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# CREATING EFFECTIVE PAY SYSTEMS FOR TEAMS

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**Creating Effective Pay Systems for Teams**

Edward E. Lawler III

Rewards are an important element in any formal organization. In order to be effective, organizations must answer the fundamental question of why individuals should commit their time, effort, and ideas to it. Creating a good alignment between the way an organization rewards its members and the strategic agenda of the business in order to accomplish this is a major challenge. There are an infinite variety of approaches to rewarding individuals for their performance and for their membership in organizations. There also are a wide variety of approaches to organizing and managing complex organizations. In this chapter, the focus will be on specifying the correct mix of rewards for organizations which adopt teams.

The traditional approach to designing work organizations calls for hierarchical decision making, simple repetitive jobs at the lowest level, and rewards based on carefully measured individual jobs and job performance. This "control approach" is losing "market share" to more involvement or high performance approaches to management (Lawler, Mohrman and Ledford, 1995). The advantages of the involvement approach are said to be greater organizational efficiency, including higher quality products and services, greater speed, less absenteeism, less turnover, better decision-making, better problem-solving and lower overhead costs; in short, greater organizational effectiveness (Lawler, 1996).

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

- *Information* about the performance of the organization.
- *Knowledge* that enables employees to understand and contribute to organizational performance.
- *Power* to make decisions that influence organizational direction and performance.

Some approaches to involvement also consider how pay systems should be changed as part of a change to a more involvement-oriented management approach. They generally favor rewards based on group or organizational performance, but do not describe in detail how pay should be designed to fit particular involvement practices. Others simply suggest paying everyone "fairly" in order to avoid the dysfunctional effects of paying for performance.

Teams have emerged as a widely used vehicle for facilitating the movement of power, information and knowledge to lower levels of an organization. As mentioned in the introduction to this book, survey data indicate that most U.S. corporations currently use one or more of the major types of teams (Lawler, Mohrman, and Ledford, 1995). As was also mentioned, they do not take a single

approach to teams; they use a variety of teams that have different designs and purposes. All types of teams, however, share at least one common attribute: in order to be effective, they require a supportive reward system (Lawler and Cohen, 1992; Mohrman, Cohen, and Mohrman, 1995; Wageman, 1995). Not surprisingly, traditional pay systems that emphasize individual jobs and performance are not adequate.

Selectron Corporation provides an interesting example of an organization that found it needed to change its reward system in order to support the creation of self-directed production work teams. Selectron is a very successful Silicon Valley high tech corporation with 14,000 employees worldwide. It is a contract manufacturer of circuit boards and it packages software. It is well known for its high quality products and rapid growth. Selectron is one of the few high technology firms to win the Baldridge Award (1991), and grew from 265 million dollars of revenue in 1991 to 2.8 billion in 1996. In 1997 it became the first company to win the Baldridge Award twice.

Despite its success, in the early 1990's it decided that it needed to improve its performance because of growing competition and a shrinking competitive advantage. This led it to create a variety of teams. The most common form was self-directed production teams that were charged with responsibility for an entire part of the production process (Seaman, 1997). In their California manufacturing operations 240 teams were created.

When Selectron began its movement to teams, a company-wide variable pay plan was already in place. It began in 1985, and involved discretionary bonuses that focused more on effort than on performance, and had no ability to focus on team performance. It did not support the right team behaviors and as a result a participative design process was begun to create a team-based pay plan. The new plan was installed in 1995 (Zingheim and Schuster, 1997b).

The team-based bonus system is funded by a measure of location profit, and return on assets. It provides a quarterly bonus payment to the members of all teams. The company set the maximum bonus that individuals could earn at a conservative five percent of their base pay. The amount the members of individual teams receive is based on the quality of their teams' output, and their teams' productivity against a team standard. The individual team members share equally in the dollar payout amounts. Temporary employees participate in the plan as do non-exempt employees who are not on teams. Non-team members are expected to set individual goals.

The goals of individual teams are based on a negotiation process with the team manager that led to the setting of different goals for each team. This is required because of the different products that are produced in the teams. One of the most unusual features of the Selectron variable pay plan is that it was participatively developed, in order to develop commitment to the plan on the part of team members as well as managers. There was also an effort to be sure that the development process fit the overall management style of the organization. An extensive communications and training program was used to introduce this plan. Since the plans introduction an extensive meeting and communications programs has been used to develop a more in depth understanding of the plan.

The results of the pay plan implementation have been positive. The quality and productivity performance of the teams has improved (Seaman, 1997). In addition, overall satisfaction with the pay system has improved significantly because individuals feel that they have more control over how much they are paid. The pay plan has also encouraged individuals to learn more about the organization's financial performance, and the overall performance of the organization. A key element of the plan is the public posting of team goals. This has tended to stimulate teams to reach their goals and has lead to peer and manager recognition for performance.

Interestingly, the group providing the biggest obstacle to the successful installation of the variable pay plan was the managers. They saw it as causing them to loose power, and raised a number of concerns that slowed the implementation process. The organization repeatedly stressed to the managers that the changes were needed to meet competition, and that it was critical to the long term success of the organization that this plan be installed and be successful. The results seem to justify the installation of the plan. Among other things, the defect rate has gone down substantially, saving the organization eighteen million in the first nine months the plan was in place (Seaman, 1997).

The installation of the team variable pay plan did not, address all the pay issues that the installation of teams raised. As teams developed, more and more questions were raised about the merit pay system and the determinants of base pay. Team members questioned the validity of this whole approach to pay as they began operating in teams. Job descriptions have become more difficult to maintain, and as a result, the organization is increasingly giving more and more consideration to installing a skill-based pay system to replace their traditional job-based merit salary increase system.

