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**PAY SYSTEM CHANGE:  
LAG, LEAD, OR BOTH?**

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## ***Pay System Change: Lag, Lead, or Both?***<sup>1</sup>

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Changes in an organization's pay system are usually high visibility, high impact and difficult to execute. As a result they are often considered "hot" change levers that potentially can derail as well as support an organizational change effort. It is precisely because of their impact that it is appropriate to ask when and how they are best deployed as part of an overall change effort. The two preceding papers make important points about the advantages and disadvantages of making reward systems changes at different points during a change effort. I find the arguments of both Ledford and Wruck convincing but not necessarily as conflicting as the authors' strong advocacy of their positions suggests. The discussion of pay and organizational which follows will, I hope, make it clear why I have reached the conclusion

### ***Pay and Organizational Change***

Before presenting an overall way of thinking about reward system change in organizational change efforts I would like to establish some basic points about pay, organizational effectiveness and organizational change.

#### *Types of Organizational Change*

There are a wide variety of different types of organizational change efforts. Pay system change does not necessarily need to be managed in the same way in all the different types of organizational change. Indeed it probably should not be handled in the same way.

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<sup>1</sup> Prepared for book based on Harvard Business School Conference, "Breaking the Code of Change."

Similarly, when different change objectives are targeted, it is important to use reward system changes selectively and to fit them to the outcome or outcomes that the change effort is focused on.

In order to focus and simplify our discussion of change efforts, I would like to concentrate on a particular type of organizational change. That is change in which a major discontinuous or transformational performance change is the objective of the effort. The discontinuous performance change can be either a dramatic rise in an organization's performance level or the creation of whole new performance areas such as those which are created by entering new businesses or establishing very different products.

In virtually every situation changes in multiple organizational systems are needed in order to produce discontinuous change in an organization's performance. By this I mean changes not just in one organization system, such as the reward system, but in its structure, information and decision processes, and business strategy. This is the type of change situation which raises the most interesting questions about when and how to change the pay system and it is the type of change I believe Ledford and Wruck have in mind in their papers.

### *Reward System Options*

There are a number of different features of an organization's pay and reward system. Elsewhere I have described these in considerable detail (Lawler, 2000). Rather than discuss all of them here I would like to focus on the two that have been identified as the most powerful features of a pay system. The first involves the degree to which rewards are based

on performance and the second involves how the salary or base pay of an individual is determined. These two dimensions of a reward system seem to be particularly important in determining individual and organizational behavior.

Pay for performance and base pay are a particularly important piece of the employment contract that individuals have with their organization. Other parts of this contract include the amount of job security individuals have, the type of work they do, the opportunities they have for learning and, of course, how they are treated by the organization in the areas of due process and supervision. Virtually any major change in the reward system requires altering the fundamental characteristics of the employment contract and, thus, reward system changes are often “hot” issues.

#### *Pay Systems Have Performance Impacts*

It is beyond the scope of our discussion to go into great detail about the many impacts that reward systems have on individual and organizational behavior, but it is important to point out that they do have multiple impacts (Lawler, 1990). The most important impacts involve their effect on motivation and the attraction, retention and development of employees. There is a great deal of evidence concerning how they impact these behaviors (Lawler, 2000). In essence, rewards effect motivation when they are effectively tied to performance and significant amounts of reward are given. Attraction and retention on the other hand are a function of how well individuals are rewarded relative to their opportunities in the labor market.

In addition to effecting motivation, attraction and retention, pay systems can strongly effect skill development. When learning skills can increases an individuals reward level it

can motivate skill development. Pay systems can also reinforce organizational structures and in many ways drive the culture of an organization. They effect structure by either uniting or dividing individuals, groups and business units. Thus, I view reward systems not as an inconsequential organizational system but as a potential key driver of individual and organizational performance.

