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**Organizational Impact of Executive  
Compensation**

**CEO Publication  
T 89-4 (147)**

**Edward E. Lawler III**

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## THE ORGANIZATIONAL IMPACT OF EXECUTIVE COMPENSATION

Reward systems are one of the most prominent and frequently discussed features of organizations. Indeed, the literature in organizational behavior and personnel management is replete with the examples of their functional as well as their dysfunctional role in organizations (see e.g., Whyte, 1955). In this literature, executive compensation has been given some attention, but it has received much more attention in business magazines such as Fortune and Business Week. The magazines have generally focused on the high level of executive compensation while the academic literature has focused on how it is determined and on its impact on the executives themselves (see e.g., Finkelstein and Hambrick, 1988; O'Reilly, Main, and Crystal, 1988).

This chapter will focus on how the design choices that are involved in executive compensation impact on behavior in the rest of the organization, that is on the behavior of non-executives. This is a very different focus than most of the literature has taken, but one that is important. The argument for its importance rests on the assumption that it represents a very visible model and symbol of how the organization operates, what it cares about, and what behavior gets rewarded. If, as is sometimes true, executive compensation systems are models of how individuals are compensated elsewhere in the organization, then how they operate in practice also inevitably affects how other pay systems are operated. If they are different than the compensation systems used elsewhere, then this itself may be an important feature of the organization and its culture. In short, no matter what is done with

executive compensation, it has important implications for the overall operation of the organization.

### Impact of Reward Systems

The first step in discussing executive compensation systems is to consider what behavioral impact they can have in organizations. The research so far on reward systems suggests that potentially they can influence six factors (Lawler, 1984).

1. Attraction and Retention - Research on job choice, career choice, and turnover shows that the kind and level of rewards influences who is attracted to work for an organization, who will continue to work for it, as well as which jobs individuals will try to obtain (see e.g. Lawler, 1973; Mobley, 1982). Overall, those organizations and jobs 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.

Equity theory argues that employees will feel satisfied enough to remain in their present job when their rewards compare favorable 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. Feelings of internal equity are important but they are not as likely to cause turnover. Faced with internal inequity, employees may not quit, but they are more likely to be dissatisfied, complain, look for internal transfers, and mistrust the organization.

2. Motivation of Performance - When certain specificable 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. 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. They are inherently neither motivated nor unmotivated to perform effectively; performance motivation depends on the situation, how it is perceived, and needs.

The approach that best explains how people develop and act on their mental maps is called expectancy theory (Lawler, 1973; Vroom, 1964). While the theory is complex, it is in fact made up of a series of fairly straightforward observations about behavior. Three concepts serve as the key building blocks.

A. Performance-Outcome Expectancy. Individuals believe or expect that if they behave in a certain way, they will get certain things. 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 kinds of outcomes, and outcomes can differ in their types.

B. Attractiveness. Each outcome has an attractiveness to a specific individual. Outcomes have different attractivenesses for different individuals because outcome values result from individual needs and perceptions. 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.

C. Effort-Performance Expectancy. Each behavior also has associated with it, in an individual's mind, a certain expectancy or probability of success. This expectancy represents the individual's perception of the probability of his or her successfully performing that behavior. For example, employees may have a strong expectancy (e.g., ninety-ten) 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 certain 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: "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 desired outcomes.

3. Motivate Skill Development - Just as reward systems can motivate performance they can motivate skill development. The same motivation principle applies here, basically individuals tend to learn those skills which lead to rewards. Thus, reward systems which reward promotion tend to encourage individuals to learn those skills that lead to promotion. Similarly, those systems which reward technical skills motivate individuals to learn technical skills. In case of skill development motivation, the key issues are how large the rewards are for different types of skill development (the attractiveness issue), how available opportunities are to learn the skills and, finally how sure is a reward if the skills are learned.

4. Culture - Reward systems are one feature of organizations that contribute to their overall culture. Depending upon how reward systems are developed, administered, and managed, they can cause the culture of an organization to vary quite widely. For example, they can influence the degree to which it is seen as a human resources oriented culture, an entrepreneurial culture, an innovative culture, a competence based culture, and a participative culture. Reward systems have the ability to shape culture precisely because of their important influence on motivation, satisfaction, skill development, 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 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 about performance. Having relatively high pay levels can produce a culture in which people feel they are an elite group working for a top-flight company, while 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 (Lawler, 1986).

