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A Strategic Approach**

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## **The New Pay -- A Strategic Approach**

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The "New Pay" is not alternative pay. It is not skill-based pay, gainsharing or any other specific new pay practice. Indeed, it is not a set of new practices, rather, it is a way of thinking about role pay systems in complex organizations. It argues for beginning the pay design process with a focus on business strategy and organization design. It argues against a design strategy which focuses on what other organizations are doing and which assumes that there are certain best practices which must be incorporated into an organization's approach to pay. The "new pay" is about strategic thinking, designing pay systems to fit business strategies and organization structures.

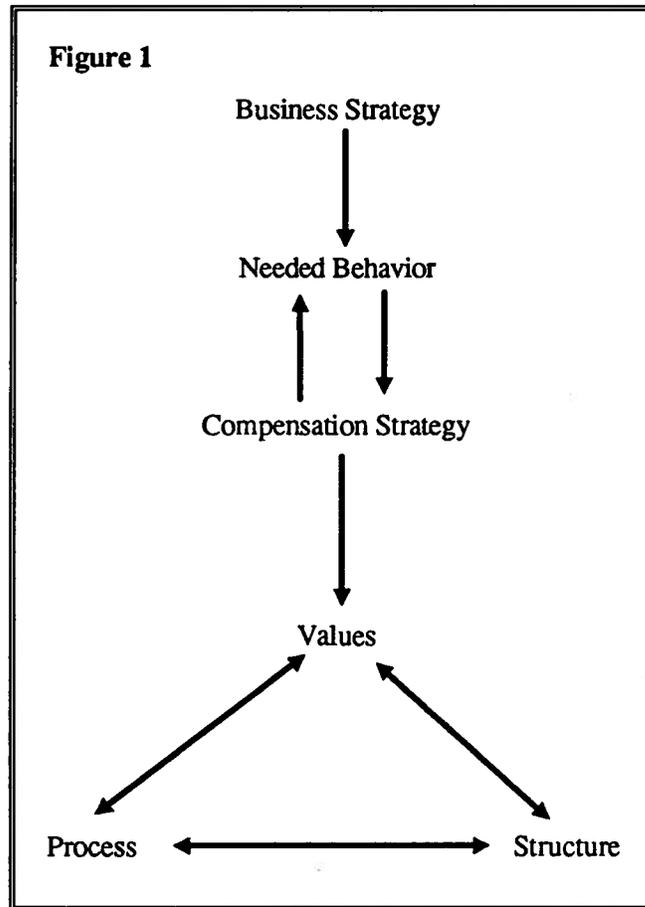
Pay systems are a critical part of any organization's design. How well they fit with the strategy and the rest of the systems in an organization has an important impact on how effective the organization is and on the quality of life that people experience in the organization. Over the past decade, some new pay practices have become popular in order to align pay systems with the important changes that are occurring in the way organizations are designed and managed (Lawler, 1990; Schuster and Zingheim, 1992). This is a natural and logical outcome of a greater focus on strategic organization design.

The over-riding principle is that in order to be effective, organizations must have congruence among their various operating systems. Particular practices are neither good nor bad in the abstract. They must be evaluated in the context of the other systems in an organization and the business strategy of the organization. The business strategy indicates what the organization is supposed to accomplish and how it is supposed to behave. It specifies the kinds of performance and performance levels the organization needs to demonstrate in order to be effective. Thus, it is a critical guide for the design of the overall organization structure as well as its information systems, human resource management systems, and of course, pay systems.

Pay system design needs to be driven by the organization design and the management style of the organization which in turn, needs to be strongly influenced by the organization's strategy. The reward system in combination with other features of the organization's design drives the performance of the organization, since it influences critical individual and organizational behaviors. Because of this, it must be designed to support the needed organizational behaviors.

Figure 1 depicts the design process an organization should use in creating a pay system, and in testing its effectiveness. It shows that business strategy should be the foundation for identifying the critical behaviors that the organization needs to demonstrate. This in turn is shown as driving the design of the

reward system. The challenge here is to correctly identify those features of a reward system which will produce the behavior that is needed to make the strategy come alive in terms of individual and organizational behavior.