### *Reward System Change Needed*

It is precisely because reward systems effect behavior that change in the pay system and other reward systems is almost always needed when major organizational change is attempted. This point is made by those organizational effectiveness theories which emphasize the concept of fit. For example, the classic star model of organizational effectiveness argues that organizations are effective to the degree that their strategies, structures, processes, rewards, and people strategies fit each other (Galbraith, 1973). It goes on to argue that if a change in organizational performance is needed it is rarely adequate to simply change one of these because this only creates a misfit and a possible decrease in organizational effectiveness. In order to move to a new more effective and different level of organizational performance, all of the elements of the star model need to be changed. This, of course, is what makes change so difficult and why organizations often do not change even when their performance is no longer effective.

In another fit theory, I have argued that in order to move to a high involvement approach to organizing, four elements of an organization need to be changed- information, knowledge, power, and rewards (Lawler, 1996.). Any employee involvement change effort which does not move all four of these to the lower levels of an organization inevitable creates

an imbalanced situation which is potentially ineffective and dysfunctional from an organizational design point of view. For example, failing to move rewards to the lower levels of an organization runs the risk of creating behavior without responsibility or consequences. This can be particularly problematic if considerable decision making power is given to individuals at lower levels of the organization. On the other hand, simply moving rewards down is unlikely to increase organizational effectiveness if individuals do not have the information, knowledge and power they need to act in ways that will influence performance and help them understand the reward system.

### ***Change Strategy***

The literature on organizational change suggests that most organizational change efforts go through three phases. Each of these phases needs to be effectively executed in order for the overall change effort to be successful.

The first phase involves the unfreezing of the organization. During this period, the organization needs to recognize the need for change, explore change alternatives and develop a willingness to change. The second phase involves the implementation of changes which are targeted at improving or changing the performance of the organization. The third phase involves making the new ways of performing standard operating procedure, not something new which is to be learned and experimented with. Increasingly because of the dynamic nature of the business environment and the need for continuous change theories argue that the final phase should be thought of as part of the beginning of the next change sequence. For the purposes of this discussion, I would like to look at each of these three phases separately

and consider what role pay system changes can and should play in making each of them successful.

### *Unfreezing*

The key task in the first phase of change efforts is creating a willingness to abandon the old and to search for new more effective organization designs and management practices. Much of the literature on organizational change emphasizes the problem of resistance to change and argues that almost inevitably the individuals in an organization resist major organizational changes. There are a number of reasons why individuals resist change. Some of these include perceptions that the change will have significant negative reward consequences for them. The negative reward consequences can range from lay-offs to jobs being made smaller so that individuals lose job evaluation points and therefore fall into a lower pay grade.

Just as the pay system can create resistance to change it potentially can create a willingness to consider change. What kind of reward systems practices are likely to do this? The paper by Wruck does a good job of pointing out the answer to this question. Reward systems which reward people for organizational performance can be a powerful motivator of change because they can create dissatisfaction with the existing performance of the organization and they can offer the prospect of increased rewards.

Particularly if the organizational changes that are proposed can be clearly tied to improvements in organizational performance, profit sharing plans, stock ownership plans, stock option programs and other programs which reward individuals for organizational performance can help motivate the search for and the acceptance of change. In some

organizational change situations, these types of plans may already be in place and therefore they only need to be highlighted and related to the need for organizational change in order to motivate change.

Installing pay for performance plans before a change program is implemented can have a second advantage. It can avoid the negative situation of executives gaining tremendously from an organizational change effort while the employees lose or gain nothing from the implementation of the changes. This is not a trivial point since large outcome differences among organizational members can threaten the long term effectiveness of a change effort.

One other possibility exists with respect to using organization-wide reward systems such as stock plans and profit sharing plans. Some organizations have promised their employees that these will be installed once an organizational change has been put into place. In essence, the installation of these plans has been used as a reward for not resisting the change. This is a potential way to use pay as a kind of lead system, but probably is not as effective as actually putting the plans in first and using the rewards that these plans may generate as an incentive for exploring and accepting change. In most cases putting in the plans is likely to be more effective simply because it makes more tangible the rewards that individuals will get if the right changes are identified and implemented. The motivation to change does not depend on a rather vague promise that at some point in the future an undeveloped plan will be installed that will give an undetermined amount of reward to individuals if the change effort is undertaken and is successful.

