

C

E



Center for  
Effective  
Organizations

---

**Employee Involvement and  
Pay System Design**

**CEO Publication  
G 89-12 (155)**

Edward E. Lawler III  
Center for Effective Organizations

January 1994

**Employee Involvement and  
Pay System Design**

**CEO Publication  
G 89-12 (155)**

Edward E. Lawler III  
Center for Effective Organizations

January 1994



### Abstract

A pay strategy that supports employee involvement is outlined. It emphasizes pushing information, knowledge, power and rewards to lower organization levels. Gainsharing, profit sharing and skill based pay are examples of reward systems that support employee involvement.



## EMPLOYEE INVOLVEMENT AND PAY SYSTEM DESIGN

The most prevalent approach to designing work organizations calls for such features as hierarchical decision making, simple repetitive jobs at the lowest level, and rewards based on carefully measured individual jobs and job performance. This "control approach," appears to be losing favor (Lawler, Ledford, and Mohrman 1989). Numerous articles and books have recently argued that organizations need to move toward a more involvement or commitment oriented approach to management (e.g., Lawler, 1986; Walton, 1980). The advantages of the involvement approach are said to include higher quality products and services, less absenteeism, less turnover, better decision making, better problem solving, and lower overhead costs; in short, greater organizational effectiveness (Dennison, 1984; Lawler, 1986).

Employee involvement approaches to organization design generally argue that three features of an organization should be moved to lower organization levels. Briefly the features are:

- (1) Information about the performance of the organization and the ability to bring information about needed organizational changes to the attention of key decision makers.
- (2) Knowledge that enables employees to understand and contribute to organizational performance.
- (3) Power to make decisions that influence organizational direction and performance.

Information, knowledge, and power are the central issues in all organizations (Galbraith, 1973). How they are positioned in an organization determines the core management style of the organization. When they are concentrated at the top, traditional control-oriented

management exists; when they are moved downward some form of participative management is being practiced.

### Pay In Organizations

Reward systems are an important part of the very fabric of organizations. As such, they must fit with the overall management style of the organization and must reinforce and support the kind of behavior and culture that is desired. How organizations handle rewards is as important as how they handle information, knowledge, and power. Indeed, the literature in organizational behavior is replete with examples of their functional as well as their dysfunctional role in organizations. The underlying assumption in this chapter is that, when properly designed, the reward system of an organization can be a key contributor to its effectiveness.

The first step in discussing the strategic role of reward systems is to consider what behavioral impact they can have. That is, we need to first address the outcomes that one can reasonably expect an effective reward system to produce. The research so far on reward systems suggest that potentially they can influence 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 (e.g., Lawler, 1973). Overall, those organizations which give the most rewards tend to attract and retain the most people. Research also shows that better performers need to be rewarded more highly than poorer performers in order to be attracted and retained. Finally, the way rewards are administered and

distributed influences who is attracted and retained. For example, better performing individuals are often attracted by merit based reward systems.

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

3. Skill Development - Reward systems help determine the type of skills that individuals develop because of the influence of the motivation to learn as well as the legitimacy of learning. Just as is the case with performance motivation individuals are motivated to learn these skills that lead to important rewards.

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

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 key features here are the degree to which the reward system is strongly hierarchical and the degree to which it allocates rewards on the basis of movements up the hierarchy.

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

Overall, reward systems in organizations should be looked at from a cost/benefit perspective. The cost can be managed and controlled and the benefits planned for. The key is to identify the outcomes needed in order for the organization to be successful and then to design the reward system in a way that these outcomes will in fact be realized. Because it represents a different management style, employee involvement requires a different approach to rewards, one that produces an identifiable set of benefits (see Lawler, 1986). It requires one that (1) supports a low level of turnover; (2) motivates team and group performance; (3) motivates individuals at all levels to develop a broad

range of skills; (4) creates a culture of open communication, power sharing, and a focus on human resources; (5) reinforces a structure that is flat and developed around lines of business; (6) relates the costs of a business to its ability to pay.

#### Features of Pay Systems

Reward systems in organizations are made up of core values, structures, and processes. Often in organizations the emphasis is on the structures. They are tangible and often easy to manipulate. They include such things as the merit pay delivery system, the job evaluation system, the pay ranges, and so forth. Associated with the various forms and procedures are a number of process issues that concern communication and decision making. In the area of communication, organizations vary from being highly secret to quite open. As far as decision making is concerned, they can use a participative strategy which allows a number of people to be involved in decision making or they can use a top-down strategy. Finally, organizations have core values with respect to their pay systems. These may be explicitly stated as they are in some corporations, or they may simply develop over time and be generally shared as part of the culture. Core values usually concern key process issues (e.g., communication) and key structural issues (e.g., pay for performance). They guide what is done in these areas.