Three critical elements of the reward systems are identified in this figure. The first is the core principles which the organization holds. These core principles may be stated or simply implicit in the way the organization operates. But, they are part of any reward system. Examples of core principles are a belief in pay for performance, a belief in secrecy about pay, and other fundamental relatively long-term commitments that organization make in the area of reward systems.

The pay system also is shown to be made up of process features and structural feature. Process design features include such things as communication policies, and decision making practices. These are critical, because they reflect not only the overall management style of the organization, they influence how well pay system practices will be accepted, understood, and how much commitment there will be to them.

Finally, pay systems include actual pay system practices and structures. These are the features of reward systems that get the most attention. They include pay delivery systems such as gain sharing plans, profit-sharing plans as well as administrative policies and a host of other specific organizational programs.

Pay systems are assumed to be effective to the degree that the core principles, processes and practices are in alignment. This is depicted in the figure by the arrows among the three elements. Fit is critical because organizations need to be consistent in what they say and what they do. Violations of this consistency inevitably leads to misunderstanding about how the pay system works, and failure to motivate the proper or needed behavior.

Later we will consider the critical design decisions that need to be made concerning the core values, processes and structures. Before these are discussed consideration needs to be given to how reward systems in general, and pay systems in particular, can actually effect individual and organizational behavior.

### **Objectives of the Reward System**

The research on reward systems suggests that potentially they can influence six factors which in turn impact strategy implementation and organization 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. Overall, those organizations which give the most rewards tend to attract and retain the most people.

The type of rewards offered are also critical in determining who is attracted and retained by an organization's pay systems. For example, high levels of risk compensation attracts different types of people than do pay systems which emphasize security and extensive benefits.

The objective should be to design a pay system that is effective at attracting and retaining those employees which the strategy say are most important. To do this, a reward system must distribute rewards in a way that will lead them 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.

*2. Motivation of Performance* - When certain specifiable conditions exist, reward systems have been demonstrated to motivate performance (Gerhart and Milkovich, 1992, Lawler, 1990; 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 their own 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. Therefore they are inherently neither motivated nor unmotivated to perform effectively; performance motivation depends on the situation, how it is perceived, and the needs of people.

In general, an individual's motivation to behave in a certain way is greatest when:

1. The individual believes that performance will lead to certain outcomes.
2. The individual feels that these outcomes are attractive.
3. The individual believes that performance at a desired level is possible.

The implication of this for pay systems is clear. In order to be motivational, they must create a line of sight between the behavior of employees and the reception of important amounts of pay.

3. *Skills and Knowledge* - Just as pay systems can motivate performance they can motivate learning and development. The same motivational principles apply. Individuals are motivated to learn those skills which are rewarded. As will be discussed later, a relatively new approach to pay, skill based pay, has been developed to capitalize on just this point. It allows organizations to strategically target the learning its wants employees to engage in. This is in contrast to many job based systems which indirectly do this by tying increased pay and perquisites to obtaining higher level jobs.

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, a fair culture, and a participative culture.

Reward systems have the ability to shape culture precisely because of their important influence on skills, 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.

5. *Reinforce and Define Structure* - The pay system of an organization can reinforce and define the organization's structure (Lawler, 1990). Often this impact of a reward system is not considered in the design of pay 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. It can have a strong impact of how integrated and how differentiated it is (Lawrence and Lorsch, 1967). When people are rewarded the same way it tends to unite them, when they are treated differently it can divide them. In

addition, it can help define the status hierarchy, and it can strongly influence the kind of decision structures which exists.

6. *Cost* - Reward systems are often a significant cost factor. Indeed, pay alone may represent over 50% of an organizations operating costs. 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 increase in costs when the organization has the money to spend and a decrease in costs 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 many ways to design and manage pay systems. This is because there are a host of financial rewards that can be given, and of course, a large number of ways that they can be distributed. A useful dichotomy in thinking about options in the design of reward systems is the process/content one mentioned earlier. Both process and content need to be aligned with the business strategy in order for the pay system to be "strategically correct." It is beyond the scope of this paper to consider all the design options that are available, therefore consideration will be given to some of the most critical.