5. Reinforce and Define Structure - The reward system of an organization can reinforce and define the organization's structure (Lawler, 1981). Often this feature of reward systems is not fully considered in the design of reward systems. As a result, their impact on the structure of an organization is unintentional. This does not mean, however, that the impact of the reward system on structure is usually minimal. Indeed, it can help define the status hierarchy, the degree to which people in technical positions can influence people in line management positions, and it can strongly influence the kind of decision structure which exists. The most important structural impact of reward systems is on integration and differentiation (Lawrence and Lorsch, 1967). Reward systems can provide a powerful force toward integration and cooperation when they create situations in which

individuals share a common fate as far as rewards are concerned. Conversely, they can be a powerful force toward differentiation when they pit individuals against each other in competition for rewards. They can also be forced toward differentiation when they put different parts of the organization on different reward systems.

6. Cost - Reward systems are often a significant cost factor. Indeed, the pay system alone may represent over 50% of an 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.

#### Design Options

There are almost an infinite number of ways to design and manage reward systems in organizations. This is because there are a host of rewards that can be given and, of course, a large number of ways that they can be distributed. The focus in the remainder of this chapter will be on the visible extrinsic rewards that an organization controls and that can as a matter of policy and practice be allocated to executives on a targeted basis. Included will be pay, benefits, status symbols, and perquisites.

A useful dichotomy in thinking about options in the design of reward systems is the process/content one. All organizational systems have a content or structural dimension as well as a process dimension.

The structural or content dimension of a reward system refers to the formal mechanisms, procedures, and practices (e.g. the salary structures, the performance appraisal forms) in short, the nuts and bolts of the system. The process side refers to the communication and decision process parts of the system. The key issues here are the degree of openness and the degree of participation.

The discussion of design choices will begin by looking at the key structural choices and then turn to a consideration of the key process choices. Once we have reviewed the design options, we will consider the organizational effects of the different executive compensation choices.

### Structural Decisions

#### Basis for Rewards

Traditionally in organizations pay and perquisites are based on the type of jobs that people hold. Indeed, with the exception of bonuses and merit salary increases, the standard policy at all levels in most organizations is to evaluate the job, not the person, and then to set the reward level. This approach is based on the assumption that job worth can be determined and that the person doing the job is worth as much to the organization as the job itself is worth. This assumption is in many respects valid since through such techniques as job evaluation it is possible to determine what other organizations are paying people to do the same or similar jobs. Among the advantages of this system is that it assures an organization that its compensation costs are not dramatically out of line with those of its competitors and it gives a somewhat objective basis to compensation practices. It also produces a number of negative consequences in the areas of costs, skill development, and culture (Lawler, 1986).

An alternative to job based pay is to pay individuals for the skills that they possess (see e.g., Lawler and Ledford, 1986). In many cases, this will not produce dramatically different pay rates than are produced by paying for the job. After all, the skills that people have usually match reasonably well the jobs that they are doing. It can, however, produce some different results in several respects. Often people have more skills than the job uses and, in such cases, these individuals are paid more than they would be paid under a job based system. In other cases, individuals don't have the skills when they first enter a job and do not deserve the kind of pay that goes with the job. In these cases, individuals have to earn the right to be paid whatever the job related skills are worth.

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

#### Performance Based

Perhaps the key strategic decision that is made in the design of any reward system is whether or not it will be based on performance. Once this decision is made, a number of other features of the reward

system tend to fall into place. The major alternative to basing pay on performance is to base it on seniority. Many government agencies, for example, base their rates on the job the person does and then on how long they have been in that job. In Japan, individual pay is also often based on seniority, although individuals may receive bonuses based on corporate performance.

Most business organizations in the United States say that they reward individual performance. However, having a true merit pay or promotion system is often easier said than done. Indeed, it has been observed that many organizations would be better off if they did not try to relate pay and promotion to performance and relied on other bases for motivating performance (Kerr 1975). The logic for this statement stems from the difficulty of specifying what kind of performance is desired and then determining whether it has been demonstrated. There is ample evidence that a poorly designed and administered reward system can do more harm than good (see e.g., Whyte, 1955, Lawler, 1971).