In reviewing how a pay system can be aligned with an employee involvement approach to management, consideration will be given to how it should affect core values, process, and structures. As will be seen, employee involvement calls for specific approaches in all three areas.

## Core Values

To support employee involvement pay needs to be driven by a clearly articulated, well accepted set of core values. These core values should not be a temporary commitment of the organization, rather they should be fundamental beliefs which will be unchanged for decades.

There are a set of important core issues that the values ought to address. These include:

- (1) Job security
- (2) How pay levels will compare to those of other organizations.
- (3) The major determinants of an individual's pay, that is, whether it is performance pay, seniority based, etc.
- (4) What the individual's rights are concerning access to information and involvement.
- (5) The relationship of pay levels to business success.
- (6) The degree to which the system will be egalitarian.
- (7) The degree of support for learning, personal growth, and involvement.

There are no "right" core values, indeed a part of the employee involvement process may in fact be developing them. However, it is possible to make some statements about the general orientation which is congruent with the major principles of the employee involvement approach to management. In particular, the core values need to emphasize the relationship of pay to the success of the business, individual rights, due process, open communication, egalitarian approaches, pay rates that are competitive with similar businesses, and an emphasis on rewarding individual growth and skill development. These core values are supportive of a management style in which the organization depends upon

people to both think and do, and which stresses broad scale business involvement on the part of all employees.

#### Process Issues

Employee involvement suggests some specific process approaches to pay administration. In particular, it suggests greater openness of communication about pay practices and broader involvement on the part of all organizational members in the development and administration of pay and reward system practices. Greater openness, of course, is a prerequisite for understanding the business as well as for broader involvement and participation in the development and administration of pay practices. Openness and participation are congruent with the emphasis on moving power downward, and having individuals involved in both the thinking and doing sides of the business. They acknowledge that for a reward system to be effective it has to be both understood and designed in ways that lead to individuals accepting it. Participation in the design and administration process helps assure this as well as that the system will fit the situation, because it allows the people who will be affected by the system to influence its design.

With openness and participation, widespread ownership of the reward system should develop so that it is not simply the responsibility of the compensation or personnel department. Instead, it becomes the responsibility of everyone in the organization to see that it operates effectively and fairly (Mohrman, Resnick-West, and Lawler, 1989). This is a particularly important point, since in traditional management structures all too often the reward system becomes the property of the personnel department, and as a result, it ends up being ineffectively and poorly supported by line management. It almost goes without saying

that in the absence of broad support in the organization, the reward system cannot support particular business objectives and strategies.

### Pay System Structure

Here are some structural mechanisms which fit particularly well with employee involvement. Many of them represent important changes in the way pay is currently administered in most organizations (O'Dell, 1987). In particular, the following structural approaches to rewards are appropriate for organizations practicing employee involvement.

1. Decentralized - In a large corporation a centralized compensation approach is incongruent with the idea of business involvement and with targeting structure and reward system practices to the business strategy. By their very nature, most large corporations are engaged in multiple businesses which have quite different needs and which compete with organizations that pay differently. Having a single approach to pay which emphasizes a corporate-wide approach to market position, to merit pay, performance measurement, and so forth, makes it impossible for particular business units to structure their reward system effectively. Business units end up being forced to adopt a corporate structure which often is not congruent with what is needed to compete in their particular environment. Smaller organizations tend not to have this problem because they often face a single external environment. Some large organizations that are in a single business may not need to decentralize since they also face a single external market. In most cases, however, organizations which have multiple businesses need to decentralize compensation practice.

Decentralized pay argues for a dramatically different role for the corporate compensation staff. In a centralized system, they are the

designers and controllers of the corporate driven system. In effect, they administer, in a centralized manner, a single compensation system which is monolithic within the corporation. Decentralized pay requires locally driven and designed plans, and needs a central compensation function which is capable of taking on a support and consulting role to the different business units. Carrying this out effectively requires a knowledge of the business strategy, the determinants of business effectiveness, and alternative pay system approaches. It also requires consulting skills.