There is one final way to use the reward system as a way of unfreezing the organization. It is most likely only appropriate in organizations that have severe financial



problems and need to rapidly introduce major change. It involves reducing the rewards of individuals but offering them the opportunity to return to their previous higher reward level if they implement successful change. For example, some organizations have reduced the base pay of individuals but told them that if the organization develops and implements changes which produce a certain performance level they will be able to recapture their lost money, either through pay increases or through the payment of a bonus.

### *Change Implementation*

The motivation to implement change is a key issue that the reward system can address. There are a number of variable payment approaches that can be used to facilitate implementation. Some of them have already been mentioned in our discussion of unfreezing, that is creating an organization wide profit sharing, stock option or other stock plan that rewards individuals for improved organizational performance. Gainsharing has not been mentioned yet but it is frequently installed early in the change implementation process.

Rewarding performance can encourage implementation just as it can encourage creating a plan for change, but pay for performance plans have a critical weakness with respect to change implementation. They are not specifically targeted to the implementation process. Thus, the so-called line of sight between implementation and the reception of financial rewards may be weak. This suggests the need for a short term bonus plan that is specifically targeted at implementation.

It is possible and often desirable to identify implementation milestones and goals and to tie variable payment's to the achievement of these goals. This type of goal sharing plan is becoming increasingly popular (Lawler, 1998). It is usually structured to reward the ongoing

performance of an organization but it can also be used to highlight particular performance areas and implementation activities that are part of an organization's strategic agenda. For example, GE used this type of plan when it installed its Six Sigma quality program. Specific implementation targets for the quality effort were set and reaching them was part of the bonus plans of most senior managers. At the plant level, goal-sharing plans were used which covered all employees, not just the management population.

Giving an important reward for implementing a change is potentially a quite powerful way to be sure that change actually happens in an organization. It can be difficult to manage however since it requires establishing clear implementation goals and the ability to estimate the implementation time of specific parts of the change process. Thus it is a reward system approach to change that does not fit every change situation but when it does fit it is likely to be effective because it creates a clear line of sight.

Since change often requires individuals to learn new skills and to change the kind of work they do change implementation can be aided by pay systems which reward individuals for learning new skills, knowledge and competencies. The growing popularity of knowledge/skill based pay systems is a testimony to the potential effectiveness of these plans in changing the skills of individuals (Lawler, 1998).

In some cases knowledge/skill based pay plans result in an increase in the base pay of individuals, but in others they simply make a one-time payment to individuals who learn new skills. Where they are being used to support the implementation of a major change, a knowledge/skill based pay plan which pays a bonus amount for learning new skills is often the most appropriate. Base pay changes increase the fixed pay costs of an organization and this may be a significant negative for an organization if its employees are already reasonably

paid. Thus, it often makes sense to keep base pay the same and to encourage change by giving a one-time bonus to individuals for learning the new skills that are needed for them to operate effectively in the changed organization.

Effectively designing a knowledge/skill based pay system to support a change process requires that the changes be understood well enough to be able to identify the specific skills and knowledge that individuals need. This is not always possible when a major organizational change process is first undertaken. Thus, it may not make sense to make this kind of intervention when the change implementation begins. Instead it may be better to keep it for later in the change process and to use it more as a lag change.

So far we have been discussing approaches which will motivate individuals to implement change, not approaches which are intended to reduce the resistance to change. As was mentioned earlier often resistance to change comes about precisely because individuals feel that they will lose out on financial and career opportunities as a result of the change. One way to prevent this from being a resistance factor is to guarantee individuals at the beginning of the change implementation process that they will not lose either pay or other rewards as a result of the change process. This is often combined with an employment security guarantee so that individuals are protected from negative consequences as a result of the change process. In essence, what organizations can do is create an employment contract which is loyalty based and which suggests that the organization will be loyal to individuals if they go along with the change process.