There are numerous ways to relate pay to performance. The kind of pay reward that is given can vary widely and include such things as stock and cash. In addition, the frequency with which rewards are given can vary tremendously from time periods of a few minutes to many years. Performance can be measured at the individual level so that each individual gets a reward based on his or her performance. Rewards also can be given to groups based on the performance of the group and rewards can be given based on the performance of total organizations. Finally, there are many different kinds of performance which can be rewarded. For example, managers can be rewarded for sales increases, productivity

volumes, their ability to develop their subordinates, their cost reduction ideas, and so on.

Rewarding some behaviors and not others has clear implications for performance. Thus, in decisions about what is to be rewarded consideration needs to be given to such issues as short- vs. long-term performance, risk taking vs. risk aversion, division performance vs. total corporate performance, ROI maximization vs. sales growth, and so on. Decisions about such issues as whether to use stock options (a long-term incentive), for example, should be made only after careful consideration of whether they are supportive of the kind of behavior that is desired (see e.g. Crystal; 1978, Ellig, 1982). At the top management level of large organizations, it is quite likely that the managers of different divisions of businesses should be rewarded for different kinds of performance. Growth businesses call for different rewards systems than do "cash cows" because the managers are expected to produce different results (See Stata and Maidique, 1980 for an example).

#### Market Position

The reward structure of an organization influences behavior partially as a function of how the amount of rewards given compare to what other organizations give. Organizations frequently have well developed policies about how their pay levels should compare with the pay levels in other companies. This structural issue in the design of pay systems is a critical one because it can strongly influence the kind of people that are attracted and retained by an organization as well as influencing the turnover rate and the selection ratio. Simply stated, those organizations that adopt a more aggressive stance with respect to the marketplace end up paying more but attracting and retaining more

individuals. This may pay off for them, particularly if turnover is a costly factor and if a key part of the business strategy demands attracting and retaining highly talented individuals.

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

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

#### Degree of Hierarchy

Closely related to the issue of job-based versus competence-based pay is the hierarchial nature of the reward systems. Hierarchial systems usually pay people greater amounts of money as they move higher

up the organization ladder, and give people greater perquisites and symbols of office as they move up. The effect of this approach is to strongly reinforce the traditional hierarchial power relationships in the organization and to create a climate of different status and power levels. In steeply hierarchial reward systems, the reward system may have more levels in it than the formal organization chart and as a result create additional status differences in the organization.

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

As with all reward system strategic choices, there is no right or wrong answer as to how hierarchial a system should be. In general, a steeply hierarchial system makes the most sense when an organization needs relatively rigid bureaucratic behavior, strong top down authority and a strong motivation for people to move up the organizational hierarchy. A more egalitarian approach fits with a more participative

management style, and the desire to retain technical specialists and experts in non-management roles or lower level management roles. It is not surprising, therefore, that many of the organizations which have emphasized egalitarianism are in high technology and knowledge based industries.

### Process Issues and Reward Administration

#### Communication

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

The difference between an open and a closed communication policy is enormous but, there is no clear right or wrong approach. Rather, it is a matter of picking a position on the continuum from open to secret that is supportive of the overall climate and types of behavior that are needed for organizational effectiveness. An open system tends to encourage people to ask questions, share data, and ultimately be

involved in decisions. On the other hand, a secret system tends to put people in a more dependent position to keep power concentrated at the top and to allow an organization to keep its options open. Some negative side effects of secret systems are the existence of considerable perceptual distortion about the actual rewards that other people get and creation of a low trust environment in which people have trouble understanding the relationship between pay and performance (see e.g., Lawler, 1971). Thus, a structurally sound pay system may end up being rather ineffective because it is misperceived if strong secrecy policies are kept in place.

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

#### Decision Making Practices

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

In discussing the type of decision-making processes that are used with respect to reward systems, it is important to distinguish between

decisions concerning the design of reward systems and decisions concerning the ongoing administration of reward systems. It is possible to have different decision-making styles with respect to each.

