C E Center for Effective Organizations

Pay for Performance
a Strategic Analysis

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Edward E. Lawler III

University of Southern California

Center for Effective Organizations - School of Business Administration
University of Southern California - Los Angeles, CA 90089-1421 (213)740-9814

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ABSTRACT

Individual, group, and organization wide approaches to paying for performance are reviewed. Emphasis is placed on how they fit with different management styles and organizational strategic objectives. It is concluded that a combination of several pay for performance approaches are usually needed to get the maximum positive impact of pay on organizational performance.

PAY FOR PERFORMANCE: A STRATEGIC ANALYSIS

Edward E. Lawler III

The idea of paying for performance is so widely accepted that almost every organization says that it does it. A recent survey of 557 large U.S. corporations found that 80% of them rate pay for performance as a very important compensation objective (Peck, 1984). Even the U.S. Government calls its pay system a merit system and under the Carter administration, legislation (the Civil Service Reform Act) was passed that calls for the system to be more dependent on merit. The major reason for the popularity of paying for performance is the belief that it can motivate job performance and increase organizational effectiveness. The psychological research evidence clearly supports this view. There has been, and continues to be, considerable evidence that pay can be a particularly powerful incentive (Lawler, 1971; Locke, et al., 1980; Nalbantian, 1987). Studies show productivity increases of between 15 and 35 percent when pay for performance systems are put into place (Lawler, 1971).

Although pay for performance is often treated as a single approach, there are, in fact, many different approaches to paying for performance. Because different pay for performance plans have very different consequences, they need to be treated separately. They can be easily classified based upon the level of performance that they focus upon: individual, organizational subunit, or total organization. Within each of these general approaches, there are literally hundreds of different approaches to relating pay to performance.

This chapter will focus on the choices that are involved in designing pay for performance systems and their relationship to organizational effectiveness. The details of pay system technology and management will not be covered. They can be obtained from one of a number of sound books on this topic (see e.g., Henderson, 1985, Patten, 1977, Ellig, 1982).

In choosing an approach to pay for performance, organizations need not only to answer the basic questions of whether they want to pay for performance, they need to choose the approach which best fits them. This choice should be driven by careful consideration of what they want the pay for performance system to accomplish. Different objectives call for different systems. The nature of the organization also comes into play here. Organization structure, culture and management style need to be considered when the choice is made. Some approaches to paying for performance fit more participative management styles, while others fit a more traditional control oriented approach (Walton, 1985). Similarly, some approaches fit work that is structured for individuals, while others fit work that is structured for teams or groups (Hackman and Oldham, 1980). Thus, when each approach to pay for performance is discussed, consideration needs to be given to the kind of organizational conditions it fits as well as to the reason why a pay for performance system is to be installed.

OBJECTIVES OF PAY SYSTEM

The first step in discussing pay for performance systems is to consider what impacts they can have. That is, we need to first address the outcomes that one can reasonably expect an effective pay for performance system to produce. The research on reward systems suggest

that potentially they can influence six factors which in turn influence organizational effectiveness.

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. This seems to occur because high reward levels lead to high satisfaction, which in turn leads to lower turnover. Individuals who are presently satisfied with their jobs expect to continue to be satisfied and, as a result, want to stay with the same organization.

The relationship between turnover and organizational effectiveness is not a simple one. It is often assumed that the lower the turnover rate, the more effective the organization is likely to be. This is a valid generalization because turnover is expensive. Studies that have actually computed the cost of it have found that it can cost an organization five or more times an employee's monthly salary to replace him or her (Macy and Mirvis 1976). However, not all turnover is harmful. Organizations can certainly afford to lose some individuals and, indeed, may profit from losing them, either because they are poor performers or because they are easy to replace. In addition, if replacement costs are low, as they may be in unskilled jobs, it can be more cost effective to keep wages low and suffer with high turnover. Thus, turnover is a matter of rate, who turns over, and replacement cost.

The objective should be to design a reward system that is very effective at retaining the most valuable employees. To do this, a reward system must distribute rewards in a way that will lead the more valuable employees to feel satisfied when they compare their rewards with those received by individuals performing similar jobs in other organizations. The emphasis here is on external comparisons because turnover means leaving an organization for a better situation elsewhere. One way to accomplish this is to reward everyone at a level that is above the reward levels in other organizations. However, this strategy has two drawbacks. First, it is very costly. Also, it can cause feelings of intraorganizational inequity because the better performers are likely to feel inequitably treated when they are rewarded at the same level as poor performers. Faced with this situation, the better performers may not quit, but they are likely to be dissatisfied, complain, look for internal transfers, and mistrust the organization.

What then is the best solution? Often the answer lies in having competitive reward levels and basing rewards on performance. This satisfies the better performers and cause them to stay with the organization. It also serves to attract achievement oriented individuals since they like environments in which their performance is rewarded. However, it is important to note that not only must the better performers receive <u>more</u> rewards than poor performers, they must receive <u>significantly more</u> rewards because they feel they deserve more. Just rewarding them slightly more may do little more than make the better and poorer performers <u>equally</u> dissatisfied.

In summary, managing turnover means managing anticipated satisfaction. This depends on effectively relating rewards to

performance. When this cannot be done, all an organization can do is try to reward individuals at an above average level. In situations where turnover is costly, this should be a cost effective strategy, even if it involves giving out expensive rewards.

2. Motivation of Performance. When certain specifiable conditions exist, reward systems have been demonstrated to motivate performance (Lawler 1971; Vroom 1964). What are those conditions? Important rewards must be perceived to be tied in a timely fashion to effective performance. Organizations get the kind of behavior that leads to the rewards their employees value. This occurs because people have needs and mental maps of what the world is like. They use these maps to choose those behaviors that lead to outcomes that satisfy their needs. People are inherently neither motivated nor unmotivated to perform effectively; performance motivation depends on the situation, how it is perceived, and the needs of people.

The approach that can best help us understand how people develop and act on their mental maps is called expectancy theory (Lawler, 1973). While the theory is complex at first view, it is in fact made up of a series of fairly straightforward observations about behavior. Three concepts serve as the key building blocks of the theory.

A. Performance-Outcome Expectancy. Every behavior has associated with it, in an individual's mind, certain outcomes (rewards or punishments). In other words, individuals believe or expect that if they behave in a certain way, they will get certain things. Examples of expectancies can easily be described. Individuals may have an expectancy that if they produce ten units, they will receive their normal hourly rate, while if they produce fifteen units, they will

receive their hourly pay rate plus a bonus. Similarly, individuals may believe that certain levels of performance will lead to approval or disapproval from members of their work group or their supervisor. Each performance level can be seen as leading to a number of different outcomes.

B. Attractiveness. Each outcome has an attractiveness level to individuals. Outcomes have different attractivenesses for different individuals. This is true because outcome values result from individual needs and perceptions, which differ because they reflect other factors in an individual's life. For example, some individuals may value an opportunity for promotion or advancement because of their needs for achievement or power, while others may not want to be promoted and leave their current work group because of needs for affiliation with others. Similarly, a fringe benefit, such as a pension plan, may have great value for older workers but little for young employees on their first job.

C. Effort-Performance Expectancy. Each behavior has associated with it, in an individual's mind, a certain expectancy or probability of success. This expectancy represents the individual's perception of how hard it will be to achieve such behavior and the probability of his or her successful achievement of that behavior. For example, employees may have a strong expectancy that if they put forth the effort, they can produce ten units an hour, but that they only have a fifty-fifty chance of producing fifteen units an hour if they try.

Putting these concepts together, it is possible to make a basic statement about motivation. In general, an individual's motivation to attempt to behave in a certain way is greatest when:

1. The individual believes that the behavior will lead to outcomes (performance-outcome expectancy).
2. The individual feels that these outcomes are attractive.
3. The individual believes that performance at a desired level is possible (effort-performance expectancy).

Given a number of alternative levels of behavior (ten, fifteen, or twenty units of production per hour, for example), an individual will choose the level of performance which has the greatest motivational force associated with it, as indicated by a combination of the relevant expectancies, outcomes, and values. In other words, when faced with choices about behavior, an individual goes through a process of considering questions such as: "Can I perform at that level if I try?" "If I perform at that level, what will happen?" and "How do I feel about those things that will happen?" The individual then decides to behave in a way that seems to have the best chance of producing positive, desired outcomes.

On the basis of these concepts, it is possible to construct a general model of behavior in organizational settings (see Figure 1). Working from left to right in the model, motivation is seen as the force on an individual to expend effort. Motivation leads to a level of effort by the individual. Effort alone, however, is not enough. Performance results from a combination of the effort that an individual puts forth and the level of that individual's ability. Ability reflects the individual's skills, training, information, and talents. Effort thus combines with ability to produce a given level of performance. As a result of performance, the individual attains certain outcomes. The model indicates this relationship in a dotted line, reflecting the fact

that sometimes people perform but do not get outcomes. As this process of performance-reward occurs, time after time, the actual events serve to provide information that influences an individual's perceptions (particularly expectancies) and thus influences motivation in the future. This is shown in the model by the line connecting the performance outcome link with motivation.

Outcomes, or rewards, fall into two major categories. First, the individual can obtain outcomes from the environment. When individuals perform at a given level, they can receive positive or negative outcomes from supervisors, co-workers, the organization's reward system, or other sources. A second type of outcome occurs purely from the performance of the task itself (e.g., feelings of accomplishment, personal worth, achievement, etc.). In a sense individuals give these rewards to themselves when they feel they are deserved. The environment cannot give them or take them away directly; it can only make them possible.

The model also suggests that satisfaction is best thought of as a result of performance rather than as a cause of it. Strictly speaking, it does influence motivation in some ways. For instance, when it is perceived to come about as a result of performance, it increases motivation because it strengthens people's beliefs about the consequences of performance. Also, it can lead to a decrease in the importance of outcomes (satisfied need is not a motivator), and as a result, decrease the motivation for those performances which are seen to lead to whatever reward becomes less important.