### **Basis for Rewards**

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

An alternative to job based pay which has recently been tried by a number of organizations is to pay individuals for the skills that they possess (Lawler and Jenkins, 1992). Perhaps the most important changes that are introduced by this approach occur in the kind of culture 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 culture of concern for personal growth and development, and a highly talented work force. In the case of factories where this systems has been used, it typically means that many people in the organization can perform multiple tasks and thus, the work force is highly knowledgeable and flexible.

In most cases where skill based pay has been tried it tends to produce somewhat higher pay levels for individuals, but this is usually offset by greater work force flexibility and performance (Jenkins et al., 1992). Flexibility often leads to lower staffing levels, fewer problems when absenteeism or turnover occur, and indeed, it often leads to lower absenteeism and turnover itself because people like the opportunity to utilize and be paid for a wide range of skills. On the other hand, skill based pay can be challenging to administer because it is not clear how one goes to the outside marketplace and decides, for example, how much a skill is worth. Skill assessment can also often be difficult to accomplish. There are a number of well developed systems for evaluating jobs and comparing them to the marketplace, but there are none which really do this with respect to the skills an individual has.

In general, skill based pay seems to fit those organizations that want to have a flexible, relatively permanent work force that is oriented toward learning, growth, and development. It has been frequently used in new plant start-ups and in plants that are moving toward high involvement management approaches (Lawler, Mohrman and Ledford, 1992). It is beginning to be used more with knowledge workers and with managers. It is also being used more in service situations where the organizations strategy call for one stop service and high level of customer satisfaction.

### **Performance Based**

Perhaps the key strategic decisions that need to be made in the design of any reward system is whether or not it will be based on performance and if it is, how it will do it. Once these decisions are made, a number of the features of the reward system tend to fall into place. One alternative to basing pay on performance is to base it on seniority. Many government agencies, for example, base their pay rates and some benefits on the job the person does and on how long they have been in that job. In Japan, individual pay is also often based on seniority, although individuals often receive bonuses based on corporate performance.

Most business organizations in the United States say that they reward individual performance, and they call their pay system a merit system. Having a true merit pay system is often easier said than done however. Indeed, it has been observed that many organizations would be better off if they didn't try to relate pay and promotion to performance, and relied on other bases for motivating performance (Kerr,

1975). It can be difficult to specify what kind of performance is desired, and to determine whether it has been demonstrated (Heneman, 1992).

There are numerous ways to relate pay to performance, and one of the most important strategic decision that organizations make is how they do it (Blinder, 1990). 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 based on the performance of groups, and the total organization. Finally, there are many different kinds of performance which can be rewarded. For example, managers can be rewarded for sales increases, productivity volumes, their ability to develop their subordinates, their cost reduction ideas, and so on.

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

It is beyond the scope of this article to go into any great detail about the pros and cons of the many approaches to relating pay to performance. A few general points do need to be made however. Bonus plans are generally better motivators than pay raise and salary increase plans. This is due to the fact that with bonus plans it is possible to substantially vary an individual's pay from time period to time period. With salary increase plans, this is very difficult since past raises become an annuity. Approaches that use objective measures of performance are better motivators than those that use subjective measures. In general, objective measures enjoy higher credibility, that is, employees will often accept the validity of an objective measure, such as sales volume or units produced, when they will not accept a boss's rating. When pay is tied to objective measures, therefore, it is usually clearer that pay is determined by performance. Objective measures are also often public. When pay is tied to them, the relationship between performance and pay can be much more visible than when it is tied to a subjective, non verifiable measure, such as a supervisor's rating.

Group and organizational bonus plans are generally best at producing integration and team work. Under group and organizational plans, it is generally to everyone's advantage that an individual work effectively, because all share in the financial results of higher performance. As a result, good performance is likely to be supported and encouraged by others when group and organizational plans are used. If people feel they can benefit from another's good performance, they are likely to encourage and help other workers to perform well. This is not true under individual plans. They tend to produce differentiation and competition.