Executives compensation systems typically are designed by some combination of consultants, board members, and the executives themselves. Systems for lower level typically are designed by top management with the aid of staff support and administered by strict reliance on the chain of command. The assumption is that this provides the proper checks and balances in the system and in addition locates decision-making where the expertise rests. In many cases, this is a valid assumption, and it certainly fits well with a management style that emphasizes hierarchy, bureaucracy, and control through the use of extrinsic rewards. It does not fit, however, with an organization that believes in more open communication, higher levels of involvement on the part of people, and control through commitment. It also does not fit when expertise is broadly spread throughout the organization.

There have been some reports in the research literature of organizations experimenting with having employees involved in the design of pay systems (Lawler, 1981, reviews these). For example, employees have been involved in designing their own bonus system in some instances and the results have been generally favorable. When employees are involved, it leads to them raising important issues and providing expertise which is not normally available to the designers of the system. Perhaps more importantly, once the system is designed, the acceptance level and understanding of it tends to be very high. This often leads to a rapid start-up of the system and to a commitment to seeing it survive.

There has been some experimentation with having peer groups handle the day-to-day decision-making about who should receive pay increases and how jobs should be evaluated and placed in pay structures. The most visible examples of this are in the new participative plants which use skill-based pay (see e.g., Walton, 1980). In these plants, typically the work group reviews the performance of the individual and decides whether he or she has acquired the new skills. Interestingly, what evidence there is suggests that this has gone very well. In many respects, this is not surprising since the peers often have the best information about performance and, thus, are in a good position to make a performance assessment. The problem in traditional organizations is that they lack the motivation to give valid feedback and to respond responsibly, thus, their expertise is of no use. In more participative open systems, this motivational problem seems to be less severe and, as a result, involvement in decision-making seem to be more effective. There also have been isolated instances of executives assessing each other on a peer group reward system and practices (e.g., in Graphic Controls Corporation).

Overall, there is evidence that participative approaches to reward system design and administration can be effective. The key seems to be articulating the reward systems with the general management style of the organization. In more participative settings, there is good reason to believe that participative approaches to reward systems can be effective because of their congruence with the overall style and because the skills and norms to make them effective are already in place.

## Executive Compensation: Structure and Process

### Basis for Rewards

Executive compensation systems are classically job based systems, at least the formal policies say they are job based. It can be argued that with the kind of individual deals that are struck, they are more person based (Finkelstein and Hambrick, 1988). In any case, they are not formal skill based systems. Pay levels are set by comparing senior management jobs to similar jobs in other corporations. The adoption of a job-based system for executives usually means that "the way" to pay all managers is through a job-based system. Most jobs below the executive jobs in organizations are scored on a job-evaluation system that places great weight upon the amount of responsibility in the job. Because job-based systems evaluate senior management positions highly, it means that all other jobs in the organization are paid at lower rates. In effect, executive compensation rates are a cap on the entire pay system.

Looking at skill development, job-based pay in essence creates a world in which the most rewarded skills are those that lead to vertical movement within the organization. The clear message that is sent by the executive compensation system is to get promoted because that is what is rewarded. This is often particularly evident to people because of the public nature of executive salaries. It doesn't take a particular observant individual to recognize that the most highly rewarded individuals in an organization are those at the top and, that therefore, learning managerial skills is the way to get the largest rewards in their organization. This is not necessarily a problem in terms of organizational effectiveness, however.

In a traditionally managed organization, the objective may be to motivate the best and the brightest individuals to become managers. It can be a problem, however, in a technical organization where it is important that many of the best and brightest in the organization strive for technical excellence and perhaps stay in lower level technical or managerial positions.

Another consequence which a job based system can have concerns the way people try to restructure their jobs. Since job- evaluation systems pay individuals for the size of the job, there is a clear incentive for individuals to try to grow their jobs. They are rewarded for taking on more responsibility and increasing their budget, the number of subordinates they have and the number of management levels under them. Often, this can lead to empire building and to competition among executives and those below them for management responsibilities and budgetary size. It can also drive the entire organization toward a growth culture and high overhead costs.