In many ways, the expectancy model is a deceptively simple statement of the conditions that must exist if rewards are to motivate performance. It is deceptive in the sense that it suggests all an

organization has to do is actually relate pay and other frequently valued rewards to obtainable levels of performance. Not only is this not the only thing an organization has to do, it is a very difficult task to accomplish.

In order for employees to believe that a pay for performance relationship exists, the connection between performance and rewards must be visible, and a climate of trust and credibility must exist in the organization. The reason why visibility is necessary should be obvious; the importance of trust may be less so. The belief that performance will lead to rewards is essentially a prediction about the future. For individuals to make this kind of prediction they have to trust the system that is promising them the rewards. When they do and when they see a line of signt and a line of influence between their behavior and their pay motivation will be present.

3. Motivation For Self Development. Just as reward systems motivate performance they can motivate the learning of skills and development of knowledge. The key here is the same as it is with performance motivation. Individuals need to see a connection between their learning skills and a valued pay reward. Often effective pay for performance systems motivate learning and development because individuals perceive that they must develop their skills in order to perform effectively. Of course if individuals feel they already have the skills then a pay for performance system may not have this impact.

Sometimes pay for performance system may discourage individuals from learning new skills. This can happen when the skills are not directly related to present performance and as a result are not likely to lead to a reward and indeed may detract from a performance based

reward. In order to counter this tendency some organizations are currently using skill based pay when they want individuals to add new skills and to develop a broader understanding of how the organization operates (Lawler and Ledford, 1985).

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 cooperate with people from other departments and within their work area. It can also strongly influence the kind of decision structure which exists.

A pay for performance system can have a particularly strong impact on the degree to which people feel they share a common fate with others in the organization. Because of this it strongly influences that degree and kind of cooperation which exists within an organization. The decision to cover a group of people with a pay for performance system is an important structural decision that causes both integration and differentiation (Lawrence and Lorsch, 1967). It sets them off or differentiates them from others thereby creating a kind of structural boundary that reduces cooperation and sharing with individuals and groups outside the boundaries of the pay system. If the system pays them the same based on a measure of their collective performance it can integrate them and cause them to cooperate and work as a team. On the other hand if the reward system asks the individuals to compete among

themselves for a fixed amount of money that has been allocated for raises or bonuses it can serve to differentiate them from each other and cause them to compete with each other.

5. 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, a hierarchical culture, and a participative culture.

Reward systems have the ability to shape culture precisely because of their important influence on motivation, satisfaction, and membership. The behaviors they cause to occur become the dominant patterns of behavior in the organization and lead to perceptions and beliefs about what an organization stands for, believes in, and values. Perhaps the most obvious tie in between pay system practice and culture concerns performance based pay. The absence/presence of this policy can have a dramatic impact on the culture of an organization because it so clearly communicates to organization members what the norms are in the organization about performance. Many other features of the reward system also influence culture. For example having relatively high pay levels can produce a culture in which people feel they are an elite group working for a top flight company. Introducing such innovative pay practices as flexible benefits can produce a culture of innovativeness. Finally, having employees participate in pay decisions can produce a participative culture in which employees are generally involved in

business decisions and as a result are committed to the organization and its success.

6. Cost. Reward systems are often a significant cost factor in organizations. 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 costs than business competitors.

Relationship to Strategic Planning

Figure 2 presents a way of viewing the relationship between strategic planning, organization design, and reward systems. It suggests that once the strategic plan is developed the organization needs to focus on the kind of organization design and management style that is needed in order to make it effective. The next step is to design a pay for performance system which will motivate the right kind of performance, attract the right kind of people, and create a supportive culture and structure.

In the remainder of this chapter, we will first look at pay for performance approaches which reward individual performance and then at approaches which focus on groups of individual and total organizations. Incentive and merit pay approaches will be considered in the discussion of individual pay for performance. Gainsharing, profit sharing, and ownership will be considered in the discussion of group and organization approaches to paying for performance.

The focus in looking at the different approaches to paying for performance will be on their impact and on the fit between them and the organization structure and management style. Pay for performance systems are not stand alone systems, to be effective they need to fit the organizational context in which they operate, thus, as different approaches to pay for performance are reviewed consideration will be given to how they fit with different management styles and organization designs.

INDIVIDUAL PAY FOR PERFORMANCE SYSTEMS

There are two common approaches to paying for individual performance. One, incentive pay, has been declining in popularity for decades; while the other, merit salary increases, remains very popular. They are similar in that they measure and reward individual performance. They are different in how they measure performance and in how they adjust an individual's pay according to performance. This is shown in Table 1 which summarizes the characteristics of the two approaches.

Incentive Pay

Incentive plans pay employees bonuses based on the number of units produced. They are perhaps the most direct way to relate pay to performance. There is a great deal of evidence that incentive pay can motivate individual behavior, indeed much of this research is decades old (see eg., Lawler, 1971). There is also good reason to believe it can attract and selectively retain good performers because they end up being paid more.

The literature on pay incentive plans is full of vivid descriptions of the counterproductive behaviors which piece-rate incentive plans produce (see e.g., Whyte, 1955). Most of the earlier accounts are from

the manufacturing world, but the same kind of issues arise when salespersons and other service personnel are put on incentive pay. In many respects, these behaviors are caused not so much by the concept itself, but by the way it has been managed. Nevertheless, it is difficult to separate the practical problems with particular plans from the general idea of incentive pay. Let us briefly review the major problems with incentive plans.

Beating the System. Numerous studies have shown that when piece rate plans are put into place an adversarial relationship develops between system designers and employees (Lawler, 1971). Employees engage in numerous behaviors in order to get rates set so that they can maximize their financial gains relative to the amount of work that they have to do. They work at slow rates in order to mislead the time study expert when he or she comes to study their job. They hide new work methods or new procedures from the time study person so the job will not be restudied. In addition, informal norms develop about how productive people should be and workers set limits on their production. Anyone who goes beyond this limit is socially ostracized and even physically punished. Unfortunately for the organization, this limit often is set far below what people are capable of producing.

Other forms of gaming include producing at extremely low levels when the rates are set at levels that the employees consider too difficult to reach and using union grievance procedures to eliminate rates that are too difficult. Another version of gaming involves doing only what is measured. In the case of production workers, this may mean not doing clean up and material handling work. In the case of

salespersons, it may mean not doing customer service activities and tying up customers so that other salespersons can't get the sale.

Finally, it is often suggested that in order to gain leverage in negotiating piece rates, employees will organize unions so that they can deal from a more powerful base. Often, when unions do exist, they are able to negotiate plans which allow workers to work off standard, while being paid at a rate which represents a previous high level of performance. Thus organizations end up with the combination of high pay and low performance.

In summary then, incentive plans often set up an adversarial relationship between those on the plan and those designing and administering the plan. The result is that both sides often engage in practices designed to win the game or war at the cost of organizational effectiveness.

Divided Work Force. Since many support jobs and nonproduction jobs do not lend themselves to piece rate pay, the typical organization that has incentive pay has part of the work force on it and part of the work force not on it. This often leads to a we/they split in the work force that can be counterproductive and lead to noncooperative work relationships. This split, interestingly enough, is not a management worker split, but a worker worker split that horizontally differentiates the organization. In its most severe form it can lead to incentive people complaining about materials handling people, maintenance people, and others whom they depend on for support. This split can also lead to some dysfunctions in the kind of career paths people choose. Often, individuals will bid for and stay on incentive jobs even though they do not fit their skills and interests. The reason for this is the higher

pay. The higher pay of incentive jobs may additionally cause individuals to be inflexible when asked to change jobs temporarily and it causes them to resist any new technology which calls for a rate change.

Maintenance Costs. Because incentive plans by themselves are relatively complicated and need to be constantly updated, a significant number of people are needed to maintain them. The problem of maintaining incentive systems is further complicated by the adversarial relationship that develops between the employees and the management. Since employees try to hide new work methods and avoid changes in their rates (unless, of course, it is to their advantage), management needs to be extremely vigilant in determing when new rates are needed. In addition, every time a technological change is made or a new product is introduced, new rates need to be set.

Finally, there is the ongoing cost of computing peoples' wages relative to the amount of work and kind of work they have done during a particular performance period. All this takes engineers, accountants, and payroll clerks. Together, the support costs of an incentive system are significantly greater than those associated with a straight hourly pay or a traditional pay for performance salary increase plan.

Organization Culture. The combined effects of dividing the work force into those who are and are not on incentive pay and the adversarial process of rate setting can create a hostile differentiated organization culture or climate. In particular, they produce a culture of low trust, lack of information sharing, conflict between groups, poor support for joint problem solving, and inflexibility because individuals want to protect their rates. Overall, incentive pay works against

creating a climate of openness, trust, joint problem-solving, and commitment to organizational objectives.

Small Group Incentive Plans. Closely related to individual incentive plans are small group incentive plans. Technically, they are different from individual ones since they are based upon the performance of groups. They tend to fit situations where individual performance is not easily measurable, but group performance is because group products are desired. They are, usually a little less effective in motivating performance than are individual incentive plans because the lines of influence and sight are less. However, they can be quite effective if the groups are kept small. In general, they suffer from all the same problems as the individual incentive plans do, because they too are based on a top down installation process, engineered standards and adversarial relationships.

Conclusion. The above analysis should make it clear that the installation of incentive pay is, at best, a mixed blessing. Although it may improve productivity, the counterproductive behaviors, the maintenance costs, the division of the work force, and the poor culture it leads to, may make it a poor investment. Many organizations have dropped it or decided not to put it in simply because they have decided that the negative effects and maintenance costs outweigh the potential advantages that come from the increases in performance it typically produces.