Despite the appeal of the loyalty contract approach there is little evidence to suggest that that it leads to effective change. In a recent study of change in Fortune 1000 corporations we found that it is not associated with the effective implementation of the changes which are

part of employee involvement, reengineering and total quality management change efforts (Lawler, 1998). However we did find that stating an employment contract which emphasizes the importance of performance and learning new skills is associated with successful change implementation of these efforts. Apparently, it is better to make it clear to individuals that supporting change is necessary for them to keep their job and pay, than it is to tell them that they will not be harmed by the change regardless of how they respond to it.

A more extreme practice than stating a performance/learning employment contract is to tell individuals that they no longer have jobs but that they are free to apply for jobs in the “new” organization. They are then offered the opportunity to interview for jobs in the “new” organization when it is created. When they are selected for new jobs they get a new and different pay rate depending upon the job that they acquire. This approach clearly is a way to unfreeze the organization and eliminate old ways doing things. It also creates a strong interest in quickly creating the new organization- however, it runs a great risk of driving away a significant number of employees and it always causes a major disruption in an organization’s performance. Thus, it only fits situations where an organization is in extreme crisis and needs to motivate individuals to rapidly identify and accept a new approach to operating.

### *Refreezing: Creating an Operating Approach*

So far we have primarily focused on temporary reward systems that can be used to reward and encourage the development and implementation of change. Now its time to consider when reward systems changes that are expected to be part of the ongoing operating systems of an organization should be introduced. In many respects this is the most difficult

issue to address. As indicated earlier there are a wide variety of reward system features and practices that need to be aligned to support the way an organization operates. In order to accomplish these, changes usually are needed in the approach to performance based pay, the market position of pay and the type of employment contract that exists, not to mention other features of the reward system. What is clear is that all features of the reward system need to be assessed to be sure that they fit with the new operating approach that the organization wants to establish after the change process is complete.

It is important to put a reward system approach in place that does not just encourage the adoption of a new way of operating, it needs to support the organizations operating effectively. In most cases this means tying rewards to the key learnings, behaviors, and performance focuses that are necessary for the organization to operate effectively. Thus, the design of the reward system needs to take into account issues such as the types of capabilities the organization needs, the strategic focus of the organization, the key organizational design features, and the need for cooperation, teamwork, and interdependent action.

Often some of the pay system changes that are needed can not be identified and developed until the new operating approach is actually in place. For example, a relatively permanent knowledge/skill based pay system often only can be developed once individuals have done their new work for a while. Time is needed in order to allow the development and specification of the skills and knowledge that individuals need. Similarly the nuances of a very targeted bonus plan often can only be developed once an organization has operated in a particular manner for a while. It is also clear that work teams can only make pay decision about their members after they have matured and developed. Thus in changing to a team

based organization it does not make sense to start with a team based performance management system that involves pay.

There is considerable evidence that many pay practices (e.g. gainsharing, skill-based pay) work best when they are developed by the employees who will be effected by them (Lawler, 1990). In order to participate in the design process individuals need knowledge of how the organization should operate. Delaying the design of the reward system can help individuals gain an understanding of what it “needs” to do to help the organization be effective. Thus, there are some clear arguments for waiting until the new operating mode has been achieved in order to develop many of the pieces of the reward system that need to fit with it. In essence, the learning that takes place during the early operating period can be an invaluable input to establishing the final form of the reward system.

Before we conclude that operating or steady state pay changes should always lag other operating state changes, it is important to note how gainsharing plans have been used. They are a good example of how a permanent feature of the pay system can lead change. The research clearly shows that putting it in as a permanent operation reward system can stimulate other change activity. It is also clear that when an organization is not ready to follow the implementation of the gainsharing plan with other changes it is a poor and ineffective way to create a new operating approach.