Finally, one last point about skill-based pay versus job-based pay. Even in those organizations that they have adopted skill-based pay, they tend to do it only for non-management personnel. The reason for this starts at the very top of the organization. Career tracks and pay structures in most organizations are keyed to what happens at the top, and as a result, managers throughout the organization want a career and reward system which is tied to how executives are treated. Thus, the suggestion that they be put on a skill-based pay system and treated like production workers is resisted. The result is that even in the new participative plants skill-based pay typically does not cover the

managerial employees, and probably never will until skilled-based rewards are present at all management levels.

### Performance Based

The many performance based approaches to executive compensation have very different impacts on the behavior of executive. The concern here, however, is not with the impact of different approaches on the behavior of executives, but with their impact on the rest of the organization.

In a number of respects it is difficult to have effective pay-for-performance systems throughout an organization when no pay-for-performance program exist for senior executives, or if the one for the senior executives is poorly administered. If no true pay-for-performance system exists at the senior management level, it is hard for senior managers to argue the importance of having pay-for-performance at the lower levels. This can be a particular problem where pay-for-performance systems that are designed for the lower levels in the organizations are driven by judgement rather than by formula.

Judgment driven programs rely on performance appraisal inputs and as is well documented, performance appraisals are difficult to do well (Lawler, Mohrman and Resnick, 1985). They are particularly difficult to do well when senior management does not role model effective performance appraisal behavior (Mohrman, Resnick-West, Lawler, 1989). In essence, effective performance appraisals start at senior management levels with good role modeling among senior managers and flow down from that point. If it does not start at the top, the senior executives are implying that performance appraisals are only to be done by less important individuals

and they are in the hypocritical position of saying "do as I say, not as I do." This is hardly likely to motivate an ambitious manager to do performance appraisal well. They also are not providing the kind of role model that can support effective performance appraisal behavior at the lower levels. In essence, one level of management is asked to behave in a way that is not being modeled above them. In the case of technical skills, this may not be a problem. However, in the area of performance appraisal where so much of the behavior is influenced by norms, values, personal beliefs, and social influences, it can be a significant problem and can discourage managers from doing good performance appraisals.

The types of performance based pay systems that exist at the senior levels of management can send powerful symbolic messages to individuals throughout the organization. It has already been mentioned that whether performance is based on rewards or not can have a big influence on the credibility of an organization's commitment to paying for performance. Beyond this, the type of pay for performance reward systems that exist can say a lot about the kind of behavior which is expected elsewhere in the organization. For example, if executives are paid primarily on the basis of short term operating results, the message that is sent downward through the pay system, and the behavior of the executives is quite clear: Emphasize short term results because that is what the organization values. Inevitably in their own behavior senior managers will ask for and demand from their subordinates the kind of behavior that is congruent with their own reward systems. Thus, even if the message doesn't get through to other managers as a result of the formal reward system in the organization, it certainly will get through

in the formal and informal expectations that are delivered by senior managers.

Pay-for-performance systems among senior managers that focus on individual pay-for-performance can have a very different impact from those that are centered upon group and organizational performance. Again, they communicate very different cultures and different desired behaviors to individuals throughout the organization. For example, plans which focus on individual rewards tend to contribute to an internal climate of individual performance excellence, competitiveness, and individual visibility. Plans which are collective in nature tend to encourage senior executives to behave in cooperative team oriented ways and they send a message throughout the organization that cooperative behavior is okay and is desirable. This, of course, is particularly likely to be true if the same kinds of plans which cover senior management also cover individuals at lower levels of the organization.

Finally, there is the issue of how much of executive compensation is at risk based upon performance. This has implications not just for how variable the salary costs of an organization are, it also has implications for the kind of culture that exists in an organization and what will be seen as fair and equitable at other levels in the organization. For pay to be at risk at other levels of the organization, it almost has to be at risk at the senior level. Indeed, in most cases logic demands that more be at risk at the senior levels than at other levels because it is at this level that the greatest control over organizational performance exist. Thus, it is important that a significant amount of senior executive pay be at risk in those

organizations that want pay for performance to exist at all levels of the organization.

It would also seem to be hard for senior executives to run an organization based on a management style of commitment and involvement if they personally do not have a considerable amount of their compensation tied to organization performance and in particular long term organizational performance (Lawler, 1986). If their compensation system communicates to the rest of the organization that they are in the organization for short term gains rather than for long term ownership purposes, it is hard for them to be a trusted source of a management philosophy which talks about commitment, involvement, and a management style that is committed to the long term effectiveness of the organization.