Overall, the movement to a team-based pay plan at Selectron seems to have improved the fit between the pay system and the organization design and management style of the organization. This occurred because it shifted what was measured, and how teams were rewarded. It also is, in part due to the involvement that occurred in the design of the plan, and to the extensive communication and training process that was associated with its implementation. It most likely, however, is not a completed change effort. The fit between a team-based organization design approach and individual job-based pay system is poor. And as a result, Selectron will most likely have to continue to do further redesign work on its pay system.

As is illustrated by the Selectron example, in order for teams to be optimally effective a reward system is needed that recognizes the kinds of behavior and skills that are needed. The challenge is to create a fit between the characteristics of the reward system and the characteristics of the team. Because teams differ, no reward system design is likely to be universally effective. The key is to design a reward system which fits the characteristics of the team and the organizational context in which it operates. This is not a simple task. It requires an approach which chooses among the major pay system design options based on the outcomes they will produce when they are applied to a particular type of team in a specific environment.

Our consideration of the design choices will first look at the outcomes which pay can effect and then it will consider two major design decisions: how to determine base pay and how to pay for performance.

## Reward System Objectives

Reward systems in general, and pay systems in particular, can affect individual and organizational behavior in important areas (Lawler, 1990). The research on reward systems suggests that they influence a company's strategy implementation and overall effectiveness in six ways:

1. *Attracting and Retaining Employees*. Studies on job choice, career choice and employee turnover clearly show that the types and level of rewards an organization offers influence the types of employees it attracts and retains. Overall, companies that offer the most rewards tend to attract and retain the most people. However, different types of rewards appeal to different types of people. For example, high levels of risk compensation may attract entrepreneurial personalities, while extensive, security-oriented benefits generally attract those who like to avoid risk. Individual incentive plans attract people who want to operate on their own and control their own fate while collective rewards are more likely to attract individuals who like shared responsibility and collective action.

2. *Motivating Performance*. Reward systems can motivate performance when certain conditions exist. What are those conditions? Employees must perceive that the organization ties important rewards—in a timely fashion—to effective performance. They also need to feel that they can influence the type of performance which drives pay. People have mental maps of what the world is like, and they use these maps to choose the behaviors that will lead to outcomes that satisfy their needs. Employees are inherently neither motivated nor unmotivated to perform effectively; their motivation depends on the situation, how they perceive it, and what rewards they need and value.

   In general, an individual is most motivated to behave in a certain way when he or she believes that behaving in that way will lead to outcomes that are attractive. This is often referred to as a line of sight. They also need to believe that they can behave in rewarded ways, and that it is possible to perform at the desired level. These conditions have clear implications for pay systems: to be motivational, the systems must create a clear and achievable line of sight between a person's behavior and the receipt of amounts of pay that are important to them.

3. *Promoting Skills and Knowledge Development*. Just as pay systems can motivate performance, they can encourage employees to learn and develop new skills. The same motivational principles apply, thus individuals focus on learning the skills a company rewards. Some organizations have implemented skill based pay, a relatively new compensation approach, to capitalize on this very point. With skill based pay, they can

strategically target the types of learning they want employees to acquire and as a result improve their ability to perform in strategically important ways. By contrast, many job-based systems tie increased pay and perquisites to higher level jobs, thereby encouraging individuals to learn those skills which they feel will lead to a promotion.

4. *Shaping Corporate Culture*. Along with other organizational features, reward systems help define culture. A company's approach to developing, administering and managing reward systems can influence many facets of an organization's culture. For example, reward systems can influence the degree to which employees view a company as a human resources oriented culture, an entrepreneurial culture, an innovative culture, a competence-based culture, a team-based culture, an entitlement-based culture and a participative culture.

   Reward systems can shape culture precisely because they have such an important effect on employees' skills, motivation, satisfaction, and sense of what is important to the organization. The behaviors they promote become the dominant patterns of behavior in the organization and influence employees' perceptions and beliefs about what the company stands for , believes in , and values.

5. *Reinforcing and Defining Structure*. Pay systems can reinforce and define an organization's structure. Often this is not considered when pay systems are designed. Thus, their impact on structure is unintentional. But that doesn't mean the impact is minimal. Pay systems primarily effect the level of integration and differentiation in an organization. People tend to unite when they are rewarded in the same way and divide when they are treated differently. In the case of a group they can cause the individuals in it to pull together or to compete with each other. They can also cause teams to compete with each other as well as to cooperate with each other, depending upon whether the teams compete for rewards or share equally in a reward pool that is influenced by the performance of multiple teams. In addition, pay systems can help define a company's status hierarchy and strongly influence the types of decision-making structures and processes which exist.

6. *Determining Pay Costs.* Reward systems often represent a significant cost factor; pay alone makes up more than half of many companies' operating costs. Therefore, the system designer must focus on how high these costs should be and how they will vary with the organization's ability to pay. For example, a reasonable outcome of well-designed pay systems might be an increase in costs when the company has money to spend and a decrease in costs when it does not. Another objective might be to have lower overall reward-system costs than do competitors.

Overall, because reward systems affect so many critical features of an organization, they are a crucial determinant of strategy implementation and organizational effectiveness. In order for a strategy to be successfully implemented, the reward system needs to be aligned with it in at least two respects. First, it needs to reward those behaviors which the strategy calls for. Second, it needs to support the

development of those organizational capabilities and core competencies which are needed in order to execute the strategy.

## Design Options

In designing an organization's reward system, dozens of design decisions need to be made. All of them are important but two have a particularly important impact on the effectiveness of teams (Lawler, 1990). The first involves whether the pay system is based on a job description approach or a skills / competency approach. This feature is a critical determinant of the capabilities of individuals, teams, and the total organization. The second is how, if at all, the organization chooses to pay for performance. This feature is, of course, a critical determinant of whether individuals are motivated to perform effectively. It also effects the structure and culture of the organization in important ways. We will focus on these design decisions in the remainder of this chapter.