Incentive pay clearly fits some organizational situations better than others. It fits best situations where the work is designed for individuals or in some cases small groups. It best fits work that is simple, repetitive, and easy to comprehensively measure. More than any

other system, it differentiates the organization to create isolated individuals or small groups who often feel they are competing with each other. Thus, it is very important that it be used only where the need for integration is negligible or where other mechanisms can be used to produce it.

Incentive pay tends to be most useful where the nature of the work is stable, so that it can be carefully studied and there is not the need to constantly revise standards and payment approaches. Finally, it seems clear that incentive pay fits the control approach to management. It is important, however, that the managements who use it, retain a sense of fairness and due process, otherwise the situation may deteriorate from one of control to one of all out confrontation, misrust, and deceit.

Merit Salary Systems

The idea of merit pay is so widely accepted that almost every organization says that it has a merit pay system. Merit pay systems typically give salary increases to individuals based upon their supervisor's appraisal of their performance. Their purpose is to affect motivation and to retain the best performers by establishing a clear performance reward relationship.

Despite the widespread adoption of merit pay, there is considerable evidence that in most organizations merit pay systems fail to create a close relationship between pay and performance (Lawler, 1981). As a result, they also fail to produce the positive motivational effects which are expected of them. In addition, there are some reasons to believe that in the future, it is going to be harder to have effective merit pay programs. But before we consider what the future holds and

what can be done to make them effective, we need to briefly review the reasons why merit pay systems often do not produce the perception that pay and performance are related.

Poor Performance Measures. Fundamental to an effective merit pay system are credible comprehensive measures of performance. Without these, it is impossible to relate pay to performance in a way that is motivating. There is a great deal of evidence that in most organizations, performance appraisal is not done well and that as a result, good measures of individual performance don't exist (see e.g., Meyer, Kay and French, 1965; Devries, Morrison, Shullman and Gerlach, 1981). Sometimes good measures of plant or group performance exist, but similar measures are not available for individuals. In the absence of good objective measures of individual performance, most organizations rely on the judgments of managers. These judgments are often seen by subordinates as invalid, unfair, and discriminatory. Because the performance measures are not trusted, when pay is based on them, little is done to create the perception that pay is based on performance (Lawler, 1981). Indeed, in the eyes of many employees, merit pay is a fiction, a myth that managers try to perpetuate.

Poor Communication. The salaries of most individuals in organizations are kept secret. In addition, some organizations keep many of their pay practices secret. For example, it is common for organizations to keep secret such things as how much was given out in salary increases and what the highest and lowest raises were. Thus, the typical employee is often in the position of being asked to accept, as an article of faith, that pay and performance are related. Given secrecy, it is simply impossible to determine if they are.

In situations of high trust, employees may accept the organization's statement that merit pay exists. However, trust depends on the open exchange of information; thus, with secrecy, it is not surprising that many individuals are skeptical. In a significant number of organizations, the communication situation is worsened because organizations don't spend the time and energy needed to explain their system, and they communicate in ways that lead people to doubt the system. For example, organizations often state that all pay increases are based on merit, even though virtually everyone gets an increase because of inflation and changes in the labor market. It is hardly surprising that individuals often question how much merit had to do with their "merit increase."

Poor Delivery Systems. The actual policies and procedures which make up a merit pay system often lead to actions which do little to relate pay to performance. In addition, the policies and procedures often are so complex that they do more to obfuscate than to clarify the relationship between pay and performance. The typical merit salary increase is particularly poor at actually relating pay and performance, because it allows for only small changes in total pay to occur in one year. All too often only a few percentage points separate the raises given the good performers and those given the poor performers. This is particularly likely to be true in terms of low inflation because salary increase budgets are usually low. Thus, the differences are often both unimportant and invisible.

Salary increase systems further compound the problem of relating present pay levels to present performance by making past "merit payments" part of the individual's base salary so that it becomes an

annuity. This means that an individual can be a poor performer for several years, after having been a good performer, and still be highly paid. The good performer, on the other hand, has to perform well for a number of years in order to achieve a relatively high pay level. This can have disastrous effects as far as retaining outstanding performers. Because of their inability to quickly increase their pay, they often find it best to look for a job elsewhere. The annuity feature leads to one other problem, topping out. After a long period in a job, individuals often reach a point where they are at the top of the range for their job. The effect is to eliminate pay as a motivator because it cannot go up as a result of performance.

Poor Managerial Behavior. Managers do a number of things that adversely affect the perceived and actual connection between pay and performance. Perhaps the most serious is the failure to recommend widely different pay increases for their subordinates when large performance differences exist. Some managers are unwilling to recommend very large and very small pay changes, even when they are warranted. One reason for this seems to be the unpleasant task of explaining why someone got a low raise.

The difficulty of explaining low raises often leads to a second destructive behavior on the part of managers: disowning the pay decision. Despite the fact that they may have recommended a small raise and believe it is appropriate, supervisors sometimes deny or discount their role in determining their subordinates' pay. They may, for example, say that they fought hard for the subordinate to get a good raise but lost out. This clearly communicates to the subordinate that pay increases are beyond their control, and thus not based on performance.

Using Individual Merit Pay. The existence in most organizations of any one of the common problems which plague the administration of merit pay programs is usually enough to destroy the belief that pay is related to performance and as a result the motivational impact of merit pay. In reality, the merit pay systems of most organizations typically suffer from all or most of these problems. As a result, the policy of merit pay fails to achieve its intended objectives.

The problems with merit pay do not mean, however, that it should be entirely written off. Most of the problems are solvable if an organization is willing to make a strong commitment to solving them and if merit pay fits the organization's structure and needs. Like incentive pay, it focuses on individuals and as a result, does little to integrate the members of the work force. Indeed, the typical approach of allocating a raise budget to be divided among a small group of employees clearly sets up a competition among them for the larger raises. This can be a serious problem if the organization needs them to cooperate in order for it to be effective. One approach to supporting team work is to appraise teams and distribute merit increases on a team basis. This can support cooperation and overcome the dysfunctions of pitting team members against each other when merit increases are allocated. Overall, though, merit pay systems seem to fit best where work can be designed for individuals who work independently of others.

There is a question whether basing pay on appraisal can work in a pure top down organization. Since judgment is involved in appraisals, trust must be established if subordinates are to believe that they will be paid fairly based upon their performance. Trust is difficult to build in the absence of openness, and at least a minimal degree of

mutual influence. This all seems to call for using merit pay only where at last a minimal level of participative management can be practiced.

Effective Merit Pay. In order to be effective, a merit pay program must overcome the two major problems that plague most plans, namely the merit increase delivery systems and poor performance appraisals. Finding a solution to the first problem is not difficult, particularly when compared to the difficulty of developing an effective appraisal system.

There is only one way to solve the annuity problem in merit salary programs. The annuity feature must be eliminated, otherwise there will never be enough pay at risk to motivate performance and differentiate the total compensation of good performance from that of lesser performers, thereby attracting and retaining good performers. The most straight forward approach to relating individual pay to performance is a bonus plan in which bonuses are based on individual performance appraisal results. This can be done simply by paying a job rate to everyone who holds a particular job and then establishing a merit bonus range and pool of money that can be used to take some individuals substantially above the job rate. Each year, new appraisals are made and the total bonus range is open to each individual so that past performance gives no assurance of present total pay or bonus. A person newly in a job who performs well can quickly become quite highly paid so that the system can retain the best performers even if they are newly with the organization or newly in the job. In this type of system, market movement results in changes in the job rate so individuals may get an annual adjustment but is clearly a market move not a merit move.

Finally, the amount of the bonus pool can be determined by organizational performance, but it does not have to be. It can simply reflect a budgeted amount of salary costs. One obvious advantage of basing it on the organization's performance is that it can reduce the internal competitive dynamic since it bases part of an individuals reward on collective performance. It can also help tie salary costs to the organizations ability to pay.

When the performance appraisal system is tied to pay, positive and negative impacts on the performance appraisal can occur. On the positive side, recent research evidence (Prince and Lawler, 1986) suggests that when pay is discussed in the performance appraisal event, both the superior and subordinate tend to take the appraisal more seriously and exchange better information about performance expectations and performance results. The same research also suggests that individuals feel that pay and performance should be linked and that indeed they should be discussed at the same time so that individuals will have a chance to understand how the performance appraisal system effects their pay.

On the negative side, there is evidence that when pay and performance are discussed, little attention tends to be paid to career development issues and to future performance concerns. Instead, the conversation focuses on past performance and on the impact of performance on pay. There also may be a tendency for the subordinate to withhold negative information about his or her performance in order to look good during the performance appraisal. This can cloud the degree to which a valid performance discussion takes place and, if the data are used for planning purposes, it can cause poor planning.

In addition, when individuals feel that their performance appraisal results are going to be used for pay determination purposes, they often set lower goals and are more conservative in their estimates of what they can accomplish (Lawler and Rhode, 1976). This can have a negative effect on motivation, because lower goals are set (Locke and Latham, 1984). It also can have a misleading effect on the planning process since individuals have, in essence, provided misinformation to it.

When pay is tied to performance appraisal ratings, it can have a strong influence on the behavior of the appraiser. They are under pressure to give high ratings so that their subordinates will get a "good" raise or bonus. Indeed, to a degree, they may give ratings that are more targeted at getting a particular pay action for someone than they are at rating the person's performance. The result can be false ratings of performance and ratings that are very inflated.

Perhaps the best way to summarize our discussion so far is to say that, when they are connected, the pay system puts certain stresses on the performance appraisal system. These stresses are not all negative, but they do need to be taken into account in the design of any performance appraisal system.

When to Relate Pay to Performance Appraisal Results. Unless performance appraisal can be done well, it is foolish for an organization to tie the performance appraisal system to the pay system. The positive advantages of relating it to pay are more than wiped out by then potential negatives of tying pay to a poorly done performance appraisal. This point leads directly to a consideration of the conditions under which performance appraisal can be done well.