In summary, pay for performance at the executive level is important not just because of how it drives the behavior of executives, but because of how it drives the perceptions and behavior of individuals elsewhere in the organization. Because it is so visible and so symbolically important, executive compensation can signal to the rest of the organization how important cooperation is, what kind of commitment people are expected to make to the organization, and how much compensation risk is reasonable. Finally it can set the tone for an organization in which costs are variable based on organizational performance, or it can indicate that the organization is one where security and fixed rewards are the dominant approach.

#### Market Position

Executive compensation can play a critical role in determining the market pricing of jobs throughout the organization and the perceived

fairness of that pricing. The pricing of executive jobs relative to the market is quite visible to all levels within the organization and, therefore, forms an important reference point in terms of what an individual feels should occur in the rest of the organization. If senior executives are particularly well paid, then individuals throughout the organization can argue, and will argue, that they, too, should be well paid relative to the market that they are in. This is an internal equity argument that can be a powerful one.

Of course, just because an organization pays high wages at the senior management level does not mean it has to pay high wages at all levels of the organization. Indeed, it can have very different policies at different levels of the organization. If it does, however, this raises some important cultural issues. It sends a message that is hierarchical and in many respects elitist. It not only sends a strong message that senior management is more important, it may even say or imply they take advantage of their senior position to see that they are particularly well rewarded. In terms of behavioral consequences, this may not lead to turnover at the lower levels but, it certainly can lead to low trust of management, internal conflict, low commitment, and feelings of inequity.

If senior executives are restrained in the compensation levels that they receive, then they are in a particularly powerful position to argue for restraint at other levels. Ken Olsen, the CEO of Digital, has done just this for years and it seems to have been relatively effective even though his low pay is somewhat offset by his large ownership position. Other executives who have relatively low pay include Vagelos at Merck

and Akers at IBM. Interestingly, both Merck and IBM are widely admired for their positive corporate cultures.

If executives do not exercise restraint, it can set off demands for higher pay throughout the organization. This point is illustrated by the union management discussions in the U.S. auto industry. The executives have tried to focus on the "high wages" of U.S. auto workers while the union has pointed out that the executives are very highly paid on both a national and international basis. For example, in 1987, Lee Iacocca made \$17 million while Kume with the much more successful Honda made \$450,000. The CEO's at Ford and General Motors made over \$2 million in 1987 while the CEO of Peugeot made \$250,000 and the CEO of Daimler-Benz made \$1.2 million.

Particularly interesting is the issue of an organizations response to a business down turn. One scenario is to ask for the greatest sacrifice at the lowest levels because that is where costs are greatest, and in some cases the individuals there are more highly paid than are foreign competitors. A second approach is to emphasize equal cuts throughout the organization. Finally, a third approach is to emphasize greater cuts at senior management levels than elsewhere in the organization. Control Data and Hewlett-Packard have done just this. The approaches of equal or greater cuts at the senior management level should have a dramatically different cultural impact than an approach which emphasizes greater cuts at the lower levels of the organization. It certainly puts management on a higher moral ground when it comes to them asking for sacrifice at other levels. Again, it may not show up in short term turnover rates, but it may well show up in issues of culture and long term commitment to the organization.

## Hierarchy and Structure

In considering executive compensation, it is important to separate three hierarchical features of reward systems. The first has to do with the degree to which total compensation differs from the top to the bottom of the organization. The second has to do with the degree to which symbols, perquisites, and highly visible rewards differ from the top to the bottom of the organization. The third concerns the degree to which different rewards system practices and policies are in effect at different levels of the organization.

Let us look first at the issue of how total rewards differ from the top to the bottom of the organization. As is well documented elsewhere, American organizations tend to be very hierarchical with respect to total rewards. Individuals in senior executive positions get substantially more in total compensation than individuals elsewhere in the organization (O'Reilly, Main and Crystal, 1988). Many senior executives in the United States make over a million dollars. This is 50 times more than the lower paid employees in their companies. In most cases, this is a much higher multiple than exists elsewhere in the world. One clear impact of this is to make obtaining a management position particularly attractive. Thus, from a reward system point of view, there is a strong pull on individuals to move upward in the organization. As was noted earlier, this may be dysfunctional if it is important to keep skilled technical individuals at lower levels in the organization.