## Paying the Job or the Person

For decades, organizations have based their financial reward systems on the types of jobs people do. Indeed, with the exception of individual incentive pay, sales commissions, and merit salary increases, most organization take the approach of evaluating the job, not the person, to set a pay level. This approach assumes 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. Job-evaluation programs and salary surveys are used to determine what other organizations pay for the same or similar work. Pay grades are created, often as many as 40, and jobs are placed in one of the grades based on the results of the job evaluation. This approach has several advantages: it can assure an organization that its compensation costs are not dramatically out of line with those of competitors, and it gives a somewhat objective basis for pay rates.

### *Paying for Skills*

The major alternative to job-based pay is to pay individuals for the skills and/or competencies they possess. Rather than reward people for scaling the corporate hierarchy or "growing" their jobs, the company rewards them for increasing what they can do. This approach generates very different corporate cultures and employee skill development patterns. Skill-based pay can help to create a culture of concern for personal growth and development and a highly talented workforce. In factories that use this system, it typically means that many people can perform multiple tasks, resulting in a highly knowledgeable and flexible labor force.

One of the first skill-based pay plans in the United States was installed in a General Foods plant in Topeka, Kansas over two decades ago (Lawler, 1978, 1986). The plant had a skill-based pay from its inception. Its approach to skill-based pay encouraged individuals to learn all of the tasks that their team was asked to perform. As individuals were certified as having learned the skill, they got anywhere

from 25 to 50 cents added to their hourly pay rate. Over time, most individuals reached the top pay rate; in effect, they almost doubled their pay from their entry wage rate. Skill certification was handled by a peer appraisal process, except in a few cases where technical experts were brought in to certify more complex skills.

The approach used in this plant is very similar to ones that are used in many manufacturing locations today. It is used most commonly in process technology operations such as chemical plants, oil refineries, and other situations where highly interdependent team behavior is needed. This pay per skill learned approach typically is not used in union situations. In them two, three, or four pay rates are established; over time, individuals progress from an entry wage to a fully skilled wage (often level two), and then some continue progressing to an expert level. This progression is based on them learning certain identified packages of skills, and in that respect, it is quite similar to the pay per skill learned approach. But instead of pricing individual skills, it simply bundles them together, sometimes giving individuals choices about which sets of skills they learn in order to complete a package which will allow them to "be promoted" to the next higher pay rate. This approach is somewhat simpler to administer than the pay-per-skill approach since it involves fewer pay rates.

An alternative to traditional job-based pay plans that is used in some team situations is to establish a small number of very flexible, generic job descriptions. This approach reduces some of the dysfunctional features of a traditional job-based system but does not incent individuals to learn a specific mix of skills that can contribute to team effectiveness.

In most cases, skill-based pay tends to produce somewhat higher pay levels for individuals, but these costs usually are offset by greater workforce flexibility and performance (Jenkins, et al., 1992). Flexibility often leads to lower staffing levels and less absenteeism and turnover, both of which may drop because employees appreciate the opportunity to utilize and be paid for a wide range of skills. On the other hand, skill-based pay can be a challenge to administer. To date, for example, there are no well-developed systems for determining the worth of individual skills in the marketplace.

In general, skill-based pay seems to fit well in companies that want a flexible, relatively permanent workforce oriented toward learning, growth, and development. Many new team-based plants use this approach, as do plants that are moving toward high-involvement management methods. In addition, more companies are applying skill-based (often called competency-based) pay to knowledge workers, managers, and service employees where the strategy calls for high performance teams or one-stop service and a high level of customer focus and satisfaction. Examples here include American Express, Frito-Lay and Aid Association for Lutherans.

***Fit with Teams***

Table 7.1 summarizes what has been said so far about job-based versus skill-based pay. The characteristics associated with skill-based pay seem to be a much better fit for most types of teams than are those associated with job-based pay. A key requirement for the effective operation of any kind of team is learning on the part of team members. They need to learn about how to operate as team members, often they also need to develop new technical knowledge about the organization and its work processes and methods. This is particularly true when the team is self-managing and when the individual team members need to work in a highly interdependent mode. Properly administered skill-based pay or competency-based pay can be a powerful tool for encouraging individuals to learn what is necessary in order to make teams effective.

Insert Table 7.1 about here

A key issue in many types of teams is the management of lateral processes. This is often best facilitated by individuals on teams learning multiple steps in production and service processes, so that they can communicate with individuals who are before and after them in the process, and participate in lateral process management activities. Paying for skills also creates the possibility of varying individuals' pay by the amount of skill and knowledge that they can contribute to a team. Highly skilled individuals can be paid more, and this is an important retention device, particularly in environments where knowledge and skill are an important key to team effectiveness and competitive advantage.

### *Types of Teams*

There is some variation among the skill needs of the different types of teams, thus the importance of using skill-based pay, as well as the kind of skill-based pay that is needed, varies somewhat from one type of team to another. Parallel problem solving teams (e.g., quality circles and suggestion teams) are often the ones that have the least need for skill-based pay. They rely on individuals contributing their ideas to various problem solving activities. Since the team activity is not a full-time commitment on the part of the people, investing heavily in learning additional skills is often not worthwhile. A few additional skills may be needed to aid with problem solving and group process, but these are often learned by individuals without their needing to be paid for them. Skill-based pay that encourages cross-training like the pay per skill approach can sometimes be a significant aid, because it gives individuals a better overall understanding of the work process. It also can improve people's ability to problem solve, diagnose, and innovate in work system design. There remains the question, however, whether it is worth investing in cross training simply so that people can participate for short periods of time in parallel teams.