The lesson from gainsharing is clear, for a new reward system to operate effectively, its implementation needs to be carefully positioned in the sequence of the new operating systems that are put into place. Sometimes gainsharing processes and other reward system changes should be some of the first of the permanent operating practices of an organization to be put into place but in other cases, they should not be. It is hard to generalize about when

reward system practices such as pay for performance bonus plans, knowledge/skill-based pay, employment contracts, etc. should be put into place. This question can only be answered when specifics are known about what the other changes are planned. Those changes which are likely to be effective and create support for other planned changes are the ones that should be implemented first.

### *A Strategic Approaches To Pay System Change*

It is clear that there is no simple answer to the question of whether pay system change should lag or lead other key changes. What is clear is that pay system change must occur in order for organizational change efforts to be successful. Table 1 presents an approach to thinking about the different periods of a change process and the reward system changes that can support each stage of the change process.

The first stage of the change process, unfreezing or opening up the organization to change is perhaps the simplest to consider from a reward systems point of view. It clearly calls for pay for performance approaches which encourage individual's in the organization to think about improvement and increased organizational effectiveness. The best vehicles for doing this typically are profit sharing, stock, and other forms of variable pay that reward performance. In situations where organizations need to continuously develop and change it makes sense to keep these plans in effect.

Things get more complicated in the implementation period. One alternative is to put in place transition pay for performance plans which specifically reward implementation of the change effort. This makes particularly sense when the implementation process can clearly be measured and a timeline is specified. It also can make sense to reward individuals for

developing the skills that they need to operate the new organizational systems and do their jobs.

In some cases, it may make sense to simply skip the use of implementation bonuses and move directly to bonuses and variable pay plans which reward successful operation in the new system. That is to identify the key performance indicators that should improve as a result of the change process and begin to reward individuals based on their performance in these areas. The risk in doing this is that it may take a while to improve performance and earn a bonus, as a result individuals may not be as highly motivated to work on the implementation process as they would be if they were directly rewarded for it.

Most difficult to specify is how reward system changes should be sequenced and designed to support the ongoing operations of the organization. This is an area where it is particularly important to state that it all depends on what the nature of the change is and how and when the new reward system practices can be developed.

In general it probably makes sense to wait on many of the major reward system design decisions if there are sufficient incentives to unfreeze an organization and to motivate its members to implement the other changes that are part of the organizational change effort. This is a big if, however, since in many cases new pays practices do need to become a permanent part of the organization's operating system and are needed in order to facilitate implementation of other changes. The challenge therefore is combine and sequentially introduce temporary reward system changes that will encourage the implementation of change and permanent ones that are intended to become part of the ongoing operation of the organization. Together they can encourage change implementation and help to establish the new operating approach of the organization.



My answer to the question of whether pay system changes should be a lag or lead factor in large-scale organizational change is now clear: They should be both. They should be used as a lead variable in most cases to stimulate the development of the change process and to encourage its implementation. They should be used as both a lag and a lead variable in supporting the ongoing operations of the organization once the change process has been completed. In short, there is no single answer to how pay system change should be managed in a change process. We can say, however, that it is always important to recognize what reward system options there are and what impact the reward system can have on behavior and to use this knowledge in determining when and how to introduce pay system change. Finally, it is important to remember that ignoring reward systems is not an option and that change efforts which do are most certainly doomed to failure.

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TABLE 1

	<i>Unfreezing</i>	<b>Implementation</b>	<b>Operating</b>
<b>Key Issues</b>	Motivation for developing change effort	Motivation for skill learning and adoption of change	Motivation and capability to perform effectively
<b>Reward Actions</b>	Profit Sharing and stock ownership	Bonuses for change implementation. Knowledge/Skill based pay for new skills. New employment contract. Possible bonuses for achieving new performance targets.	Pay for Performance Systems which focus on strategic performance and on the attraction, retention and development of high performers. Strategic practices which support systems that are/or soon can be put into place.