### **Market Position**

The reward structure of an organization influences behavior partially as a function of how the amount of rewards given compare to what other organizations give. Organizations frequently have well developed policies about how their pay levels should compare with the pay levels in other companies. For example, some companies feel it is important to be a leading payer, and they consciously set their pay rates at a higher level. Other companies are much less concerned about being in the leadership position with respect to pay, and as a result, are content to target their pay levels at or below the market for the people they hire. This structural issue in the design of pay systems is a critical one because it can strongly influence the kind of people that are attracted and retained by an organization. It also influences the turnover rate and the selection ratio.

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 appropriate. It can increase labor costs and produce a minimum number of benefits. Of course, organizations don't have to be high payers for all the jobs. Indeed, some organizations identify certain key skills they need, and adopt the stance of being a high payer for them, and an average or below average payer for other skills. This has some obvious business advantages in terms of allowing organizations to attract the critical skills that they need to succeed, and at the same time to control costs.

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 in the organization that it is elite, that people must be competent to be there, and that they are indeed fortunate to be there. A policy which puts certain skill groups into a high pay position and leaves the rest of the organization at a lower level, can on the other hand, contribute to a spirit of elite groups within the organization and cause decisive social tensions.

Finally, it is interesting to note that some organizations try to be above average in non-cash compensation as a way of competing for the talent they need. They stress working conditions as well as interesting and challenging work. This stance potentially can be a very effective one, because it puts organizations in the position of attracting people who value these things, and could give them a competitive edge at least with these people.

### **Centralized/Decentralized Reward Strategy**

Organizations that adopt a centralized strategy typically assign to a corporate staff group the responsibility for seeing that pay practices are similar throughout the organization. They typically develop standard pay grades and ranges, standardized job evaluation systems, and perhaps, standardized promotion systems. In decentralized organizations, the design and administration of pay systems are left to local option. Sometimes the corporations have broad guidelines or principles they wish to stand for, but the day to day administration and design of the system is left up to the local entity.

The advantages of a centralized structure rest primarily in the pay administration expertise that can be developed at the central level and the degree of homogeneity which is produced in the organization. This homogeneity can lead to a clear image of the corporate culture, feelings of internal equity, the belief that the organization stands for something, and a sense of organization wide integration which may make a career moves easier and can support cooperation. It also eases the job of communicating and understanding what is going on in different parts of the organization. The decentralized strategy allows for local innovation and practices which fit particular businesses and strategies.

Just as is true with many other of the critical choices, there is no right choice between a centralized and decentralized approach. Overall, a decentralized system tends to make the most sense when the organization is involved in businesses that face different markets, and perhaps, are at different points in their maturity. It allows those unique practices to surface which can give a competitive advantage to one part of the business but may prove to be a real hindrance or handicap to another. For example, such perquisites as cars are often standard operating procedure in one business while they are not in another. Similarly, extensive bonuses may be needed to attract and to motivate individuals in a start up business but make little sense in a more mature business.

### **Degree of Hierarchy**

Closely related to the issue of job-based versus competence based pay, is the strategic decision concerning the hierarchical nature of the reward systems. Often, no formal decision is ever made to have a

hierarchical or an egalitarian approach. A hierarchical approach simply happens because it is so consistent with the general way organizations are run. Hierarchical systems usually pay people greater amounts of money and give greater perquisites and symbols of office as they move higher up in the organization. The effect of this approach is to strongly reinforce the traditional hierarchical power relationships in the organization and to create a climate of different status and power levels. In steeply hierarchical reward systems, the reward system usually has more levels in it than the formal organization chart and as a result, creates additional status differences.

The alternative to a hierarchical system is one in which differences in rewards and perquisites that are based only on hierarchical level are dramatically downplayed. For example, in those large corporations that adopt an egalitarian stance pay systems may contain just a few broad bands and such things as private parking spaces, executive restrooms, and special entrances are eliminated. This less hierarchical approach tends to encourage decision making by expertise rather than by hierarchical position, and it is supportive of team work and vertical integration.

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

### **Communication Policy**

Organizations differ widely in how much information they communicate about their reward systems. Some organizations are extremely secretive, particularly in the area of pay. They forbid employees from talking about their pay, give minimal information to individuals about how rewards are decided upon and allocated, and have no publicly disseminated policies about such things as market position, the approach to gathering market data, and potential increases and rewards. At the other extreme, some organizations are so open that everyone's pay is a matter of public record, as is the organizations pay philosophy. In addition, all promotions are subject to open job postings, and in some instances peer groups assess the eligibility of people for promotion.