The situation, with respect to the advantages to skill-based pay is quite different when the teams involved are self-managing production and service teams. Here, individuals typically spend all their time in a single team, and there is a great need for learning and development. Depending upon the kind of production or service process the individuals are in, this learning may involve simply cross-training, so that individuals can understand the entire work process and better coordinate their work. Alternatively, it may involve developing particular kinds of management and technical expertise so that supervisors and

staff support are not needed. This latter type of skill-based pay is particularly important if the team is doing complex knowledge work, and it is impossible for any one individual to learn all the knowledge necessary to address the kind of issues that come up as a team does its work. This is often true in management, project, and action teams. A typical approach in this case is to identify a few individuals as depth experts in various areas, and to reward them with extra pay for their depth expertise. In the absence of a skill-based pay system, there is often no way to reward this kind of depth. Many organizations, for years, have recognized this fact by putting in technical ladders, which reward individuals for becoming more and more expert in a particular topic. Bell Labs had one of the best known systems. It relied on maturity curves and promotion to provide a career track for their scientists that covered new graduates to Nobel Prize winners. Typically these technical ladders, however, do not reward breadth of skills, and thus there is nothing to encourage an individual to develop team skills and understand other parts of the work process.

Project teams are a form of team, where skill and knowledge-based pay is a particularly good fit. A key success factor in knowledge work teams of ten is the presence of some individuals who have knowledge of multiple functions. In job-based pay systems, it is hard to get individuals to learn multiple functions, because there is usually no reward, and indeed, there may be a punishment for learning a second function, for example, marketing or engineering. When complex project work is involved, it is often impossible to have a person who has a good knowledge base in all of the functions that are required to make for a successful project. This doesn't mean that there can't be a number of individuals who have mastery outside of the single function, however. This is critical to allowing the project team to integrate its work and to make good trade-offs among the demands of the different disciplines in developing a new product or service (Mohrman, Cohen, and Mohrman, 1995).

In order to encourage lateral career moves, an organization often has to do more than simply have a pay per skill approach. Often, lateral career tracks need to be developed, so that individuals will be significantly rewarded for making cross-functional moves that don't necessarily involve moving to a higher level of responsibility or a higher pay grade. In the absence of such a structure, typically, individuals run the risk of actually losing money by making a lateral move. This can come about because they don't move into a higher pay grade and they are in an area where they are not an expert, thus are likely to loose out in the case of merit pay increases or bonuses which are based upon performance. While they are learning a new function, they are at a disadvantage when competing for pay increases, since the other individuals in the area are already experts in the function.

If a project team's work involves complex knowledge work, depth expertise in one or more areas is often critical to its success. Knowledge-based pay, which rewards people for developing deeper and deeper levels of expertise, as in a technical ladder, can be a very helpful tool here. It not only rewards people for developing important knowledge; it helps to retain the technical experts in the organization by paying them more than they would be paid in many traditional job-based structures. The typical approach here involves defining multiple levels of technical expertise in disciplines such as engineering, accounting, finance, and human resources. Each level has a set of skill descriptors attached to it, and when individuals demonstrate that they have mastered the skill set at a new level, they are given a "promotion and a pay increase," recognizing their additional skills and knowledge.

### *Conclusion*

Given the positive fit between skill and knowledge-based pay and teams, it is not surprising that the research evidence on the use of this approach to pay shows that it is most frequently used in team environments (Lawler, Mohrman and Ledford, 1995). This is particularly true with respect to production and service teams. They make more use of skill or knowledge-based pay than any other kind of team structure. A good guess is that the combination of skill-based pay and teams started in the 1950's in Scandinavia, and continued in the 1960's in the United States when the first team-based manufacturing plants were created. Today the evidence is that it is the predominant pay practice when production and service teams are used. There is less knowledge available on how much skill based pay is used in conjunction with project teams, and other kinds of teams. A good guess is that project teams in particular tend to stimulate its adoption, and the abandonment of job-based systems.

As more and more organizations move toward being team-based overall, the pressure to change to skill and knowledge-based pay is likely to grow. This very much ties into the point made earlier in this book, that in team-based organizations, individuals don't so much have jobs as they have temporary task assignments. Given this situation, it is unrealistic to base someone's pay on their job. It makes more sense to pay them based on the value they can add to the organization, that is their skills and knowledge. This also encourages them to learn skills and knowledge which can help them add more value in the organization.

Insert Table 7.2 about here

Table 7.2 summarizes what has been said about the applicability of skill and knowledge-based pay teams. As can be seen, slightly different forms of pay for skills fit each of these types of teams. Thus, the challenge is to design skill and knowledge-based pay systems which fit the type of team that is the focal point of the design process.

## Performance-Based Pay

The most important strategic decision a company must make about its reward system concerns whether and how pay will be based on performance. Although paying for performance is the most common approach in the United States it is not the only approach that can be or is used. One alternative is seniority-based pay, frequently used by government agencies in the United States and in other parts of the world. Many Japanese companies base pay on seniority, although they often give bonuses tied to corporate performance.

Most U.S.-based businesses say they reward individual performance through a merit system. But creating an effective merit pay system is easier said than done (Kerr, 1975; Heneman, 1992). In fact, some observers have concluded that many organizations would be better off if they didn't try to

relate pay to performance and relied on other factors to motivate performance (Kohn, 1993). The main reason: Companies find it difficult to specify the types of performance they desire and to determine whether or not employees have demonstrated them. A second reason is the fear that it will reduce intrinsic motivation. Despite the attention this fear receives, the research evidence does not support the view that it is a serious problem (Cameron and Pierce, 1997).