2. Business Based Rewards for Performance - If people are to be concerned about the success of a business, then their rewards must be driven by the success of the business (Lawler, 1986). This is not to say that individual pay for performance systems should be eliminated since they may still be appropriate if performance can be measured at the individual level (Mohrman, Resnick-West, Lawler, 1989). It is to say that organizations need more systems which reward organization and business unit performance. Indeed, organizations need to be riddled with performance based reward systems so that individuals' pay is driven by such things as their own performance, the performance of their business, and total corporate performance. For example, at the plant level, gain sharing plans as well as corporate wide stock ownership and profit sharing plans, could cover every employee. This combination can help push both power and information downward because it gives rewards for business performances to lower level employees, legitimize their getting information and power (Frost, Wakeley, and Ruh, 1974). It also, of course, can influence motivation and create a team culture.

At the management level emphasis needs to be placed upon long term performance. Particularly in the case of executive compensation, this suggests the importance of replacing or supplementing many of the current short-term profit driven incentive plans with five to ten year incentive plans. It also argues for paying managers based on the organizational units they managed in the past as well as on the performance of their current units. This can help to assure that when managers leave a position, they cannot simply walk away from their past decisions.

3. Choice Oriented - Traditional approaches to compensation provide the individual with a fixed package of benefits, cash, and perquisites. This approach is inconsistent with the substantial individual differences which exist in the workforce and with the idea that individuals can and should be able to make decisions concerning their own lives. Some organizations are already giving individuals greater choice. Initially, this was evident in the popularity of flexible working hours, and more recently, it is evident in the growing popularity of flexible benefit systems. In flexible benefit systems, individuals are given the opportunity to choose the mixture of benefits they feel best fits their needs.

Individual choice does not need to be limited to fringe benefits and hours of work. Ultimately, organizations taking the employee involvement approach could allow individuals to have tremendous flexibility in determining their own total reward package. Flexibility could extend, for example, to the kind of perquisites and benefits offered, and to the mixture of cash, stock, and bonuses. This has the potential of benefiting both the individual and organization, because it

will help individuals to get the rewards they value and assure the organization that the money they are spending is being spent in ways that produce the maximum impact on individuals.

4. Skill Based - Traditional pay approaches emphasize paying people for the jobs they do rather than the skills they have (Lawler, 1986). Employee involvement suggests paying individuals for the skills they have. This has already been done in a number of high involvement manufacturing settings (Lawler, 1978, Lawler, 1981, Lawler and Ledford, 1985). In these settings individuals are put into self managing work teams and are cross-trained so they can perform all the functions within the team's area of responsibility. In this situation it is particularly useful to have individuals who understand the whole manufacturing operation, and thus, paying individuals more to learn additional job skills fits with the general management style and business strategy. Paying for skills in manufacturing situations also reinforces psychological participation and ownership of the business results. It creates a situation where individuals are able to understand the total operating situation and feel responsible for the overall performance of the organization.

Skill based pay represents a truly revolutionary change in the nature of compensation practice. To mention just a few of the potential changes, it might mean that an individual who is promoted would not receive a pay raise for being promoted. First, he or she would have to demonstrate the skills associated with a new job. Once demonstrated, however, a pay increase would be awarded. It also means that individuals at lower levels of the organizational hierarchy could be paid more than people at higher levels. With an emphasis on skills, it



is quite possible that a highly skilled production worker or a highly skilled specialist might make considerably more than a middle level manager, particularly if the specialist and production worker are encouraged to learn managerial skills in order to become more self-managing. In this sense pay would become unhinged from the hierarchical nature of the organization and be used to reinforce skills rather than hierarchy.

Relatively little use has been made of skill based pay in non-manufacturing situations, and even in manufacturing situations it has been limited to the lower level employees. There is reason to believe, however, that the use of skill based pay should be expanded. Skills are the key to effectiveness in the growing number of organizations that are emphasizing employee involvement. In addition, knowledge based work organizations require that skills be spread throughout the organization. Skill based pay can motivate skill acquisition and reinforce it so knowledge work and high involvement organizations can build the kind of skill base they need to be effective.

The changing demographics of the society also suggest that skill based pay should be increasingly popular. The "baby boom" group of individuals is rapidly approaching the age when they can be expected to end up in middle management. At the same time, employee involvement calls for flatter organizational structures and leaner staff groups. This means that the number of positions in middle management will be limited, and there will be less upward mobility opportunities for the large group of individuals in the age group which typically staffs middle management. In traditional management this would simply mean individuals staying on a plateau or in a dead-end position for a long

period of time. If skill based pay were put into place, they could be rewarded for making lateral moves, and as a result, continue to learn and develop. They also might become more valuable to the organizations since they would have a better overall understanding of the business, and not be subject to the negative impact of topping out in pay.