High executive compensation levels can also have an interesting impact in global businesses. In global businesses, comparisons between the U.S. and other countries are very relevant. This creates an

interesting dilemma, or perhaps more accurately, problem for U.S. executives. Clearly, it is to the competitive advantage of their companies for them to keep the salaries in their organization in line with, or below those of the companies they compete with elsewhere in the world. It is difficult for them to do this in a credible way, however, when their own salaries are the ones that are most out of line with salaries elsewhere.

Very important from a culture point of view is the issue of visible perquisites and symbols of office. If these are plentiful and given out based on hierarchical position, they can strongly contribute to an organization in which power, prestige, and decision making rest in the management position rather than with the person holding that position. This creates and supports a culture of top down bureaucratic management. It also further reinforces the desirability of moving up the management ladder and influences the skill development system in the organization toward people acquiring management skills. The U.S. auto companies come to mind here as prime examples of corporations which have extensive perquisite systems that are based on hierarchy and that have had very top down management styles. Ford and General Motors are now publically committed to making their management styles more participative. A good guess is that in order to accomplish this they may have to abandon their extensive perquisite systems.

Finally, many organizations have different incentive plans, different benefit plans, and different perquisites plans at different levels in the organization. It starts at the bottom level, where individuals are put on hourly pay programs and treated quite differently. This has the effect of differentiating them from managers

and certainly from executives while at the same time, integrating them by giving them a sense of commonality with other individuals at that level in the organization. In many respects, this can be dysfunctional if the intended management style is one that intends to integrate individuals and develop a strong commitment to the success of the business.

Creating different performance based reward systems for different levels in an organization can differentiate the organization by hierarchical levels. For example, bonus plans and pay for performance plans that are targeted just at executives can separate them very dramatically from individuals in the rest of the organization. Separation can be both a cultural separation and a behavioral separation. When this separation exists, it can lead to serious conflict between individuals in senior management positions and those elsewhere in the organization. Particularly if actions are good for one group but not necessarily good for people at other levels in the organization this separation can lead to conflict and other dysfunctions. Just this phenomenon has occurred in some widely reported cases where executive bonus systems have paid off extremely well while profit sharing plans for others have not paid off. The effect was to create two very different perceptions of the organization and to culturally split the organization on a hierarchical basis. Ultimately, General Motors had to respond to union complaints about high executive bonuses and low profit sharing checks for union members by changing their profit sharing plan to bring it more in line with the executive bonus plan.

An interesting example of symbols concerns the use of so called parachutes for employees who are displaced because of mergers and acquisitions. Most organizations have chosen to offer "golden parachutes" to a few senior executives. A few organizations have offered silver or tin parachutes that cover all employees in the organization. A prime example of this is Herman Miller, which has long been admired for its positive work culture. Clearly, these two approaches give very different signals to the organization about who is important to the organization and who the organization is concerned about. The issuance of "golden parachutes" is hardly likely to communicate a sense of concern for all members of the organization and to lead to lower level employees developing a strong long term commitment to the organization. On the other hand, the issuance of top to bottom parachutes says very clearly that everyone in the organization is in a common situation and is valued by the organization. Obviously, this is more likely to build a culture of commitment and over time it is more likely to build a high involvement work culture.

#### Communication

In the area of executive compensation, organizations have a limited ability to keep practices and compensation rates secret. The highest paid members of the organization have to be listed in the annual proxy statement. Thus, inevitably, compensation at the senior management level is public. However, for the rest of the executives in an organization, pay rates can be, and usually are kept secret. This creates an odd kind of two class system in which the pay of a few executives is very public, but the pay of other executives and usually the rest of the managers in the organization is very secret. In some

ways, this may separate the top people from the rest of the managers in the organization. It can reaffirm their special status and their unique role in the organization. It can be argued that being open about all executive compensation data could potentially reinforce the idea that all executive compensation is defensible and open to scrutiny while keeping it secret suggests that the organization is not interested in doing more than the law requires.