Organizations face a lot of choices in how they relate pay to performance. They must determine what kinds of rewards they will give (possibilities include stock, cash and a variety of other options); how often they will give them (ranging from time periods of a few minutes to many years); and whether performance will be measured at the individual, group or organizational level. Finally, they must determine what kinds of performance will be rewarded. For example, managers might be rewarded for sales increases, productivity volumes, cost-reduction ideas, the ability to develop subordinates, and so on. Teams can be rewarded for quality and productivity as is the case in selection, but they can also be rewarded for safety, cost reductions, and helping other teams.

Rewarding some behaviors and not others has a major effect on performance, so a company must pay close attention to its strategic plan in deciding what to reward. Once it develops a strategic plan, it can define key performance objectives and design reward systems to motivate the appropriate performance. In the process, pay-system designers should consider issues such as short-term versus long-term performance, risk taking versus risk aversion, individual performance versus team performance, team performance versus total corporate performance, cash versus stock, and ROI maximization versus sales growth. An organization can only make effective decisions about an issue, such as whether to use stock options and what to reward, after it has carefully considered what it supports the desired behaviors.

Three general points about relating pay to performance bear mentioning here. First, bonus plans generally do a better job of motivating employees than do pay raises and salary increase plans ( Lawler, 1990). The reason is simple: with them, an individual's pay can vary substantially from time period to time period, while a raise usually becomes an annuity and as a result does little to relate current pay levels to current performance.

Second, objective performance measures are better motivators than subjective measures. In general, employees assign higher credibility to objective measures, such as sales volume or units produced (Lawler, 1990). Thus, they often accept the validity of these measures when they will not accept the validity of a boss's rating. Thus, an organization that ties rewards to objective measures typically can create a much more credible link between pay and performance than can one that bases pay on subjective, nonverifiable measures, such as a supervisor's rating.

Third, group and organizational plans generally work best in creating integration and teamwork (Schuster and Zingheim, 1992; Zingheim and Schuster, 1997a). Under these plans, it is usually to everyone's advantage that each person work effectively because all share in the financial results of higher performance. When people feel they can benefit from another's actions, they are likely to support and encourage good performance by others (Wageman, 1995). This is not true under

individual plans, which tend to produce differentiation and competition. On the other hand, group and organizational bonus plans separate individual behavior from rewards and as a result have a more difficult time establishing a clear line of sight from individual performance to the reward.

Insert Table 7.3 about here

Table 7.3 elaborates a little more completely the consequences of different pay for performance approaches. As can be seen, they have quite different impacts. In reviewing the right combinations of them for different kinds of teams we will look separately at parallel, work, and project teams.

### *Parallel Teams*

Because parallel teams do not represent a fundamental change in the structure of organizations, they have the fewest implications for the reward system. Some argue that no pay for performance-system changes need to be made in order to support their operation. However, there is evidence that rewards can and should be used to motivate effective problem-solving.

Advocates of participative management have suggested for a long time that the Scanlon plan and other gainsharing plans that share cost savings with all employees fit extremely well with the use of problem-solving teams (Lawler, 1986). There is a history of more than 40 years of combining suggestion groups with the type of cost-saving bonuses that are part of the Scanlon plan and the research shows very positive results. Virtually every review of these plans argues that it improves the economic performance of an organization (Lawler, 1990). It works particularly well when it is combined with open financial-information systems and participative decision-making. The major motivational weakness with gainsharing plans is that the line of sight between a suggestion and the size of a bonus is weak. A group can make a major breakthrough and receive only a small bonus in return because the savings are shared among all employees in an organization.

Profit sharing and stock option and stock ownership plans that cover all employees also can be somewhat supportive of problem solving groups. They distribute financial rewards that may be somewhat related to the effectiveness of the problem solving groups and to the implementation of their ideas. Their major weakness, of course, is line of sight, and thus, in many instances (e.g. in large organizations) they do not have a significant impact on the effectiveness of the problem solving groups.

Donnelly Mirrors is a good example of a company that over decades, has worked hard to relate their problem solving activity to the size of their bonuses (Frost, Wakeley, and Ruh, 1974). Through extensive education and communication programs, they have done a good job of informing the workforce both about the economics of the business, and about the financial impact of the suggestions that the workforce develops through their problem solving meetings.

Donnelly is not an isolated example. A number of other Scanlon companies, such as Dana Corporation and Herman Miller, have used the same approach. It is hard to determine exactly how

good a line of sight has developed, but there is little doubt that the logic of bonuses for everyone based on improvement suggestions is well accepted, and generally seems to be meaningful.

The alternative to gainsharing and profit sharing is to give bonuses, stock or other valued rewards to teams for their suggestions. A number of organizations have used this approach, which, in most respects, is simply a group version of the classic individual-suggestion-program approach. An estimated savings amount is calculated and individuals who contribute to the idea are given a percentage of the estimated savings. It closely ties the development of the idea to the financial bonus. It involves a number of risks, however. Often, the estimated savings are not realized. Thus, individuals are rewarded even though the company does not gain. Further, individuals may feel they are not rewarded fairly because they only get a percentage of the savings. There are almost always issues of who should be included among the recipients of the bonus. Finally, most useful suggestions have to be accepted and implemented by many people. The classic suggestion program does not reward people for accepting and further developing the suggestion. Thus, they may not have the motivation that is needed to produce gains. Quite the opposite of course, is true with gainsharing plans where no one gains unless an idea is successfully implemented.

What clearly is incompatible with parallel suggestion teams is the use of individual suggestion systems that reward individuals. They are in direct conflict with the idea of teams developing ideas. They reward the wrong kind of behavior and compete directly with group-suggestion and problem-solving approaches. In cases where they have been used, individuals have been known to claim ownership of ideas that were developed as part of the group problem solving process. In some cases, they have submitted them through individual suggestion reward programs, in order to try to get a personal bonus for an idea that was actually a product of a problem solving group. Also with them in place, individuals are much less willing to share their ideas and thoughts in a group setting than they are where only collective rewards for groups developing a suggestion are offered.

