CE Center for Effective Organizations

PAY STRATEGIES FOR THE NEW ECONOMY: LESSONS FROM THE DOT-COM ERA

CEO PUBLICATION
G 01-17 (407)

EDWARD E. LAWLER III

Center for Effective Organizations
Marshall School of Business
University of Southern California

September 2001

Center for Effective Organizations - Marshall School of Business
University of Southern California - Los Angeles, CA 90089–0806
(213) 740-9814 FAX (213) 740-4354
http://www.marshall.usc.edu/ceo

Pay Strategies for the New Economy:
Lessons from the Dot-com Era

Edward E. Lawler III

The 1990's saw the rise of the dot-coms. They soared to amazing stock market evaluations that defied the laws of economic gravity. In many cases they also seemed to refute the principles of management that have guided organizations for decades. The dot-coms have come back to earth, indeed many of them have disappeared entirely, thus, it is an appropriate time to look back at what can be learned from their rise and fall.

One area where I believe a considerable amount can be learned concerns motivation and rewards. Many of the dot-coms offered reward system approaches that differed significantly from those of better established companies. They emphasized stock options for all employees, low cash compensation, few fringe benefits, minimal formal salary structures, and a host of special perquisites such as free latte's, concierge services, pet friendly office environments, and so on.

The dot-coms were very successful at attracting large numbers of job applicants and particularly effective at attracting recent college graduates. They also were able to motivate their employees to work long hours. They clearly were doing some things right, but as the rapid decline of many of them shows they also were doing a number of things wrong. In many respects they were a bold experiment in changing the employment relationship between individuals and organizations and, as such, provide a valuable opportunity to learn about reward systems and organizational effectiveness. What can we learn from them? I would like to briefly summarize what I think some of the major learning's are from the dot-com experience with reward systems.

Money Matters

Prior to the dot-com era there were an increasing number of articles which argued that money doesn't matter to many employees, or that it was relatively unimportant compared to other factors. The initial success of the dot-coms seems to suggest just the opposite. Their offering of stock options to all employees seemed to be a very powerful attractor of talented individuals, and the opportunity to profit from stock options appeared to be a powerful motivator of performance. Many individuals developed a 24/7 lifestyle, became highly involved, and very committed to seeing their dot-com company be successful.

When interviewed by me and others, one of the reasons they almost always stated for their high level of involvement and commitment was the chance to make a substantial amount of money. Yes, they were excited by the opportunity to build a new organization and develop a new industry, but money always came up as a key factor. It was also obvious in the behavior of the dot-comers that money mattered. Companies with rapidly appreciating stock were swamped with job applicants, many from established companies, and they were the "hot" places to work.

Amount of Money Matters

There is little doubt in my mind that part of the reason that money was such an effective motivator in the dot-com world is that large amounts of money were at stake. Without a doubt 4 and 5 percent salary increases are not effective motivators, but that doesn't mean that money can't be a motivator. When one hears that there is an opportunity to make hundred's of thousand's of dollars in stock option profits the situation is much different. Individuals pay attention to the stock price of their company, they cheer when it goes public, and they do what they can to see that the organization is successful and that the stock price goes up.

Do organizations have to promise the kind of riches that dot-com organizations did in order to have pay be an effective motivator of employees? I don't think so, but they certainly have to have more money at risk than is provided by the typical salary increase plan. They need bonus amounts and stock option amounts that offer individuals at least 15 to 20 percent additional compensation over and above their base pay.

Stock is Good

The opportunity to own stock proved to be a very powerful incentive in the dot-com world. The fact that stock was given to virtually all employees created a unified workforce, one that had a common purpose and source of motivation. This was clearly part of the reason that individuals were so committed to the initial success of many dot-com companies, and a major reason why individuals were willing to leave their well established, secure positions in large corporations to take positions in dot-coms.

The use of stock options was particularly functional during the start-up stage of most dot-coms. It minimized the amount of cash compensation that needed to be offered to individuals and it proved to be a powerful rallying focus for employees. It also, and perhaps most importantly, created a very positive, virtuous circle in many organizations. As the stock went up employees got more and more excited about the future of their organizations. The organization became more attractive to work for, and as a result more and more individuals wanted to work for them. Because they had better applicant pools the organizations were able to upgrade the quality of their workforce, this, in turn, helped the organizations perform better and increase their stock price even more.

Stock is Bad

The down side of depending upon stock and stock options for compensation became all to clear when the equity markets became concerned about the high stock prices and the viability of many dot-com corporations. Stock after stock dropped dramatically, and as a result many dot-com organizations began a death spiral. Precisely because many employees joined dot-coms in order to get rich, when that opportunity disappeared and their stock became worthless employees quickly looked for the nearest exit. As more and more individuals left investors became more and more disillusioned with the companies, and as a result the stock price dropped further. This continued the downward spiral of many dot-com companies and ultimately resulted in many of them going bankrupt.

In many respects the dot-coms first profited from and then suffered from the fundamental point that the price of a stock is only somewhat influenced by the performance of the organization and the employees who work there. Thus, it is a poor incentive in many respects. It can go up when organizations don't necessarily perform well and can go down when they don't necessarily perform poorly. This can lead to a situation where employees believe they do not control their own fate and, thus, a situation where employees are not particularly motivated to try to improve their organizations performance.

