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ORGANIZATIONAL CHANGE**

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Reward Systems, Motivation and Organizational Change¹

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Organizational excellence is about change. We would not have said this in the 1970s, 1980s, or perhaps even in the 1990s. Today it almost goes without saying. Most organizations simply cannot sustain excellent performance unless they change in response to shifting environmental demands. As the rate of change in the business environment continues to increase, the premium on organizations being able to change is likely to grow ever more significant.

In the 1980s, the best-known management book was *In Search of Excellence*. It identified a number of companies that were excellent performers. By the late 1980s many of them had ceased to be excellent performers. It was not that they had lost the ability to do what they had done; it was simply that what they had done no longer met the demands of the business environment. This raises the critical question: Why didn't they change?

Our research and experience with a variety of organizations leads us to a sobering conclusion: many organizations do try to change but most of their change efforts are doomed to failure from the beginning. The type and amount of change that is attempted is simply beyond the ability of most organizations to implement successfully. Admittedly, some organizations have made amazing transformations. Nokia, for example, has become a successful global electronics company even though its roots were in a different technology and a local market. Intel was able to abandon its memory business and build a strong microprocessor business. But the reality is that most change efforts in established organizations fail to meet expectations because the internal barriers to change, most of which are human, are so formidable. A key barrier in most change efforts is the motivation to change; all too often it is simply missing.

¹ Based on E.E. Lawler and C.G. Worley, Built to Change (Jossey-Bass, 2006)

We believe that the only way to ensure that organizations will be able to change is to *design* them to change. Although we are pessimistic about organizational transformations of the kind that AT&T failed to make and the kind that Kodak is trying to make, we are optimistic that organizations can be built to change. Our optimism is based on the ability of some companies to change and on research that suggests the right policies, practices, and organization designs can make a company “change ready.”

In looking at practices and designs that make an organization ready to change, it is important to consider whether they contribute to current organizational effectiveness. The optimal practices and designs are those that create high-performance organizations that are ready and able to change. Although there are a variety of features that contribute to an organization that is “built to change” and effective, this article focuses on the role of rewards and motivation in promoting change.

Human and Social Capital

Any discussion of building organizations that are change ready needs to recognize that the era of human and social capital has arrived. The rapid growth in scientific and technological knowledge is one driver that has contributed to the growing importance of human capital. A second driver is the information technology boom of the 1990s. The accompanying talent shortage got firms thinking about human capital as never before. Finally, a growing recognition that more and more of a firm’s market value is tied up in their human capital has spawned a focus on talent management.

The centrality of knowledge to organizational effectiveness has changed the very essence of organizations, what they do, and how they do it. Its implications for the motivation and reward systems of an organization are significant. Organizational reward systems need to

simultaneously support the application of state-of-the-art knowledge to solve current business problems and support the development of changes in the type of knowledge an organization will need as the environment changes.

Reward System Design

Organizations have the ability to reward individuals in a multitude of ways. Because they can vary both the kinds of rewards they give and the reasons for which they give them, there is an almost infinite number of approaches that organizations can take to rewarding individuals.

People don't automatically come to work, continue to work, or work hard for an organization. They need to be motivated to take a job with a company, to come to work on a daily basis, to continue to work there, to learn, to perform efficiently, and to accept change. The most widely accepted explanation of why people are motivated to work, perform, learn, and change is rooted in what psychologists call expectancy theory.

Expectancy theory argues that people are mostly rational decision makers who think about their actions, and act in ways that satisfy their needs and help them reach their goals. The theory assumes, and research evidence confirms, that people generally try to deal rationally with the world as they see it. It views people as proactive, future orientated, and motivated to behave in ways that they believe will lead to valued rewards. It does not suggest that people will always resist change. Quite to the contrary, it suggests they will seek it if it leads to their receiving valued rewards.

Since organizations get the behaviors they reward, organizations that wish to perform well and change effectively need to create systems that reward both performance and change. Sounds simple, but it is not easy to do. It is also not what most organizations do. All too often

they reward stability more than change, seniority more than performance, and job size more than skill development.

If you want people to change, you cannot reward stability, yet that's exactly what many organizations do. They set annual performance goals and develop bureaucratic job description systems that are resistant to change.