A number of organizations use a recognition approach in order to reward teams for their successes. Unfortunately, there is virtually no research evidence to indicate how effective recognition rewards are in this application. The variety of recognition vehicles used is enormous. Some companies emphasize appearances before senior executives, while others give symbols that, in some cases, involve significant outlays of money (e.g., clocks, TV's). Although little research has been done on recognition programs, an educated guess is that they can be powerful if they are used astutely. The key is to give them when groups accomplish something significant and to deliver a reward that is valued by the group.

Determining what is valued by a group can be a challenge. Obviously, there are cultural differences in how much various types of recognition rewards are valued. For example, there may be differences within a group as to the value of a trip to a ballgame or a chance to present an idea to the CEO. With the exception of the issue of how much recognition rewards are valued, most of the other considerations with recognition programs are the same as those involved in giving financial rewards for producing an idea.

Xerox Corporation provides a good example of a company that has extensively used recognition to reward quality improvement teams. They run a very high quality national TV broadcast that features the improvement ideas of carefully selected teams. There is no question that this is a powerful reward, and that teams compete quite hard for the honor of being on the telecast, and receiving the attention and recognition that it provides. It helps that the CEO of Xerox hosts the program and is knowledgeable about the suggestions that have come out of the individual groups.

### *Production Teams and Service Teams*

Perhaps the most common way to reward the members of work teams today is to appraise their individual performance. Instead of rewarding the team as a whole, organizations simply add a dimension to the performance appraisal of individuals that focuses on how good a team member they are. This usually counts towards their overall appraisal, and determines the amount of pay increase or bonus they get. In essence, it continues the historical individual pay for performance practices of most organizations, but adapts it slightly to a team-based environment. In some ways, it is a conflict in direction that can be self-canceling with respect to effective team behavior. It asks individuals to compete for a given amount of money, but changes the basis of the competition from individual performance to performance as team member. In other words, individuals end up competing with other team members for who is the most helpful, cooperative, and best team member. This, of course, fails to change the performance focus from the individual to the team, and does nothing to get individuals to focus on how effectively the team is performing. Thus, it makes sense to use this only where work teams are loosely interdependent, and need a minimum of highly interdependent behavior in order to be effective.

There are three ways of directly rewarding performance at the team level. First, rewards can be tied to team performance through the use of a merit-pay system that bases salary increases or bonuses on a team performance appraisal. Second, special awards can be provided to teams in order to recognize outstanding performance. Third, a gainsharing or profit sharing plan can be used. They can be structured so that they pay all teams the same bonus or, as is the case in Selectron, so that they pay bonuses that are funded by the overall plan but adjusted to reflect the performance of particular teams.

The most powerful way to motivate team performance is to establish objectives and metrics for successful team performance, and link rewards to team success (Mohrman, Mohrman and Lawler, 1992). Merit pay in the form of salary increases or bonuses can be distributed equally to team members based upon the results of a team performance appraisal. In order for team performance pay to work, there must be clear and explicit objectives, accepted measures and good feedback about team performance (Abosch and Reidy, 1996). Team performance appraisals provide opportunities for teams to conduct self-appraisals and obtain customer evaluations. These data can be used to assist managers in the determination of team ratings.

Frequently, managers are uncomfortable with giving the same size reward to all team members, so they differentially reward individual performance. This is potentially a counter-productive action.

Providing different rewards to individual team members can undermine cooperation and collective effort. Further, if there is high interdependence among team members, often it is not possible to measure individual performance accurately; as a result, the rewards are not based on valid measures of performance.

If the work of team members is not highly interdependent, then it may make sense to combine team and individual merit pay (DeMatteo, Rush, Sundstrom, and Eby, 1997). A bonus pool can be created based on team performance, with the amount divided among members based on the kind of measures of individual performance that were considered in the previous chapter. For this not to be divisive, it is critical that the manager solicit input from team members about the relative contributions of individual members. A mature work team may be able to use a peer evaluation system to differentiate individual rewards based on individual contributions to the team's performance. It is possible to have teams do appraisals of individuals, in which they divide up a pool of money that originally was generated by the effectiveness of the team. This, in effect, rewards individuals for being cooperative in producing the bonus pool, but still recognizes individual performance. It is more effective if team members assess team performance before they assess individual performance, because team performance sets the framework for individual performance.

The experiences of Motorola highlight a major problem with team-based rewards. For years, Motorola had team-based incentive plans in many of their manufacturing facilities. The bonuses were often quite large, and were targeted to meeting specific performance objectives. In many cases, they did motivate the teams to perform well as teams, but they did a poor job of recognizing the interdependencies that existed among the teams. Since Motorola tends to have large manufacturing facilities which do relatively complex work, their teams often need to cooperate with each other in order to produce a product, and they need to share a number of key services such as maintenance and technical support. Because of the team incentive plans, a considerable amount of conflict developed among the teams over who got first access to help and support, and there was tremendous focus on the inequities that were perceived to exist when some teams got large bonuses while others did not. Ultimately, Motorola decided to abandon their team-based incentive plans because they failed to produce a general cooperative environment in the workplace, and they caused too many parts of the organization to optimize their performance at the cost of the performance of the overall organizational performance. The learning from Motorola is clear. Strong team incentive plans should be used only where teams operate relatively autonomously with respect to their production and service needs.

The second way of linking pay to team performance is through the use of special award or recognition programs. In contrast to appraisals with goals and formula-driven approaches, they reward exceptional performance after it has occurred. In order to be effective, special awards should be used only to recognize truly special team achievements. Because work teams perform ongoing and repeated work to produce products or services, performance that meets the requirements of customers should happen regularly, but extraordinary performance is likely to be rare. Therefore, special rewards often are best used to supplement and not to substitute for other team pay-for-performance systems. Special awards can be motivating and enhance team cohesiveness. There is a certain pride that comes from being associated with a successful team, and public recognition can solidify it.