There are a large number of factors which determine whether an effective performance appraisal is done (Lawler, Mohrman, and Resnick, 1984). Those factors that are situational in nature and are not a part of the appraisal system will be considered first. How the forms and procedures surrounding performance appraisals should be developed and structured will be dealt with next, when we consider how to design a performance appraisal system that drives pay. It is extremely difficult to have an effective performance appraisal system when job design, superior/subordinate relationships, and the culture are not supportive of effective performance appraisal. We will look at each of these in turn.

Job design is probably the single most crucial determinant of whether performance appraisal can be done effectively for pay purposes. Unless jobs are designed in ways that allow individual performance to be measured, it is extremely difficult to do effective performance appraisal. Many of the job design characteristics which lead to effective performance appraisal are the same ones that are associated with effective individual job enrichment. As research on individual job enrichment has shown, when jobs are designed such that people can do a whole piece of work, have responsibility for performing that task, and get feedback on their task performance intrinsic motivation is high (Hackman and Oldham, 1980). The same characteristics are also necessary in order for effective performance appraisal to be done for individuals. Indeed, the feedback which comes to the individual and is key for intrinsic motivation is the same kind of data which is needed to appraise performance. In the absence of clear cut individual responsibility for a whole piece of work it is extremely difficult for the individual and for the supervisor to judge performance.

Effective performance appraisal also depends on open, effective communication between the superior and subordinate. In the absence of this kind of communication, it is virtually impossible to have effective performance appraisal. Supervisors need to gather information from subordinates in order to find out how well the individual has performed in most cases, and individuals need to gather information from supervisors in order to understand what performance is expected of them and how their performance is being judged. Thus, in the absence of good superior/subordinate relationships and effective communication, it is extremely difficult to have a performance appraisal system which reaches valid conclusions about performance.

Performance appraisal is a time consuming and often difficult task to perform in an organization. It requires skills that many supervisors do not have and requires behavior on their part which is often difficult for them to demonstrate. Because appraisal is difficult to do, it requires an organization culture that is strongly supportive of doing performance appraisals effectively. The culture needs to be one where doing performance appraisal well is valued, where there are positive role models of effective performance appraisal behavior and where the top of the organization takes performance appraisals seriously. In the absence of these positive cultural conditions, it is extremely difficult to do performance appraisal well. Thus, any consideration of whether pay should be tied to performance appraisals must consider the type of culture that the organization has concerning performance measurement and the degree to which the top of the organization will provide the necessary support and encouragement for doing appraisals effectively.

Making the Decision. Now that we have considered the conditions which favor tying pay to performance appraisal results, we are in a position to make a final decision. No formula exists which will allow this decision to be made in a highly programmed way. Indeed, there is never likely to be one. The situation is simply too complex. It requires tough judgment calls on the part of the system designers. There is a natural inclination for the system designer to choose to relate pay to performance appraisal results because of the important positive results which can come out of this. Quickly reaching this conclusion however, is often a significant error.

As was stressed earlier, the potential downside of tying pay to performance is great and can far outweigh the positives. Even if performance appraisal is done as well as possible, tying pay to appraisal results may have negative effects since it can lead to less open communication and more conservative goal setting. Pay should be tied to appraisal results only where most of the favorable conditions exist and where adequate substitutes are not available. In the absence of strongly supportive culture, good job designs and adequate superior subordinate relationships it is not advisable to relate pay to appraisal results. If it is done without the right conditions, not only will the pay system be rendered ineffective, the appraisal system itself is likely to collapse under the stress of trying to support the pay system.

The favorable conditions do not necessarily all have to exist in advance of starting performance appraisals, but they do have to exist after the appraisal system is put in place. Thus, system designers must make a decision as to whether the conditions can be created. Creating these conditions may involve a major organizational change effort and

thus, it can be extremely risky to assume that they will exist once the performance appraisal system is put into place. Sometimes the installation of an appraisal system can help move the organization in a positive direction, but it is a high risk strategy to assume this will happen.

Overall, then, the warning is clear. Do not be seduced by the potential advantage of tying pay to performance appraisal results. These results are available only if good performance appraisal can be done and this is by no means an easy thing to accomplish. A realistic assessment is needed of the situation to determine whether favorable conditions exist or can be created. A combination of attitude surveys, observations, and interviews can be used to determine whether the right conditions exist or can be created. This step is missing in most design processes and, as a result, a realistic assessment of the potential for having an effective apprisal system is not made. Not doing an assessment is equivalent to entering unexplored territory without a map, something that only the foolish or extremely risk-oriented explorer does!

Appraisal System Design. The design of an appraisal system for driving pay should begin with identifying the appropriate time period for the performance appraisal. Picking too short a time period runs the risk of having the measurement take place before the individual has had a chance to demonstrate the desired behavior. Picking too long a time period runs the risk of having the individual lose sight of the connection between pay and performance and thus, not be motivated by the results of the appraisal. Organizations typically pick an annual appraisal cycle; thus, everyone gets appraised once a year. At the

lower levels of an organization, this is probably too infrequent a cycle since the performance of people in these jobs typically is evident on a much shorter term basis. Indeed, at this level, individuals may have left the job or the organization before the appraisal is due. At the top level, an annual cycle often is too short, because in that time period individuals do not have a chance to demonstrate their performance effectiveness. Often, at the high levels, a cycle of two years or more is appropriate.

It is possible, and sometimes desirable, to vary the frequency of appraisals as a function of performance. In the case of poor performers it is desirable to have more frequent reviews not less frequent ones as is the case in some organizations. The reviews should be used to work on development and to give positive feedback and rewards if performance has improved.

Once the cycle for individuals in the organization has been identified the issue become ones of sequencing the events during the performance period. Table 2 illustrates the best sequence of events for most performance appraisal situations. It shows that at the beginning of the performance period specific goals and measures are agreed upon as well as the impact of accomplishing these goals on pay. In short, a performance contract is formed at this point that includes measures of performance, levels of performance, and pay results. It is particularly crucial that this discussion be a two-way one and that both the superior and subordinate feel that they have impacted upon the ultimate contract. If the subordinate does not see the goals as achievable and does not understand the relationship to pay at this point the motivational impact will be lost.

Not shown in the table, but potentially important are mid-course reviews of the goals, objectives, and performance of the individual. Often, situational change makes the initial goals unrealistic. In this case, they need to be reset and adjusted to fit current conditions; otherwise, the motivational impact of the system will be lost. In addition, of course, sometimes ongoing feedback can help individuals correct their performance problems.

The schedule shown in the table calls for two discussions at the end of the performance. The first is the individual's opportunity to present his or her perception of performance during the time period. Research shows that this step is important in determining whether the individual perceives the performance appraisal process as a fair and reasonable one (Lawler, Mohrman, and Resnick, 1984). Often, this step is omitted and, as a result, the individual feels that performance was apprised without adequate input and that the supervisor did not have the correct information upon which to base the appraisal. As a result, the appraisals is seen as invalid and the individual fails to perceive the connection between pay and performance.

The final meeting is the one in which the overall performance of the individual is discussed and the pay action specified. Not shown in the table but expected to follow quickly is the actual pay action. Again, it is important that this pay action follow closely upon the final appraisal in order that a clear connection be seen between pay and performance. It makes no sense to separate the pay action from the appraisal action as some organizations do. This often occurs, for example, when appraisals are done throughout the year, but pay actions are saved for year end.

One other timing issue needs to be mentioned here. It concerns the practice of varying the frequency of pay actions as a consequence of the favorableness of appraisal ratings . In some organizations, low rated individuals are "stretched out" so they go longer between pay changes and appraisals. The purpose of this is to relate pay to performance, but there are some undesirable effects of using this approach. From a motivational point of view, it is a poor practice because it forces a long separation between performance and any changes in pay, thus creating little immediate incentive to improve. This practice also creates a problem with respect to when the next appraisal should be done. As noted earlier, it should be timed to support a pay action and, if anything, should be more frequent for the poor performers. Overall, it would seem to be best to give no increase to the poor performer, but to promise an early pay review if performance improves, rather than to give a small increase with a long period before the next increase.

So far no specific mention has been made of the type of form which is to be used. This omission is not accidental, it reflects the fact that no one type of form is clearly superior to others. Whatever form is used, it should do three things. First, it should focus as much as possible on observable behavior and results. Secondly, it should give some quantitative score that can be translated into a pay action. Thirdly, it should encourage appraisals to avoid rating inflation and to report differences in performance only where they are defensible.

Organizations often force raters to come up with a particular distribution of ratings in order to avoid inflation and all employees being rated the same. Ranking and forced distribution appraisal are commonly used for this purpose. Ranking is particularly bad because it

creates differences which cannot be defended and ignores the absolute level of performance. The forced distribution approach is better if it is well designed and applied to a large enough group of individuals. However, it has its problems.

The key issue in a forced distribution approach is what type of distribution is forced. Many approaches assume a normal distribution and then ask raters to put individuals in different parts of a normal or bell shaped curve. They go on to call for putting individuals into something like the following four categories: Top 15%, next 35%, next 35%, bottom 15%. This approach has two very important problems associated with it. First, it probably wrongly assumes a normal distribution. Normal distributions assume randomness; performance in organizations is not random, it is influenced by selection, training, and other planned activities. Further, this distribution asks raters to separate individuals in the middle of the performance distribution, half go on the good side, the other half on the bad side. It is almost always impossible to defend breaking up a performance distribution in the middle. Being above or below average is a very emotional issue and what separates someone who is just over the line from someone who is just short of it is hard to specify and communicate. Around the middle is also where most of the people fall (they, of course, all tend to see themselves as above average); thus trying to draw the line in the middle means causing a lot of individuals to feel poorly treated.