When it comes to motivating change and performance, it is hard to think of a more dysfunctional practice than basing rewards on seniority. Despite this, the array of rewards that many organizations tie to seniority is vast. Some of the rewards are relatively trivial and minor, others quite valuable and important. Although we have not seen any studies of how common seniority-based rewards are today versus ten or fifteen years ago, our guess is that they are less popular today, but still very common. They fit well in a world where organizations try to build loyalty, and individuals spend their entire careers with the same organization. They fit very poorly in organizations that need to change.

Finally, rewards based on job size focus attention more on promotion and getting a bigger job. They do little to motivate individuals to learn new skills that support change but don't lead to promotions.

What doesn't work

Merit-pay plans are the most frequently used way to reward individuals for performance. Given their popularity, merit-pay systems must be effective -- right? Wrong! The evidence is clear that in most cases merit-pay plans do little to motivate performance and often do not even help retain the right employees.

Merit-based salary increases typically are small and become a permanent part of an individual's pay. As a result, the relationship pay and performance is weak and not particularly

motivating. The hope is that merit pay will lead, over a number of years, to a pay level that reflects performance. This can happen if an individual's performance is stable from year to year, and for some it is. But individual performance often varies considerably over a person's working life. As a result of performance changes, poor performers can end up with very high pay and outstanding performers with very low pay. This often occurs when a new employee performs outstandingly well and a longer-term employee performs poorly. When it happens, the poor performer is very motivated to stay and the better performer is not.

With merit pay, there is little the organization can do to change someone's reward level if that person is unwilling to support a change effort or performs poorly. It can withhold a merit increase, but this hardly has a major financial impact on an individual. Ultimately, a merit salary increase plan creates a situation in which the only way to punish people who are not supporting a change or performing well is to fire them.

What Works

A variety of rewards can create organizations that are built to change. Bonuses, stock, and person-based pay when designed properly, can help organizations be flexible and effective.

Bonus Systems. Organizations that want to motivate performance and change with cash rewards must use bonuses. An increasingly popular form of variable pay uses the results of a performance appraisal to determine the amount of bonus that is paid to an employee. This approach eliminates the major failing of merit pay: Not enough money being available to motivate individuals. It does this by eliminating the annuity feature of merit pay, thus freeing up dollars to be used for variable pay.

Built to change organizations can use bonus pay to reward individual performance and change as well as to retain excellent performers. It is particularly effective at retaining new

employees because they can almost immediately be paid at a high level if they perform well; they do not have to wait for a series of merit increases. It also has the advantage of providing a way to quickly reduce the total compensation of poor performers. Finally, it can make very clear the relationship between a performance appraisal judgment and the amount of someone's pay. There is no need to explain how a person's pay history affects his or her bonus.

Bonus plans are useful, especially during periods of change. Individual plans that offer relatively large bonus opportunities can provide a powerful incentive for individuals to perform well and to change their behavior when a new strategic intent calls for it. In some situations it makes sense to have one-time bonuses awarded at the completion of a strategic change. In other situations, using short-cycle bonus periods (for example, three months) that target change implementation can speed up the installation of major changes.

When an organization bases bonuses on such organizational performance measures as profit and market share, it creates not only a reason to perform but also a reason to embrace strategic and operational change. Our research shows that the implementation of change efforts that are directed at building capability—for example, total quality management and knowledge management—are more effective when pay is based on organizational performance. Bonus plans that are funded based on organizational performance relative to competitors and performance are an effective way to alert employees when the organization needs to change. Failure to change means deteriorating performance and thus smaller financial rewards, so it is not a surprise that individuals are more focused on how to improve performance and are more willing to accept change when they are paid based on the performance of their organization.

Impact of Stock. The effect of stock plans on motivation is likely to be less than the effect of bonuses because the connection between performance and pay is usually weaker. Stock prices

depend on more than just the somewhat controllable financial and operational performance of a company. They depend on the economy and on how the stock market evaluates the corporation's earnings, intangibles, and future. Thus, even for senior executives, the connection between their performance and the value of their company's stock may be weak.