The cultural differences between an open and a closed communication policy in the area of rewards is enormous. Like all the other choices that must be made in structuring a reward system, there is no clear right or wrong approach. Rather, it is a matter of picking a position on the continuum from open to secret that is supportive of the overall culture and types of behavior needed for organizational effectiveness. An open system tends to encourage people to ask questions, share data, and ultimately be involved in decisions. On the other hand, a secret system tends to put people in a more dependent positions 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 distortion about the actual rewards that people get and creation of a low trust environment in which people have trouble understanding the relationship between pay and performance. Thus, a structurally sound pay system may end up being rather ineffective because it is misperceived if strong secrecy policies are in place.

Open systems put considerable pressure on organizations to do an effective job in 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. Ironically, therefore, if an organization wants to spend little time administering rewards, but still wants to base pay on merit, 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 pay decision-making process. Further, if individuals are to be actively involved in decisions concerning reward systems, they need to have information about policy and practice.

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

Reward systems 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 certainly fits well with an organizational management style that emphasizes hierarchy, bureaucracy, and control through the use of extrinsic rewards. It does not fit,

however, with an organization that believes in more open communication, higher levels of involvement on the part of people, and control through individual commitment to policies. It also doesn't fit when expertise is broadly spread throughout the organization.

There have been a number of reports of organizations experimenting with having employees involved in the design of pay systems. For example employees have been involved in designing their own bonus and gainsharing systems and the results have been generally favorable (Lawler, 1990). When employees are involved, it leads them to raise important issues and to provide expertise which is not normally available to the designers of pay systems. Perhaps more importantly, once the system is designed the acceptance level of it and the understanding of it tends to be very high. This often leads to a rapid start-up of the system and to a commitment to see it survive. Not surprisingly it has been shown to be related to the success of skill-based pay systems.

There also has been some experimentation with having peer groups and lower level supervisory people 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 team based plants which use skill based pay. 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 usually goes well. In many respects this is not surprising since peers often have the best information about performance, and thus, are in a good position to make a performance assessment.

### **Pay System Integration And Fit**

Our discussion has focused on designing the individual elements of a pay strategy so that they fit with the business strategy. This is a critical first step in creating a strategic pay systems but it is not last. Once a clear picture has been developed of the pay practices which are appropriate for an organization it is important to look at them as an integrated whole in order to determine if they are in alignment with each other. It is also important to see how they fit with the overall management style of the organization and the basic information, communication and decision processes in the organization. Ultimately it is alignment of all of these features which will determine the effectiveness of the organization and it's ability to effectively implement its strategy.

Table 1 presents a basic alignment model with respect to a set of pay practices. It argues that if the business strategy calls for a traditional management strategy that should lead to a set reward system practices which fit together in a way that supports hierarchy, bureaucratic control, and top-down authority. In contrast to this are the pay practices which fit with an involvement oriented organization which

emphasizes teams, lateral processes, and knowledge-based decision making. It calls for reward system practices that emphasize involvement in decision making and the operation of the business.

<b>Table 1 Pay &amp; Management Style</b>		
	<b>Traditional Management</b>	<b>Employee Involvement</b>
<b>Communication</b>	Secret	Open
<b>Decision Making</b>	Top Down	Wide Involvement
<b>Structure</b>	Centralized	Decentralized
<b>Pay for Performance</b>	Merit Pay	Business Success Based
<b>Base Pay</b>	Job Based	Skill Based
<b>Degree of Hierarchy</b>	Steep Level Effect	Egalitarian

In conclusion, the challenge in the new pay is to obtain alignment among the elements of an organization so that they support the business strategy. The new pay does not necessarily mean new practices or even the abandonment of the traditional pay model. Rather, it means a strategically informed adoption of particular pay practices and evaluation of the success of these pay practices in terms of their contribution to the organization's strategic effectiveness. Implementing the new pay requires an understanding of the many options that are available with respect to how pay systems are designed and administered. It also requires an understanding of the business strategy and how pay systems can produce organizational behavior which is supportive of particular business strategies.

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