Balance is Critical

It is clear in retrospect that the dot-coms relied too much on stock and particularly on stock options. Stock options can easily go under water and, as such, lose much of their retention value and in some cases their incentive value. With low cash compensation it is very difficult to retain employees and motive them when their stock options are considerably under water. The learning here is obvious: organizations should not rely solely on stock options. They need to have a balanced reward package that combines stock options with market driven base salaries, cash bonuses and stock ownership.

Life Stage Matters

As dot-coms such as Amazon.com grew they quickly out-grew their heavy reliance on stock options but they didn't change their reward systems. Several problems developed. They continued to issue stock options, and as a result began to dilute the stock that was held by investors. But, perhaps more importantly, they ended up overly dependent on their stock price as a vehicle for attracting and retaining their most important employees. This proved to be a serious problem when all the stock options of recently hired employees went under water, and as a result they had no reward system incentives for individuals to remain with the organization. In retrospect it is clear that they should have shifted to cash incentives and stock ownership in order to retain critical employees.

Reward Mix Affects Attraction

The reward packages offered by dot-coms attracted large numbers of individuals, but they did not attract everyone. The approach of offering few benefits and large numbers of stock options clearly attracted a particular segment of the workforce. Younger individuals without families seemed to be particularly attracted. This is hardly surprising since they could afford to take the risks that were inherent in joining a dot-com. The reward package also seemed to attract individuals who have a high propensity to take risks. In some cases this created organizations with large numbers of individuals who enjoyed taking risks. This may well have shown up in strategic behavior of many dot-coms and partially explain why they continued to take gamble after gamble, rapidly changing their business plans and their strategies.

Many dot-coms found that when they wanted to attract more established managers to provide "adult supervision" for the organizations they had to switch the reward mix. Basically, they had to provide more salary and benefits, and to create employment contracts that contained more guarantees.

Cost Does Not Always Equal Value

The value of stock options in the eyes of employees is sometimes higher than it's true economic value, but it isn't always. When dot-coms were "hot stocks" individuals would over-value the stock options they were given and this gave dot-coms the opportunity to recruit and retain people on a relatively cheap basis. Dot-com companies found, however, that the attractive nature of stock options was limited to certain parts of the United States and to the time period when the stock was particularly hot. For example, when the west coast based Amazon.com started opening distribution centers in the mid-west and south they found that stock options had little appeal to individuals even when the stock was doing well. Individuals there wanted cash and did not understand options, so Amazon had to go to a more cash-based compensation strategy.

Markets Value Individuals Not Jobs

News reports during the dot-com era constantly reported on the "fabulous" packages that individuals got to join dot-coms. They also reported on what traditional organizations had to pay to retain individuals who had the kind of skills that dot-coms were seeking. Companies were forced to recognize that it's the skills and knowledge of individuals that matters when it comes to determining pay rates, not the characteristics of their job or their seniority. The dot-com world was a labor market where individuals with good skills could negotiate their own individualized packages and break out of the mentality of job descriptions, pay ranges, and standard packages. It was an extreme example, but it made the point that in the new economy, increasingly, it is the skills and knowledge of an individual that determines market value, not the size or nature of the job that is being filled.

Rewards Drive Culture

The use of stock options, low cash compensation, and special perquisites clearly affected the fundamental culture of dot-com organizations. As mentioned earlier, it created a more risk-oriented culture. It also created one that was very human capital centered. Because individual skills mattered dot-coms tended to focus more on their human capital, their compensation package, and their management practices. Reward systems, of course, were not the only thing that caused dot-coms to develop their unique cultures. Other factors such as the leadership style of the founders were critical, but the reward system approaches that were used helped shape the culture and became an important reinforcer of the cultural.

Conclusions: Reward Systems in the Future

The dot-com era is over, but I believe that because of it the pay practices will change. What will the changes be? First and foremost, I think corporations will make much greater use of stock and stock options in their reward systems. It is already evident in the United States where employees are increasingly getting stock options and participating in stock ownership plans. In most organizations the level of employee stock ownership will never be as high as it was in the dot-coms, but it is growing and will continue to grow. The reason for this is simple, stock ownership is a powerful vehicle and one whose time has come.

The dot-com era highlighted the importance of individual skills and knowledge in determining pay packages. It accelerated what I think is an inevitable move from focusing on paying individuals for the job they do to paying individuals for the skills, knowledge, and competencies they have. The war for talent that broke out in the dot-com era highlighted just how important individuals with critical, scarce skills can be to the bottom line of an organization, thus, providing strong justification for focusing more and more on what individuals are worth.

Finally, the individual deals that many employees negotiated with dot-com organizations illustrated the potential that is inherent in individualizing reward and employment packages. Many dot-coms went dramatically away from a traditional standardized package of benefits, working hours, etc. and allowed all employees to individualize employment relationships. Given the large individual differences that exist in any society it is hardly surprising that this proved to be a popular feature. In order to counter the offers of dot-com companies many traditional organizations had to create individualized reward packages in order to retain their most valuable employees. They, in effect, let the cat out of the bag with respect to negotiable individualized packages for key employees. Thus, in the new economy it is likely to be increasingly true that individuals will be able to have much greater choice with respect to reward packages and working conditions.

The dot-com era is over but the new economy is not. More and more companies need to focus on how to effectively manage human capital. The dot-coms didn't have human capital management 100 percent correct, but they did a number of things right. Thus, any organization that ignores the lessons from the dot-com era is missing out on important information about how to make its reward system more effective in the new economy.