Although it is not a particularly good motivator, what broad-based employee stock ownership can do is create a culture of ownership and cause people to focus on the strategic, business, and financial objectives of the organization. As a result, it can also be a powerful integrator of behavior. As is true of broad-based profit-sharing plans, it can create a "common fate" culture that supports performance and needed change.

Broad-based stock ownership may be a better motivator of change than profit sharing. The stock price of a company often is a better indicator of future prospects than earnings. A competitor's announcement of a new product or the failure to win a big contract can push stock prices down before earnings are affected. This in turn has the potential to stimulate change before performance actually declines.

Broad-based stock ownership can be particularly useful when it comes to leading change. Stock ownership gives the leaders of an organization a platform on which to stand and talk about the advantages employees will experience with a successful change effort. They can go beyond saying that change is good for the organization and say, "Change will be good for you because it will lead to improved organizational performance and an increase in your personal wealth." It also eliminates the possibility of employees' sitting back and saying, "Sure, it's all right for him to argue for change because he's a senior executive. He has an enormous amount of stock, but I don't, so why should I listen to his call for change when it really is only going to benefit him?"

Broad-based stock ownership can also be a real positive in encouraging people throughout the organization to take on leadership roles in support of change. Being an owner carries with it a certain role and image that can encourage individuals to demonstrate leadership behaviors that support organizational performance. It is only when members of the organization develop the attitude of shared fate and shared responsibility that a company can truly be said to have a culture of shared leadership.

Person-Based Pay. The distribution of financial and status rewards in most organizations is primarily based on the jobs people do. A reward system that focuses on jobs does little to produce an understanding of the new skills and knowledge individuals need or, for that matter, an understanding of what new individuals the organization needs in order to develop new competencies and capabilities. It also typically offers little or no incentive to develop the new skills and knowledge that will help the organization change. As a result, when organizations with job-based systems need to change their capabilities and competencies, they usually end up either failing to change or having to replace most of their existing workforce.

When an organization is constantly changing, job-based pay systems are particularly likely to create problems in determining how much to pay individuals and, as a result, lead to unwanted turnover. In the old steady-state organization, employees and management could come to a reasonable consensus as to what various jobs were worth. In today's organizations, often there are no traditional jobs, only clusters of tasks and activities, and these are always changing. As a result, it is hard to decide what is fair for a job and to adjust pay accordingly. In addition, paying the job runs the risk of mispricing employees in the labor market, because the tasks they are doing at the moment may not represent their total capabilities and as a result may not reflect their market value or their value to the organization.

The solution requires a radical shift. Organizations need to pay individuals for their skills and knowledge, not for their jobs. In a work situation in which people have changing task assignments, paying the person according to their market value is much more effective than paying the job, particularly when it comes to retaining the right people. When all is said and done, it is people that have a market value, not jobs. People change companies for higher pay; jobs don't change companies.

Perhaps the most important changes that person-based pay can effect are to the organizational culture and to employees' motivation to change. Instead of being rewarded for moving up the hierarchy, people are rewarded for increasing their skills and developing themselves. This can reinforce a culture in which personal development and a highly talented workforce are receptive to change. It can be especially helpful when an organization needs to improve its competencies and capabilities, because the company can use pay to motivate individuals to develop needed skills.

A focus on the skills of individuals is highly consistent with a strategic intent in which individuals are a key source of competitive advantage. When people are an organization's key resource, it is logical to focus on them and what they are worth. It also makes sense to focus on their growth and development so that they can add more value to the organization's products and services.

Conclusion

We began by pointing out that organizations need to be built to change and that they get the behaviors they reward. We noted that traditional reward systems lead to stability and often fail to motivate either performance or change. What traditional reward systems do *not* lead to is an organization that is easy to change. The inescapable conclusion, therefore, is that organizations

that wish to be high performance and built to change need to employ significantly different reward systems than the ones commonly used in large organizations.

Organizations need reward systems that motivate performance, reward change, and encourage the development of individual and organizational capabilities and competencies. Paying the person instead of the job and using variable pay and stock are perhaps the most powerful changes an organization can make in moving its reward system toward one that supports performance and change. Decreasing the rewards for seniority and job size are important and desirable positives, but they are not likely to be as powerful as rethinking how the system should reward individuals for their skills and how it should reward performance.