### Decision Making

As noted earlier, there are many on-going decisions that need to be made in the management and administration of compensation systems. Among the most important of these decisions are decisions about how highly a job is to be paid and decisions with respect whether someone has earned a performance related reward. Job evaluation systems and skilled based pay systems typically demand that major decisions be made throughout the organization about what pay level is warranted for an individual or a job. If the management style of the organization calls for these to be made in participative manner, then the decision process at the top becomes particularly critical. A good guess is that if a good participative decision process is going to develop at a lower levels, it needs to be modeled by senior level executives. That is senior executives need to do their own job evaluation/skill evaluation work very well, and they need to model good decision making processes.

As was mentioned earlier, the activity of evaluating performance for the purpose of determining pay changes is one where decision process at the top tends to be very important. If the desire at lower levels is to have this process be highly participative, then having participative decision making at the top seems to be particularly important. It is

hard for individuals to make tough decisions in this area because of its potentially strong impact on the well being of co-workers and, of course, ultimately on themselves. There is always a risk that participation will deteriorate into situations where everybody is "nice to everybody else" and, thus, no critical evaluation takes place. It is much easier to maintain a culture in which valid evaluation takes place, if this is modeled by senior executives. If they are willing to take a critical look at each other and make a good participative evaluation, then the role model is in place and they can speak from the high ground in requesting that this be done throughout the organization. On the other hand, if they engage in poor decision making practices, argue that there is a "club" at the top in which everyone must be doing well otherwise they wouldn't have been promoted to that higher position, it is difficult to do good participative decision making, or for that matter good decision making of any kind, at lower levels.

In plan design, the credibility of the decision process is a key issue. Executive compensation decisions typically are not made at levels far above the individuals who will be affected by the compensation system. Indeed, they are often made by the executive themselves, or with the help of an outside consulting firm. There may be an issue of adequate input for executives who are not at the very senior levels of management, but input is rarely the issue with senior level executives. The issue with senior level executives is one of the systems credibility at lower levels in the organization.

If it is perceived that the decision process at the top level is one that does not involve appropriate checks and balances, then the credibility of the executive compensation system, and indeed the

credibility of the executives, is at risk. It is all too easy for individuals at lower level to justify self-serving behavior and indeed to be poor participants in design activities involving rewards if the perception exists that executives take unreasonable advantage of their opportunity to participate in and influence reward system decisions. In many respects, if executives want to use participation throughout the organization, it is particularly important that the process they use for designing their own systems be above approach. Typically, this means a system in which they have inputs, but ultimately that the approval involve a truly independent review process by the board of directors.

Elsewhere, I have argued that in a high involvement organization the board should have representatives from all levels in the organization as well as outside members. (Lawler, 1989). In a more traditionally managed organization the key to a credible decision process lies in having outside board members control the decision making with respect to executive compensation. It is not enough to have the compensation committee made up of executives from other corporations, too often their decision making is tainted by their own self interests. Higher pay for one executive often leads to higher pay for others in the salary survey driven world of executive compensation. With overlapping board memberships, many executives end up determining each other's pay. What is needed is a compensation committee of the board that is made up of individuals who are not in a position to gain from their decisions and who will represent the interests of the shareholders.

#### Summary and Conclusions

The argument has been made that executive compensation can have an important impact on how an organization operates and ultimately upon its

effectiveness. In particular, it can impact ~~on~~ the effectiveness of pay for performance systems. Executive compensation also can have a major impact on the type of skills that individuals develop in an organization. In particular, it impacts upon a degree to which employees try to develop management skills and to move, in a career sense, up the management ladder.

Executive compensation perhaps has its biggest impact on the culture and structure of an organization. It can signal what is valued and serve as a role model in areas such as performance appraisal, employee involvement, open communication, and putting ones self interest above the long term success of the organization. It can be a major driver of the degree to which the organization is highly differentiated by horizontal levels. Special rewards for executives can drive an organization toward being highly differentiated as an organization. On the other hand, treating the executives the same by putting them on the same system as others in the organization, can lead to a much more integrated organization and one in which individuals are committed to the overall success of the organization. All these points lead to the conclusion that executive compensation systems have an organization impact that goes far beyond their impact on the executives who are directly effected by them.

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