A preferable alternative to forcing a distribution which splits down the middle is to try to identify just the extreme cases, say the top and bottom 5-10%. These groups often are the easiest to identify and by putting a large number of individuals in the middle, you avoid

the dissatisfaction which is associated with telling many individuals they are below average. The one problem with using only extreme categories is that it prevents fine tuning pay actions, but are pay actions really fine turned when they are based on indefensible ratings.

In any forced distribution it is important to not force the distribution on a group of less than fifty individuals. If distributions are forced for smaller numbers it is almost inevitable that inequities will occur because one group happens to have many good performers and another one has poor performers. It can also introduce undesirable competition into work groups because individuals realize that in order to get a high rating they must "beat out" other members of their work group.

One complexity is introduced when forced distributions cover multiple work groups. It means that more than one rater is involved. Thus some procedure or process must be put into place that gets raters to agree on how individuals from different groups will be rated. The best approach usually is to use a process that involves meetings to reach mutual agreement on how all the individuals should be rated. These meetings are difficult and time consuming but they usually are better than arbitrarily forcing raters to fit a particular distribution. They can provide a good check and balance system that prevents rating inflation and can motivate raters to do their homework with respect to appraisal documentation. Indeed, in some organizations they are so effective in fighting inflation that the whole notion of a forced distribution is unnecessary.

One last interesting possibility is to deal with the form issue by allowing each superior and subordinate pair to pick a form that they

feel fits their situation. In this approach the responsibility of the organization is to provide forms which are acceptable and, if needed, to help the superior and subordinate pick the best one. This choice process can be quite effective since it leads to the superior and subordinate being commited to the way the appraisal is done and to using a form which fits their situation.

The careful reader will notice that the suggested sequence of performance appraisal and pay includes no discussion of career development. This is intentionally omitted from this sequence because it is assumed that this will be handled in a separate session on a somewhat different cycle. Research evidence shows that this series of events is best handled in a separate session because the discussion of past performance and pay tends to drive out consideration of career issues (Meyer, Kay and French, 1965).

Conclusion: Paying for Individual Performance

The decision concerning whether to tie pay changes to an appraisal system is a complicated one that warrants considerable study before the decision is made. The potential positive effects of doing it well are great as are the downside effects of doing it poorly. Table 3 highlights the advantages, disadvantages, and fit issues involved. System designers need to take a diagnostic role with respect to this decision. This means gathering data, analyzing the risks and ultimately deciding whether the advantages outweigh the disadvantages. In doing this there is no substitute for systematic data gathering and for the involvement of people who will be ultimately affected by the system. This means involving both potential administrators of the system and those individuals whose pay will be affected. Without their commitment

to a performance appraisal driven pay system, it is impossible to have the system operate effectively.

Individual incentive systems should be approached with a great deal of caution. As shown in Table 3, they can be a positive motivator but they don't fit most situations. Thus, they are likely to be used less in the future and ultimately may be applied only to individual sales jobs, repetitive clerical jobs, and simple repetitive manufacturing jobs.

PAYING FOR ORGANIZATIONAL PERFORMANCE

Bonus payments based on the performance of an organization are an old and potentially quite effective way to improve organizational performance. Proponents argue that they can improve motivation, build a work culture in which people are committed to and care about the organization's effectiveness, and finally, adjust the labor costs of an organization to its ability to pay (Weitzman, 1984). There is no question that in some instances, organizations have been able to accomplish just these outcomes as a result of paying bonuses based on organizational performance (Kanter, 1987). However, it is far from simple to design an effective plan. There are literally thousands of approaches to paying for organizational performance, and there are many complex organizational issues that must be dealt with if a plan is to be successful. The good news is that decades of research have pointed out a number of things that must be done if plans are to be successful.

Historically, there have been two major approaches to paying for organizational performance. The oldest is the approach of paying bonuses based on the profitability of the organization. This is undoubtedly the most widely accepted approach around the world, and as

will be discussed later, has important advantages, as well as some very important limitations. Closely related to this are stock ownership plans which give individuals all or some part of the ownership of the organizations for which they work. They are similar in that they use existing measures of performance. They treat employees like investors rewarding them when the organization does well and reducing their wealth when the organization does poorly.

Less well known but increasingly popular is gainsharing. Gainsharing differs from profit sharing in two respects. First, it is always combined with a participative approach to management, and secondly, it typically measures controllable costs or units of output, not profits or stock price in its approach to calculating a bonus.

Table 4 gives an overview of the characteristics of the three major types of organization pay for performance systems. In the discussion which follows, we will first consider what is known about gainsharing, and then consider profit sharing and ownership plans. Once we have done this, we will be in a position to consider what an organization should do, if it wants to base pay on organizational performance.

Gainsharing

Gainsharing has been around for at least 40 years. It has been successfully used by hundreds of organizations (Bullock and Lawler, 1984). Employees and companies have profited from gainsharing, companies in the form of reduced costs and employees in the form of bonus payments and improved job satisfaction. The original and best known gainsharing plan is the Scanlon Plan. Other gainsharing plans include Improshare and the Rucker Plan. In addition to these plans, many companies have their own gainsharing plans which are custom designed.

In the typical gainsharing plan, financial gains in organizational performance are shared on a formula basis with all the employees. A historical base period is established and is used as a basis for determining whether gains have occurred; hence the name "gainsharing." Typically, only controllable costs are measured for the purpose of computing the gain. Unless a major organizational change takes place, the historical base stays the same during the entire history of the plan; thus, performance is always compared to the time period before starting the gainsharing plan. When performance is better than it was in the base period, a bonus pool is funded. When it falls short no bonus pool is created. In the typical plan, at least half of the bonus pool is paid out to the employees, while the rest is kept by the company. Payments are typically made on a monthly basis with all employees getting equal percentage amounts.

No one has an accurate estimate of how many gainsharing plans there are in the United States and Europe. There probably are at least a thousand, and there seems to be little doubt that their popularity has increased tremendously in the last ten years. One recent survey in the United States indicated that about 13% of all firms have them, and that over 70% were started in the last five years (O'Dell, 1987). The White House Conference on Productivity, the U.S. government's General Accounting Office, and the President's Task Force on Industrial Competitiveness have all recently endorsed gainsharing.

Until ten years ago, gainsharing was used primarily in small manufacturing organizations. Much has been written in the United States about the success of gainsharing in such companies as Herman Miller, Lincoln Electric, and Donnelly Mirrors (Moore and Ross, 1978). All

three of these plans are over thirty years old. During the 1970s, an interesting and important trend developed. Large companies such as General Electric, Motorola, Rockwell, TRW, Dana, and Firestone began installing gainsharing plans in some of their manufacturing plants. The trend of large corporations defining organizational units which have their own gainsharing is continuing, and is resulting in the adoption of many more gainsharing plans. Dana and Motorola, for example, now have virtually all of their employees covered by gainsharing.

The increased popularity of gainsharing is significant, and relates to an important feature of most gainsharing plans. They are more than just pay incentive plans; they are a way of managing and an organizational development technology. To be specific, they are a participative approach to management and are often used as a way to install participative management.

The Participative System. From the beginning, Joe Scanlon, the creator of the Scanlon Plan, emphasized that gainsharing fits a participative management style. In many cases, participative systems are needed in order for the plan to work, and in all cases, they are needed in order for the potential of the plan to be realized. In the absence of a change in employee behavior, there is no reason to expect a payout from the kind of formula which is typically developed in gainsharing plans. A payout requires an improvement in performance, and that improvement requires more effective behavior on the part of employees.

Some improvement may be gained simply from the motivation that is tapped through tying pay to performance. This is particularly true in situations where the work is not highly skilled or interdependent and,

as a result, effort is directly related to performance. In other situations, however, there are several reasons why a gainsharing plan without a participative system will not produce an appreciable improvement in performance.

First, the motivational impact of the plan may not be large because most gainsharing plans aggregate a number of people together. As a result, the plan produces only a small increment in the perceived relationship between individual performance and pay, both its line of sight and influence are weak. The formula used is also relevant here. Some plans use very simple formulas that focus on the relationship between labor input and productivity (e.g., Improshare), while others use a comprehensive set of cost measures (e.g., Rucker). Simple labor based plans are more likely to affect motivation because with them, employees can see a more direct relationship between their efforts and their bonuses. Despite their attractiveness, as will be discussed later, simple plans are not always best from an organizational effectiveness point of view.

Second, in many cases, simple effort and good intentions are not enough to improve the operating results. What is needed is a combination of people working harder, working more effectively together, sharing their ideas, and working smarter. In order for this to happen, it often takes a formal participative system that converts the motivation to improve into actual changes in the operating procedures of an organization. In the absence of new procedures or systems to accomplish these changes, they rarely seem to occur.

In traditional gainsharing plans such as the Scanlon Plan, the key to the participative system is a formal suggestion system with written

suggestions and shop floor committees to review the suggestions. Often, there is also a higher level review committee that looks over those recommendations that involve several parts of the organization and/or large expenditures. This system of committees is one way of trying to assure that new ideas will be seriously considered and, where appropriate, implemented. Recently some companies such as TRW, have combined gainsharing with highly participative management practices to produce an approach which is best called high involvement management. (Lawler, 1986). In this approach employees make most of the operating decisions and get rewarded for their organization's effectiveness through the gainsharing plan. This approach has considerable promise since it helps increase the line of influence. It gives employees a chance to influence things that determine the operating results of the organization something that is necessary if bonuses based on operating results are to influence motivation.

Research Results. The most important thing that research has shown about gainsharing plans is that they can work (GAO, 1981). Table 5 lists some of the common positive results that have been found in research studies of gainsharing plans. As can be seen, they can produce a number of positive results and, in fact, research supporting this point has been around for quite a few years. We know somewhat less about the frequency with which they work, but even here there is evidence to suggest that they work in a relatively high percentage of the cases (about 70% according to Bullock and Lawler, 1984).