Gainsharing, profit sharing, and stock plans are the third major approach that can be used to provide rewards for team performance. Gainsharing requires the work unit that is covered by it to be relatively autonomous and responsible for a measurable output as was mentioned earlier. These plans typically give the same amount of reward to all teams in a particular work unit or location. They suffer from a poor line of sight but can be effective and may be the best choice if the work of teams is highly interdependent (McAdams and Hawk, 1994). Gainsharing clearly provides the best line of sight and has been widely used to support and reward production teams in Weyerhaeuser, Monsanto, 3M and a host of other corporations that use production teams in factories whose process technologies create interdependent work. If the work is not interdependent then each team can be rewarded from a common bonus pool for its performance.

In choosing among the different approaches to rewarding teams, it is important to remember that, as the Motorola example highlights, rewarding a work team for its separate performance is not always appropriate. The critical issue here is the degree of integration and differentiation. If the team is not highly autonomous, then providing rewards at the team level may be counterproductive. When there are critical interdependencies between a team and other parts of the organization that need to be accounted for, rewarding a team for its own performance may push differentiation too far. For example, work teams in manufacturing plants often work separate shifts, and what happens during one shift affects other shifts. In addition, the interdependencies with staff groups may be important. When a work team develops its way of doing things and members become close, members may become myopic in their understanding of the needs of the broader organization, and sub-optimization can be the result. The use of a gainsharing or profit-sharing plan that rewards team members based on the performance of the larger organizational unit can serve to integrate the team into the rest of the organization and act as an offset to the strong cohesiveness that tends to develop in a work team.

In general, an organization composed of work teams needs to make sure its pay-for-performance systems motivate the right kinds of team performance. This often is best done through a mix of team-level and organizational-level pay-for-performance systems (Zingheim and Schuster, 1997a). The more that work teams stand alone as performing units, the more rewards should be focused at the team-level. The greater the interdependencies between work teams and functional groups, and among different work teams, the more that pay-for-performance systems should operate at the organizational level.

In very individualistic countries, such as the United States, there continues to be a strong demand for individual pay for performance (DeMatteo, Rush, Sundstrom, and Eby, 1997). Thus, it is very important how the assessment of individuals is handled in a team environment. The evidence clearly suggests that the assessment of individual performance should be handled in the context of the work team (Mohrman, Cohen and Mohrman, 1995). When teams are rewarded collectively, they will handle the problems associated with someone who is not contributing their fair share to the team's performance. They also, in many cases, will recognize and reward the best performers, since it is in everyone's best interest to have good performers on the team.

When the reward system formally recognizes individual performance, it reduces the pressure on the team to appraise and deal with poor performers. Indeed, in situations where the performance appraisal is a forced distribution rating system, it creates a situation where it is in the best interests of individuals to have some poor performers on their teams. Thus, they are much less likely to encourage and support performance improvement on the part of poor performers than when there is a collective pay situation in which poor performers hurt everyone's opportunity to earn a bonus.

It is unlikely that everyone will accept the idea of only having team or collective pay for performance, and no individual pay for performance. This brings us back to the point made at the beginning of the chapter on selection and attraction of individuals. In a team-based environment, individuals who are focused on getting the rewards for individual performance should not be put on teams.

### *Project and Management Teams*

Project teams present a particularly interesting challenge for reward systems. They often require a reward system that is specifically designed to support them. Traditional pay-for-performance systems focus on individuals, and tend to measure and reward performance on an annual schedule. Both of these practices are inconsistent with motivating project teams. The obvious first choice for motivating a project team is a reward system that establishes metrics for successful group performance and sets rewards that are tied to the accomplishments of the group. It also is desirable to have the rewards distributed at the time the team completes its project. Thus, one popular and effective approach to rewarding project teams is to give spot bonus awards to them when they complete their projects.

Rewarding a project team's performance may be difficult if, as is often true, the membership of the team changes during projects. It may not make sense to reward everyone equally when some individuals are there for 10 percent of the team's activities, while others may be there for 100 percent of the team's activities. Unequal rewards are a possibility, but it can be difficult to determine how large they should be because amount of time spent may not be a good measure of someone's contribution to a project.

One example of a kind of pay bonus plan that can be created for project teams is provided by a high technology firm. They do new product design by creating cross-functional dedicated teams who are charged with developing a new product. At the beginning of the design process, they are given a number of milestone targets to meet, and the members are told to dedicate their efforts to the development process until the new product is ready for manufacturing. In the case of this technology company, specific bonus amounts are tied to reaching the key milestones in the product development process. Equal dollar amounts are given to all members of the product development team when the goals are met. The bonuses can add an additional twenty to thirty percent to the employees' annual pay, so the incentive is significant. The design process often lasts for more than a year, so the incentive is more than just a transitory one. The incentive plan, however, ends before the product is actually in

the marketplace, and thus, the employees are not rewarded based upon the ultimate success of the product.

One alternative or compliment to rewarding project group performance at the end of each project is to rely on a gainsharing plan, profit sharing, or stock ownership system that covers a total organizational unit. This may be a preferred alternative to rewarding individual teams when, in fact, the teams' activities have a major impact on the effectiveness of the unit, and it is difficult to measure the effectiveness of the team. It also may be a preferred alternative if project teams are in existence for short periods of time and, as a result, the timely measurement and rewarding of the performance of individual teams is difficult. It clearly makes the most sense when organizations want their project teams employees to have a long-term organization-wide focus.

