on the part of people, and control through individual commitment to policies. It also doesn't fit when expertise is broadly spread throughout the organization. This is often true in organizations that rely heavily on knowledge workers, or that spend a great deal of effort training their people to become expert in technical functions.

There have been some reports in the research literature of organizations experimenting with having employees involved in the design of pay systems (Lawler, 1981, reviews these). For example, employees have been involved in designing their own bonus system in some instances and the results have been generally favorable. When employees are involved, it leads them to raise important issues and to provide expertise which is not normally available to the designers of the system. And perhaps more importantly, once the system is designed the acceptance level of it and the understanding of it tends to be very high. This often leads to a rapid start-up of the system and to a commitment to see it survive long-term. In other cases, systems have been designed by line managers rather than by staff support people because they feel the need to support it, maintain it, and be committed to it. In the absence of significant design input from line people, it often is unrealistic to expect them to have the same level of commitment to the pay system as the staff people have.

There also has been some experimentation with having peer groups and low level supervisory people handle the day-to-day decision-making about who should receive pay increases and how jobs shoud be evaluated and placed in pay structures. The most visible examples of this are in the new participative plants which use skill based pay (see e.g., Walton, 1981). In these, typically, the work group reviews the performance of the individual and decides whether he or she has acquired the new skills. Interestingly, what evidence there is suggests that this has gone very well. In many respects this is not surprising since the peers often have the best information about performance, and thus, are in a good position to make a performance assessment. The problem in traditional organizations is that they lack the motivation to give valid feedback and to respond responsibily, thus, their expertise is of no use. In more participative open systems this motivational problem seems to be less severe, and as a result, involvement in decision-making seems to be more effective. There also have been isolated instances of executives assessing each other on a peer group reward system and practices (e.g., in Graphic Controls Corporation). Again, there is evidence that this can work effectively when combined in a history of open and effective communication. Deciding on rewards is clearly not an easy task for groups to do and thus should be taken on only when there is comfort with the confrontation skills of the group, and trust in their ability to talk openly and directly about each other's performance.

Overall, there is evidence that some participative approaches to reward system design and administration can be effective. The key seems to be articulating the practices in the area of reward systems with the general management style of the organization. In more participative settings there is good reason to believe that participative approaches to reward systems can be effective because of their congruence with the overall style, and because the skills in norms to make them effective are already in place. In more traditional organizations the typical top down approach to reward system design administration probably remains the best. From a strategic point of view the decision about how much participation should exist in the reward system design and administration, must rest upon whether a participative high involvement type organization is best in order to accomplish the strategic objectives of the business. If so, then participation in pay decisions and reward system decisions should be considered.

Reward System Congruence

So far, each reward system design feature has been treated as an independent factor. This was done for exposition of the concepts, but it fails to emphasize the importance of overall reward system congruence. Reward system design features are not stand alone items. There is considerable evidence that they effect each other and as such, need to be supportive of the same types of behavior, reflect the same overall managerial philosophy, and be generated by the same business strategy.

Table 2 illustrates one effort to define congruent sets of reward system practices (Lawler, 1977). Here the effort is to show how two different management philosophies call for two very different reward system practices. The two management philosophies portrayed here are a traditional bureaucratic management style and a participative employee involvement strategy. As can be seen from the table, every reward system practice needs to be different in these two cases. The reward system practices which go with traditional bureaucratic models tend to be more secretive, more top down, and oriented toward producing regularity in behavior. On the other hand, the participative practices encourage self-development, openness, employee involvement in reward system allocation decisions, and ultimately, more innovation and committment to the organization.

The importance of congruence is not limited to just the reward system in an organization. The reward system needs to fit the other features of the organization in order that total human resource management system congruence exists. This means the reward system needs to fit such things as the way jobs are designed, the leadership style of

Table 2

Appropriate Reward System Practices

Reward System	Traditional or Theory X	Participative or Theory Y
Fringe benefits	Vary according to organization level	Cafeteria - same for all levels
Promotion	All decisions made by top management	Open posting for all jobs; peer group involvement in decision process
Status symbols	A great many; carefully allocated on the basis of job position	Few present, low emphasis on organization level
Pay		
Type of system	Hourly and salary	All salary
Base rate	Based on job performed; high enough to attract job applicants	Based on skills; high enough to provide security and attract applicants
Incentive plan	Piece rate	Group and organization-wide bonus, lump sum increase
Communication policy	Very restricted distribution of information	Individual rates, salary survey data, all other information made public
Decision-making locus	Top management	Close to location of person whose pay is being set

the supervisors, and the types of career tracks which are available in the organization, to mention just a few. Unless this kind of fit exists, the organization will be replete with conflicts, and to a degree, the reward system practices will potentially be cancelled out by the practices in other areas. To mention just one example, an organization can have a very well developed performance appraisal system, but in the absence of well designed jobs and effective supervisory behavior it will be ineffective. Performance appraisal demands interpersonally competent supervisory behavior and jobs that allow for good performance measure.

Conclusion

Overall, the design of an effective reward system demands not only a close articulation between the business strategy of an organization and the reward system, but also a clear fit between the reward system and other design features of the organization. The implication of this for reward system design is, not only is there no one right set of practices for reward systems, but it is impossible to design an effective reward system in the absence of knowing how other design features of the organization are arrayed. This suggests that the key strategic decisions about the reward system need to be made in an interactive fashion in which tentative reward system design decisions are driven by the business strategy, and then are tested against how other features of the organization are being designed. The key, of course, is to ultimately come up with an integrated human resource management strategy that is consistent in the way it encourages people to behave, that attracts the kind of people that can support the business strategy, and that encourages them to behave appropriately.

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