There also are some things that gainsharing plans don't do as well as some other approaches to paying for performance. Perhaps the most important is differentially attracting and retaining the best

performers. Because they don't pay better performers more, they don't necessarily motivate them to stay. The plans do vary pay costs somewhat with the organization's ability to pay but are not as effective as is profitsharing since a gainsharing plan can payout even when the organization is not profitable. Finally, gainsharing plans contribute to both integration and differentiation. They integrate the units they cover in both a vertical and horizontal respect since they treat everyone the same. On the other hand they tend to differentiate it from the rest of the organization.

Quite a bit is known about how to structure gainsharing plans. There are a number of books and articles which describe in some detail how to put together formulas, how to introduce plans, and how to manage the process side of things (e.g., Moore and Ross, 1978). As a result, there is quite a bit of "how-to-do-it" knowledge. This is particularly true with respect to the Scanlon Plan. Indeed, careful reading of the literature on this plan can make it possible for the skilled practitioner to develop and install a plan without the help of a consultant; most plans, however, are installed by consultants.

The research evidence also shows that certain situational factors favor gainsharing plans (Lawler, 1981). They include:

1. Organization size. The plan is based on employees seeing a relationship between what they do and their pay. As organizations get larger, this is harder to accomplish. Most successful gainsharing plans cover less than 500 employees. They also tend to cover operating units that can operate relatively independently of other organizational units.

2. Performance measurement. In some organizations, good performance measures and a reasonable performance history simply do not exist and cannot be established. This is often true in organizations where rapid technological and market changes occur. When this is true, gainsharing plan formulas are difficult to develop.

3. Measurement complexity. Often performance can be measured only in very complex ways. The truer this is, the more difficult it is to make a plan work, because there is no clear, easily understood connection between an individual's behavior and rewards.

4. Worker characteristics. Gainsharing depends on workers wanting to participate and wanting to earn more money. Most workers have these goals, but not all do. Unless a substantial majority of the employees want the benefits the plan offers, it cannot succeed.

5. Communication. For gainsharing to work, employees must understand and trust it enough to believe that their pay will increase if they perform better. For this belief to exist, a great deal of open communication and education is needed. If an organization does not have these already, they must be started if the plan is to succeed.

6. Management attitudes. Unless managers are favorable to the idea of participation, gainsharing will not fit the management style of the organization. In some organizations, the plan has been tried simply as a pay incentive plan without regard to management style, and it has failed because of a poor fit.

7. Supervisory skills. Gainsharing requires supervisors to change. They are forced to deal with many suggestions, and their competence is tested and questioned in new ways. Unless supervisors are prepared for and accept these changes, the plan can fail. This

point goes along with the general point that management must be prepared to manage in a different way.

As this list demonstrates, gainsharing does not fit every situation. Since they often have most of these favorable conditions it is easy to see why, for so long, the installation of gainsharing plans was limited to manufacturing situations. Recently, this has changed. Some service organizations such as banks and hospitals have begun using gainsharing plans. A good guess is that over the next five to ten years there will be increased use of gainsharing plans in nonmanufacturing situations. Although a great deal remains to be learned about how such plans should be installed in nonmanufacturing environments, it appears there are ways it can be designed to work in these settings (Graham-Moore and Ross, 1983). Indeed, it may be a more broadly applicable approach that has been assumed. As will be discussed next, as long as some basic design features can be built into a plan; there is reason to believe it can work in many situations.

Critical Gain Sharing Elements. The design of a gainsharing plan for an organization is part science and part art. Because there are so many different gainsharing plans around, it is easy to lose track of what the key elements are that make for a successful gainsharing plan. Perhaps the key issue in gainsharing design is that of fit. The formula and participative management features need to fit each other and the situation. Given the variety of situations in which gainsharing plans have been installed, it is not surprising that a wide variety of plans have been tried. Different situations require different designs; different designs require different practices. There are, however, some elements which are needed in all plans if they are to be successful.

Let us turn to a consideration of each of the elements and look at how they can be achieved.

1. Credible, Trusted Development Process. Gainsharing plans vary widely in how they are developed. In some cases, a knowledgeable expert comes with an already developed plan and convinces the organization that it will work for them. In other cases, representative task forces are created within the organization. They investigate different plans and ultimately end up making a recommendation for their particular situation. There is no right set of practices, but it can be stated that unless the practices are ones that lead to employees believing in the plan, it has little chance of success. Plans depend on employees believing that if they perform better, they will be paid more. Initially, this requires a leap of faith, because there is no payment until there is performance improvement. Although in some cases an outside expert can effectively sell a plan to an organization, a good guess is that in most cases, a participative development process that utilizes a task force is most likely to lead to a high level of plan acceptance.

2. Understandable/Influenceable Bonuses. If a gainsharing plan is going to increase motivation, employees must have both a line of sight and a line of influence to the bonus. In short, they must be able to see how through their behavior, they can influence the size of the bonus. Achieving this, particularly in a complex organization, is not simple. It is a matter of education, communication, and the development of a good approach to determining the size of the bonus.

Typically, in gainsharing plans, a formula is used to calculate the size of the bonus. This has the obvious advantage of being much more

objective than the alternative which is a discretionary decision about how much the bonus will be. We cannot rule out judgment as a possible vehicle for deciding the bonus, however. There may be situations which, because of rapid change or complexity, do not lend themselves to a formula. If a valid, trusted decision process can be developed it is still possible to have an effective plan. In some cases, for example committees have been successfully used to make bonus decisions while in others a trusted top manager has made them based on pre-set objectives.

3. Appropriate Measures. Any discussion of formula raises the question of what to measure. Some advocates of gainsharing push strongly for simple plans operating on the principle that, it is always best to keep plans simple. For example, some plans simply measure the number units of output per labor hour. These plans are effective in situations where labor costs are the key issue and the business is a very simple one. In most cases, however, ignoring other costs such as materials and supplies can be quite dangerous and counterproductive. Focusing on any cost can lead to employees' reducing it while increasing others. Thus, the key issue in deciding what to measure for the purposes of a gainsharing plan is zeroing in on all the controllable costs. This may lead to a more complex plan, but it is much better to have a complex plan than one which is not dealing with the true complexity of the business. Simple plans are great for simple businesses, but complex plans are needed for more complex business situations.

Every bonus type plan must have a standard that triggers payment. Many profit sharing plans use a financial break even point or a certain return on investment. As noted earlier, gainsharing plans typically use

a historical performance level. There are a number of advantages to using historical performance, particularly its credibility. It is credible in the sense that employees know it can be achieved, and they understand where it came from. It is not an "arbitrary number" based on some economic concept like return on investment or an estimate by someone of what performance should be. It is also often desirable from an organization's point of view because improvement over it represents real improvement in organizational performance and it is possible to argue that any bonuses are self funding because without improvement there are no bonuses. It is not, however, the only correct basis for a standard.

In the case of an organization that is on a learning curve, historical performance may be too easy to achieve and thus, some projections of the learning curve may be needed. In situations where there is a dramatic change in products or technology, history may no longer be a relevant basis for setting the standard and some other more subjective approach such as a committee decision may be required.

4. Timely Bonuses. Gainsharing plans, typically pay bonuses on a monthly basis. There is no magic in monthly payments. The important principle is that bonuses should be paid as soon after the performance as possible. In situations where the work process is simple, a month may be the right time period. In other more complex situations, however, a month may not be long enough for the organization to complete the production of the product or the delivery of a service. In this case, quarterly or even semiannual bonus payments may be the right time period.

5. <u>Involvement Opportunities</u>. Employees need to be able to influence the measures which are used as the basis for calculating the bonus. This has some direct implications for the kind of participative management models which fit different bonus formulas. If the bonus is based on labor cost only, then often the kind of suggestion program which is used in Scanlon companies is quite appropriate. Through written suggestions, employees can come up with work method improvements which speed production and reduce labor costs. However, if the gainsharing formula is a complex, multiple cost one, then different forms of employee involvement are needed so employees can influence the payout. Employees need to be able to influence not just direct production decisions, but decisions involving other costs such as materials, supplies, inventory, and so forth. In order to accomplish this, work teams and task forces to look at major business decisions may be needed.

There is no right formula for employee involvement, the key is fitting the employee involvement approach to the gainsharing formula, which in turn needs to fit the business situation. Simple business situations can use simple formulas and basic approaches to employee involvement. More complex business situations require more complex gainsharing formulas and higher levels of employee involvement.

6. <u>Maintenance</u>. All gainsharing plans require maintenance. Businesses change, environments change, and as a result, formulas and involvement approaches need to change. Typically, the key to a successful change, is that it is timely and, is done in a way which employees see as credible. Typically, this is handled by an ongoing task force which has representatives from all levels in the

organization. This group regularly reviews the plan, and recommends changes.

The alternative to an ongoing task force is to have an outside expert come in and update the plan on a regular basis. This can work, but it has the disadvantage of making the organization dependent on an outsider and it is possible that the outsider will not be as credible as an internal group. The key, to a successful internal group is that it be staffed by trusted, knowledgeable individuals who understand the business and are capable of making good decisions and communicating them to the rest of the workforce.

Profit Sharing

Profit sharing is better known, older, and more widely practiced than gainsharing. In the United States, for example, data indicate that at least one third of all organizations have profit sharing (O'Dell, 1987). Some definitions of gainsharing include it as a form of gainsharing; however, it is different in two respects. It often does not have a participative management component and it does not use formulas which only measure increases in employee controlled financial, or productivity related, performance. Profit sharing plans typically are much less effective than gainsharing plans in influencing motivation and in producing the kind of social and cultural outcomes listed in Table 5. This is particularly true in large organizations where the line of sight and line of influence from individual performance to corporate profits is virtually nonexistent.

In the typical profit sharing plan the line of influence problem is even further compounded because most firms (estimates are about 85%) defer profit sharing bonuses by putting them into retirement plans.

This compounds the problem of tying present rewards to present controllable performance to the point where it is hard to see that there can be any impact on motivation.