Sometimes, it is necessary and desirable to focus on individual performance in a project-team environment. The best approach to doing this is to measure the contributions of individuals to the team's effectiveness at the completion of each project. Individual ratings can be modified by the success of the overall project. In many cases, peer ratings, as well as customer satisfaction ratings, need to be used. Peer ratings are particularly critical because, in most project teams, peers are in the best position to assess the contribution of team members. Over the course of a year, individuals may accumulate a number of ratings that reflect their contributions to each project on which they worked. Performance-pay treatment then becomes a "simple" derivative of how effectively they performed on each of the projects on which they participated. Alternatively, spot bonuses can be paid at the end of each project.

Many of the same issues that arise when project teams are paid for performance also arise when management teams are paid for their performance. A major difference exists however, because management teams are usually permanent teams, and thus, spot bonuses and one-time awards are less relevant. They also sometimes are not as highly interdependent as project teams, and this means that a greater possibility exists for rewarding individual performance. Like project teams and production teams, they can either be rewarded as stand alone entities based on performance appraisals and/or measures of team performance, or they can be rewarded based on a larger, organization-wide gainsharing, profit sharing, or stock based plan. The choice among these is essentially one of the degree to which line of sight and motivation are important versus the degree to which integration of the total work unit is important.

Pay for performance plans which focus on an individual team's performance tend to separate the team from the rest of the organization. In the case of management teams, this may be a critical problem, because it gives the management team a different reward orientation than the teams or individuals who report to that management team. Of course, the management team is supervising relatively unrelated operations or business units, then it may make sense to measure and reward the management team separately. On the other hand if the success of a unit that they are supervising depends upon a high level of integration among the member of the management team and the people that report to them, then rewarding them separately simply does not make sense. Instead, they should

be included in either a corporate-wide or business unit-wide plan that treats them the same as it treats the teams or individuals who report to them.

Unfortunately, there is no automatic "right" approach to rewarding management teams for performance. What clearly is right is considering the degree to which the team itself needs to be integrated, and how integrated the team needs to be with other parts of the organization. Once this is determined, it should be used to determine the degree to which the team is rewarded separately or as part of an integrated unit that may include the part of the organization that reports to the team, or in fact, the total organization.

### *Summary: Paying for Performance*

Table 7.4 summarizes what has been said so far about the fit between rewards for performance and three different types of teams. It clearly makes the point that one size does not fit all types of teams. Key to all the approaches shown is the measurement of performance and interdependence. The valid measures of performance need to be available, and the reward system needs to reinforce the key interdependencies among individuals and among teams; otherwise, the reward system may reward the wrong kind of performance, and do more damage than good.

Insert Table 7.4 about here

## Conclusions: Rewarding Teams

The traditional approaches to pay simply do not fit a team-based environment. This is hardly surprising, given that the pay systems in most organizations were designed to support and reward individual behavior. As long as they remain in this mode, they are at best neutral, and in most cases, counterproductive to creating effective teams. Unfortunately, there is no easy answer to the question of what kind of reward system fits best in a team-based environment. The best answer seems to be that it all depends upon the kind of team, and the technology and strategy of the organization. Two general approaches to pay do seem to potentially fit best with teams. The first is an emphasis on paying the individual instead of the job, and the second is a pay for performance approach that focuses on collective performance more than individual performance. Taken together, these two generic approaches can encourage individuals to learn the right skills to make teams effective, and can motivate the right type of performance focus on the part of individual teams and organizations.

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## Table 7.1

## Impact of Job and Skill Based Pay

| | **Job Based** | **Skill / Knowledge** |
|---|---|---|
| ***Attraction*** | Provides Good Market Data | Attracts Learning-Oriented Individuals, High Skill Individuals |
| ***Motivation*** | No Performance Impact | Little Performance Impact |
| ***Skill Development*** | Learn Job-Related and Upward Mobility Skills | Can Motivate Needed Skill Development |
| ***Culture*** | Bureaucratic, Hierarchical | Learning, Self-Managing |
| ***Structure*** | Hierarchical, Individual Jobs / Differentiation | Horizontal Teams-Based |
| ***Cost*** | Good Control for Individuals' Pay Rates | Higher Individual Pay |

**Table 7.2**

## Teams and Skill Based Pay

| **Type of Team** | **Pay** |
|---|---|
| *Parallel* | May be used to encourage cross training and team skills. |
| *Production and Service* | Use to motivate cross-training, self management skills, and for some depth skills. Retain most skilled team members. |
| *Project* | Use to motivate development of depth expertise and cross functional knowledge. |
| *Management* | Use to motivate development of depth expertise and cross-functional knowledge and career tracks |

## Table 7.3

## Impact of Pay for Performance

| | **Individual Merit** | **Team Incentives** | **Organization Plans** |
|---|---|---|---|
| ***Attraction*** | Good for high performers | Good if team does well | Good if organization performs well |
| ***Motivation*** | Good line of sight | Moderate line of sight | Weak line of sight |
| ***Skill Development*** | Learn skills that lead to rewarded performance | Encourages team skills | Encourages learning about business |
| ***Culture*** | Performance oriented, Job focused | Team focused | Business involvement |
| ***Structure*** | Individual accountability | Team integration | Organization wide integration |
| ***Cost*** | High if significant merit awards given | High if significant rewards given | Possible self-funding from profit improvements |

## Table 7.4

## Teams and Pay for Performance

| Type of Team | Pay for Performance |
|---|---|
| *Parallel* | Gainsharing or other business unit plan to reward savings, Possible recognition rewards for teams. |
| *Production and Service* | Team bonus or business unit bonus if teams interdependent. Possible individual if based on peer input. |
| *Project* | Possible one or more time bonuses, based on project appraisal. Also, profit sharing and stock plans. |
| *Management* | Possible team bonuses. Also profit sharing and stock based plans. |