5. Egalitarian - There are several respects in which the pay system can be made more egalitarian in order to match the emphasis in employee involvement on moving information, knowledge, and power downward. A number of organizations already call all their employees salaried employees and treat them the same. Treating them the same primarily means eliminating time clocks and putting all individuals on the same benefit package. It can be, and often is, extended to include many of the perquisites which are allocated according to management level (e.g., parking spaces, offices). An egalitarian approach can be combined with flexible benefits such that, although individuals have differing total compensation levels, they have access to all benefits in the organization if they are willing to pay the price.

In those corporations that adopt a strict egalitarian approach 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 culture that encourages decision making by expertise rather than by hierarchical position and it draws fewer status differences in the organization.

Also consistent with the idea of a more egalitarian pay treatment, is lowering the level at which such things as stock option plans and profit sharing plans operate in organizations. Traditionally, incentive pay plans have been concentrated only at the top level of management. This is inconsistent with employee involvement which suggests pay for organization performance plans be pushed much further down in the organization. The one thing that probably should vary as these plans move further down the organization, is the amount of an individual's compensation which is dependent upon them. At the lower levels, individuals should participate only to a small degree in profit sharing and stock option plans which are based on corporate performance, while at the top level, compensation should be heavily dependent upon these plans. As was mentioned earlier, long-term incentive plans may be the one type of plan which should be targeted at top management.

The employee involvement approach also brings into question the wisdom of pay plans which pay senior executives much more than is paid to lower level employees. Large differences can be justified under a tradition management system since the executives are expected to exercise considerable power and to control information. However, under the employee involvement approach power, information, and knowledge are pushed downward so it follows that so should rewards like pay.

#### Summarizing Employee Involvement and Pay

The management practices and strategies which are consistent with employee involvement require new pay practices. Because compensation is the fabric of any organization, it must be congruent with the overall management style and strategy of the business. It suggests new core values, new administrative processes, and finally, some new pay

structures. As shown in Table 1, pay needs to be characterized by egalitarianism, local control of decision making, individual choice, and most importantly a strong performance based system which ties to the business itself. Taken as a package, these new pay practices are congruent with employee involvement and promise to change the way work is done.

TABLE 1  
PAY AND MANAGEMENT STYLE

	<u>Traditional Management</u>	<u>Employee Involvement</u>
Communication:	Secret	Open
Decision Making:	Top Down	Wide Involvement
Structure:	Centralized	Decentralized
Pay for Performance:	Merit Pay	Business Success Based
Reward Mix:	Standardized	Individual Choice
Base Pay:	Job Based	Skill Based
Degree of Hierarchy:	Steep Level Effect	Egalitarian

## REFERENCES

- Dennison, D. "Bringing Corporate Culture to the Bottom Line." Organization Dynamics, 1984, 12(4), 4-22.
- Frost, C. F., Wakeley, J. H., and Ruh, R. A. The Scanlon Plan for Organization Development: Identity, Participation, and Equity, East Lansing: Michigan State University Press, 1974.
- Galbraith, J. Designing Complex Organizations. Reading, MA, Addison-Wesley, 1973.
- Lawler, E. Motivation in Work Organizations, Monterey, CA, Brooks/Cole, 1973.
- Lawler, E. E. Pay and Organization Development Reading, MA, Addison-Wesley, 1981.
- Lawler, E. E. and Ledford, G. E. "Skill Based Pay." Personnel, 1985, 62(9), 30-37.
- Lawler, E. E. High-Involvement Management. San Francisco: Jossey-Bass, 1986.
- Lawler, E. E. What's Wrong With Point-Factor Job Evaluation. Compensation and Benefits Review, 1986, 18(2), 20-28.
- Lawler, E. E., Ledford, G. E., and Mohrman, S. A. Employee Involvement in America. Houston: American Productivity Center, 1989.
- Mohrman, A. M., Resnick-West, S. M., and Lawler, E. E. Designing Performance Appraisal Systems. San Francisco, Jossey-Bass, 1989.
- O'Dell, C. People, Performance and Pay. Houston: American Productivity Center, 1987.
- Vroom, V. H. Work and Motivation. New York: Wiley, 1964.
- Walton, R. E. Establishing and Maintaining High Commitment Work Systems. Chapter in The Organizational Life Cycle. Kimberly, J. R., Miles, R. H. and Associates. San Francisco: Jossey-Bass, 1980.