Before we dismiss profit sharing as being completely useless from an organizational effectiveness point of view, we need to note that there are three things even a deferred profit sharing plan in a large corporation can accomplish. First, there is some potential symbolic and communication value in paying people based on organizational performance. It can effectively point out to everyone that they are part of a larger organization and that cooperative effort is needed. Since corporate executives are often paid on the basis of profit sharing, it can also help to assure that there is an alignment between the rewards received by top management and those received by people throughout the organization. This can help avoid the all too common problem of executives getting large bonuses, while lower level employees receive none thus creating an often counter productive vertical differentiation in the organization.

Secondly, some companies, most notably Hewlet Packard, have effectively used their profit sharing plans as vehicles for educating employees about the financial performance of the business. When employees are actually sharing in the profits, it brings alive for them the issue of what profits mean, how they are calculated, and can increase their interest in learning about profits and organizational effectiveness.

Thirdly, perhaps the most important advantage profit sharing offers is that it makes the labor costs of an organization variable, and adjusts them to the organizations ability to pay. When profits go down,

labor costs go down, and thus, rather than being fixed, labor costs, at least in part, become variable. This is a particularly desirable feature for organizations that are in cyclical or seasonal businesses. In most western countries, changes in labor costs are handled through increases and decreases in the size of the workforce. This is a necessity when wages are high and fixed, because there is no other way to reduce labor costs to reflect the company's ability to pay. With profit sharing, it is possible to reduce costs significantly without reducing the number of employees. Most Japanese companies have used this approach to adjusting costs for decades. As is the case in Japan it can allow an organization to make a much stronger commitment to employment stability and help it gain the advantages which are inherent in having a stable workforce.

A key issue with profit sharing is just how much of an individual's pay is at risk through the profit sharing plan. In Japan, it is often a large percentage of the person's pay, as much as 30% to 40%. This gives Japanese companies a significant cushion and helps make their guaranteed employment model work. This is probably too great an amount for most western countries, but it is possible that a company could operate with 10% to 20% of total compensation dependent on profit sharing.

Employee Ownership

A number of pay plans exist that help get some or all of the ownership of a company into the hands of employees. These include stock option plans, stock purchase plans, and employee stock ownership plans (ESOP's). There is little question that stock ownership plans are increasingly popular. According to one study, some 11 million employees in over 8,000 businesses now own at least 15% of the companies employing

them (Quarrey, Blasis, and Rosen, 1986). It is difficult to generalize about their impact because they vary widely in how much ownership employees receive and their impact is likely to depend on the organizational situation.

Much of what has been said about the impact of profit sharing and gainsharing plans is relevant to the impact of ownership. In some situations there is reason to believe that ownership can have much the same impact as an effective gainsharing plan. In a small organization in which participative management is practiced it has a good chance of increasing organizational performance (Rosen, Klein, and Young, 1986). The key here is combining it with employee involvement since it typically produces a weaker line of influence than does gainsharing.

In a large organization with little employee ownership it can do little more than to impact the culture positively by creating integration across the total organization if, of course, all employees are included in the ownership plan. Unlike profit sharing, it doesn't adjust costs to reflect the organizations ability to pay unless it includes an approach in which stockholders share in profits. It can help organizations raise capital and finance themselves. Indeed, most plans are probably installed precisely because of the tax and financing advantages they offer (Kanter, 1987). Ownership can have a more positive impact on attraction and retention than does profit sharing. Particularly if ownership is not easily saleable it can help to lock someone into the organization both financially and psycologically.

Overall, there is reason to believe that ownership strategies can have a positive effect in a number of situations. Their usefulness however is likely to be highly situationally determined. For instance,

in the case of small organizations they might make profit sharing and gainsharing unnecessary and if combined with an appropriate approach to employee involvement they can contribute substantially to employee motivation. In a large organization on the other hand, they can be a useful supplement to other pay for performance systems. Because of line of sight and influence problems it is hard to see them having a very strong impact on motivation and retention in a large organization. They could, however, contribute to a positive culture and to the integration of the organization.

Designing an Effective Organizational Performance Pay System

Ownership, gainsharing and profit sharing all can be useful practices for many organizations. Table 6 summarizes the major advantages and limitations of the approaches. They ought not to be looked at as competing approaches, but as often compatible approaches which accomplish different, important objectives. Profit sharing can have the desirable effect of creating variable costs for an organization, thus allowing it to adjust its costs to its ability to pay. Stock ownership can help with financing and help retain employees. It and profit sharing can also affect the communication pattern and culture of an organization in ways that emphasize the performance of the total organization. Gainsharing, on the other hand, if correctly designed, can provide motivation and produce a culture in which people are committed to seeing their organizational unit operate effectively.

The ideal combination for many large corporations would seem to be a corporate wide profit sharing plan, a stock ownership program, and gainsharing plans in major operating plants or units. The combination of gainsharing and profit sharing deals direct with the need to have

costs variable and the need to motivate employees. Gainsharing alone does not do this because it tends to be based on subunits of the organization and measures which do not include all the operating costs of the business. Thus, the possibility exist for it to payout a bonus when the organization is performing poorly and vice versa. From the motivational point of view, this is quite acceptable if the employees are performing well against the things that they are measured upon and can control. However, it fails to integrate the total organization in the way an effective profit sharing plan or an effective ownership plan can. As a result, in the absence of a profit sharing or ownership plan, employees may erroneously feel that the situation is in good shape if they are receiving a bonus. The addition of a profit sharing plan and/or an ownership plan can help the organization call attention to the organization's performance and to the interdependencies which effect parts of the organization. It also can adjust labor costs according to the organization's ability to pay, something a gainsharing plan may not do.

The amount of profit sharing and gainsharing money which is paid out in an organization needs to vary according to a number of factors. In most cases it probably should not be the same for all levels in the organization. At the lowest level, gainsharing should potentially produce larger payouts than the profit sharing plan. The emphasis here is on potential since the actual amount is determined by performance. The logic is that gainsharing is easier for lower level employees to relate to and significant money must be involved for it to be motivating. At higher levels of management, the situation is different, and perhaps profit sharing should have the greatest payoff potential.

Some organizational conditions are also relevant here. The more interdependent the different units of an organization are and the smaller the organization is, the more profit sharing should come into play. The logic here is that the more these are true, the easier it is for employees to focus on organizational performance and the more important it is to focus on it.

Supportive Reward System Practices. As has already been emphasized, gain sharing, profit sharing, and ownership are not stand alone practices. To flourish, they need to be combined with a participative approach to management and communication. In a similar way, to be optimally effective, organizations which adopt a combination of ownership, profit sharing, and gainsharing need to develop educational and reward system practices which are supportive.

Not only do employees need to be educated in the economics of the business so that they can understand how profits are measured and achieved, they need to be educated in how the organization works. A helpful change in this direction is a move to knowledge or skill based pay. In this pay system people are paid according to the number of skills and amount of knowledge they have (Lawler and Ledford, 1985). Everyone is required to learn multiple skills. As individuals master new jobs their pay increases, creating a strong incentive to learn. Training is available and employees are encouraged to rotate jobs and to continually learn. This helps employees understand how the organization works and how they can influence its performance--key factors in making organizational pay for performance plans successful. It also gives them a higher level of commitment to improving performance.

A guarantee of employment stability is often critical to the success of pay plans which are based on organizational performance. If employees fear that they will lose their jobs because productivity improves and they are no longer needed, they will not be motivated to contribute their ideas and to work harder. Employees at least need to be guaranteed that they will not be laid off as a result of the improvements that result from their efforts. If financially reasonable, it is also desirable to assure employees that layoffs are one of the last approaches the organization will use to reduce costs. With an employment guarantee, employees see a fair trade off: employment stability in exchange for the fluctuating compensation inherent in profit sharing and gainsharing.

Performance based pay can be disruptive to people's personal lives because it creates income variation. Although profit sharing is not as disruptive as the layoffs that many companies use to cut costs, several steps should be taken to help employees cope. Personal financial counseling and education are a must. Employees may not know how to budget and manage their expenses when they have a variable income. Years ago Kaiser Steel failed to do this when it introduced a profit-sharing plan; the result was considerable hardship when profits dropped. People had made financial commitments they could not keep.

Flexible benefits are also a nice complement to pay based on organizational performance (Lawler, 1981). They allow employees to adjust the mix of cash and benefits they receive to fit their particular needs. Employees are given an amount of money which they can take in cash or spend on any combination of the usual array of company benefits. Typically, employees can choose among different kinds of health

insurance and different amounts of retirement, to mention just two of their choices. With variable income, people's needs obviously are going to change, and it makes sense to let them adjust their pay and benefit package to fit their current income level.

DESIGNING A PAY FOR PERFORMANCE SYSTEM

Creating a pay for performance system for an organization requires a careful design process. As has been suggested so far, the starting point should be a specification of the desired organizational impact of the system. Relevant here is what impact the system should have on costs, culture, structure, motivation, skill development, attraction, and retention. An analysis should be done which focuses on what the reward system needs to do for the organization to be effective. This should include a consideration of how other systems in the organization can effect motivation, attraction and retention, culture, structure and costs. The pay system is not the only system that can have a positive impact in these areas. Other systems can complement and support it.

A careful assessment of the organization needs to be made in conjunction with or perhaps even before the effort is made to identify the key outcomes which the pay system should have. The assessment needs to include analysis of the type of work which is present in the organization, the key interdependencies, the management style, and the culture. The results of this assessment need to be considered along with the list of pay system objectives in the design process. Together they form the wants and constraints for the design process.

It is unlikely that a single approach to paying for performance will accomplish the objectives which most organizations will have for their pay system. A creative combination of the different systems is

likely to be called for at least in part because each of them is particularly effective at accomplishing different objectives. Fortunately, many of the pay for performance approaches can be combined and are compatible with each other. The advantages of combining several approaches to paying for organizational performance were discussed earlier. These in turn can be combined with an approach to individual pay for performance. In most cases the best approach to paying for individual performance is the merit bonus payment. Incentive pay approaches tend to conflict with gainsharing in particular since they depend upon a different management style. It is quite possible, however, to combine a bonus approach which generates a pool of money with an individual performance appraisal driven approach to dividing up the pool.

Finally, consideration should be given to simply not basing pay on individual performance or for that matter organizational performance. If they can be done well they clearly can have positive effects but the if here is a big one because a poor pay for performance system is worse than none. A poor one can cause counterproductive behavior, waste time, reduce trust, split the organization into warring factions and waste money. Having no pay for performance system is better than a poor one. Thus, before an organization commits to any pay for performance approach it needs to be sure that the situation is right and that it is willing to put in the time and effort to make it work. As has been repeatedly pointed out all pay for performance approaches require a substantial investment of time and effort if they are to be effective. In addition, each pay for performance approach will work in only a limited set of circumstances. Organizational effectiveness depends on picking the

right combination of pay for performance systems given the objectives for the system and the characteristics of the organization.

TABLE 1

CHARACTERISTICS OF INDIVIDUAL PAY FOR PERFORMANCE APPROACHES

	Incentive Pay	Merit Pay
Payment method	Bonus	Changes in base pay
Frequency of payout	Weekly	Annually
Measures	Output, productivity sales	Supervisor's appraisal
Coverage	Direct labor	All employees

TABLE 2

SEQUENCE OF EVENTS IN RELATING PAY TO APPRAISALS

Pre-Performance Activities	End of Performance Period Activities	Final Activities
1. Agree on performance desired	1. Subordinate input to appraisal	1. Communicate final pay action
2. Agree on performance measures	2. Superior react to input and give own views	2. Explain how pay action fits pay system and give information on how others were treated
3. Agree on how results will affect pay	3. Agree on final performance judgement and if possible at this time agree to pay action	

TABLE 3

INDIVIDUAL PAY FOR PERFORMANCE

	Incentive Pay	Merit Pay
Performance motivation	Clear performance reward connection	Little relationship between pay and performance
Attraction	Pays higher performers more	Over time pays better performers more
Culture	Divides workforce advesarial	Competition within work groups
Organization structure	Many independent jobs	Helped by measurable jobs and work units
Management style	Control	Some participation desirable
Type of work	Stable, individual easily measurable	Individual unless group appraisals done
Costs	Maintenance high	Requires well developed performance appraisal system

TABLE 4

CHARACTERISTICS OF ORGANIZATION PAY FOR PERFORMANCE APPROACHES

	Gain Sharing	Profit Sharing	Ownership
Payment method	Bonus	Bonus	Equity changes
Frequency of payout	Monthly or quarterly	Semi-annually or annually	When stock sold
Measures	Production or controllable costs	Profit	Stock value
Coverage	Production or service unit	Total organization	Total organization

TABLE 5

RESULTS OF GAINSHARING

1. Coordination, teamwork, and sharing of knowledge are enhanced at lower levels.

2. Social needs are recognized via participation and mutually reinforcing group behavior.

3. Attention is focused on cost savings, not just quantity of production.

4. Acceptance of change due to technology, market, and new methods is greater because higher efficiency leads to bonuses.

5. Attitudinal change occurs among workers, and they demand more efficient management and better planning.

6. Employees try to reduce overtime; to work smarter, not harder or faster.

7. Employees produce ideas as well as effort.

8. When unions are present, more flexible administration of union-management relations occurs.

9. When unions support the plan, they are strengthened because a better work situation and higher pay result.

10. Unorganized locations tend to remain nonunion.

TABLE 6

ORGANIZATIONAL PAY FOR PERFORMANCE

	Gain Sharing	Profit Sharing	Employee Ownership
Performance motivation	Some impact in small units	Little pay-performance relationship	Very little pay-performance relationship
Attraction	Helps with all employees	Helps with all employees	Helps lock in employees
Culture	Supports cooperation, problem solving	Knowledge of business	Sense of ownership
Organization structure	Fits small stand alone work units	Fits any company	Fits most companies
Management style	Fits participation	Work best with participation	Works best with participation
Type of work	All types	All types	All types
Costs	On-going maintenance needed operating costs variable	Relates costs to ability to pay	Cost not variable with performance

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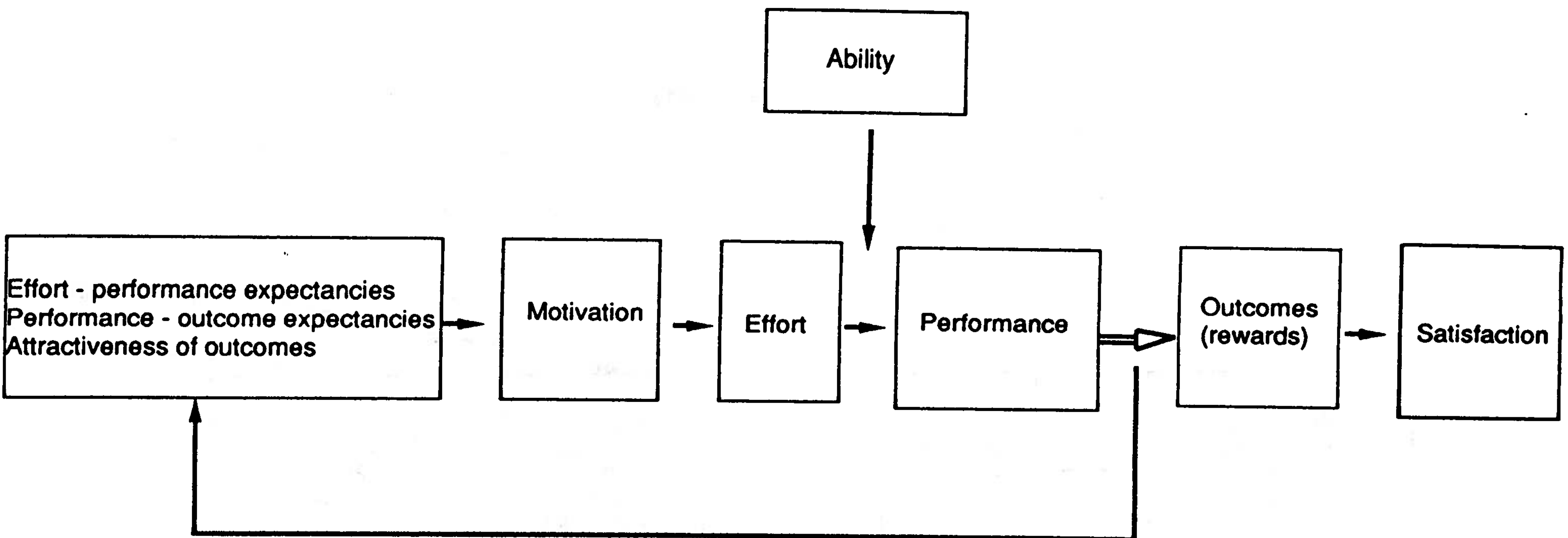

Figure 1. The Expectancy Theory Model

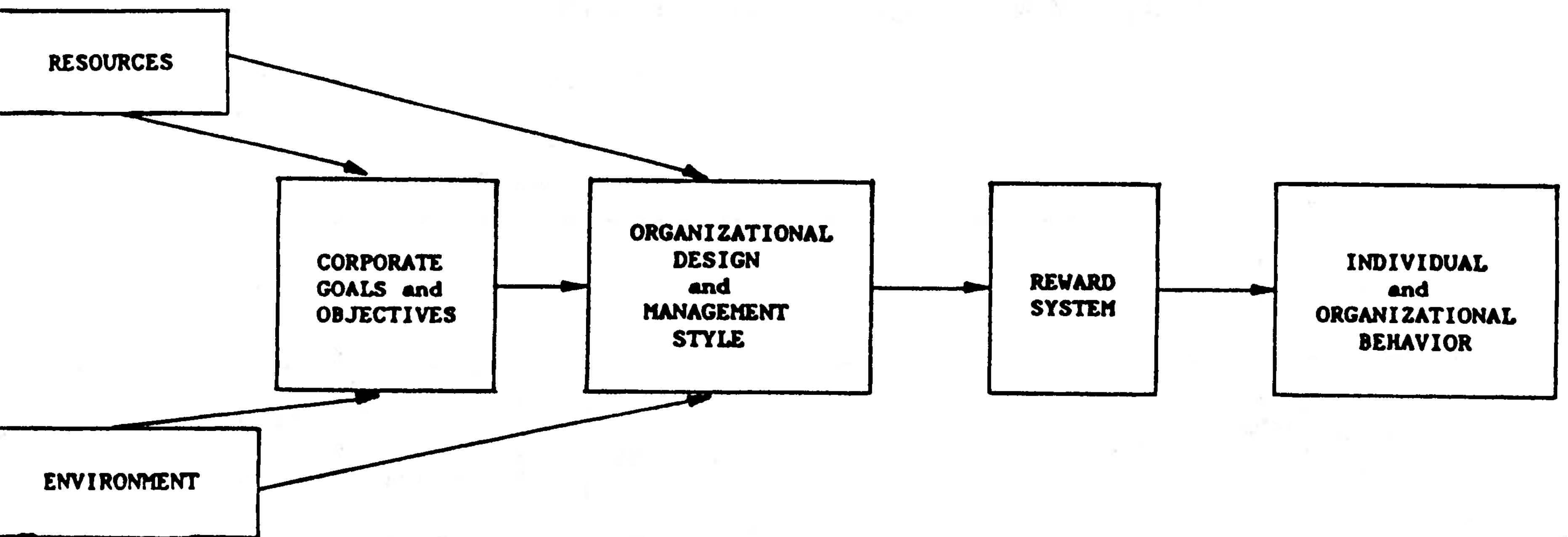

FIGURE 2