



## CHAPTER 16

# Strategic Reward Systems

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*This chapter presents theory and research on the role of pay systems in complex organizations. It first looks at the relationship between pay systems and the business strategy and structure of organizations. It then focuses on the impact of pay systems on six important determinants of organizational effectiveness: performance motivation, skill development motivation, attraction and retention, organizational structure, culture, and costs. Different approaches to pay are reviewed with a focus on their impact on these six determinants of organizational effectiveness. The specific pay system practices reviewed include job-based pay, person-based pay, individual pay for performance, organizational pay for performance, and executive compensation. Overall the evidence indicates that pay systems have a strong impact on organizational effectiveness, and there is a link between strategy, structure, and pay systems.*

### Introduction

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REWARDS SYSTEMS AND their role in organizations have been studied from many perspectives and by multiple disciplines. Psychology, sociology, anthropology, and economics all have contributed to the literature. This

chapter will focus on the design features of the major organizational reward system, the pay system, and its relationship to organizational behavior. Since this topic is not the province of a single discipline, the literature will be drawn from a range of sources. The underlying assumption is that reward systems have a

wide-ranging impact on organizations and that their impact is greatly affected by their design and by the organizational context in which they operate. Thus, to understand pay systems in organizations, it is necessary to focus on the characteristics of both the organization and the pay system.

Pay systems are one of the most prominent and important features of any organization. There is an extensive literature in psychology on the effects of rewards on human behavior that can help the understanding of the impact of reward systems. There is also considerable research on the impact of pay systems on individual behavior in organizations and on the behavior of organizations. Some areas, such as the design of job evaluation systems and the impact of merit pay plans, have been extensively researched, but many others have received little attention. The discussion in this chapter is intended to accomplish two purposes: **first, to provide an overview of the research that has been done and, second, to identify those areas that are important but have been neglected by researchers.**

This chapter looks first at the relationship between pay systems and the business strategy and structure of organizations. It then focuses on the impact of pay systems on six determinants of organizational effectiveness: performance motivation, skill development motivation, attraction and retention, organizational structure, culture, and costs. The specific pay system practices reviewed include job-based pay, person-based pay, individual pay for performance, organizational pay for performance, executive compensation, and flexible benefits. Two process issues, communication and participation, are also considered.

## Reward Systems and Strategy

There is a growing body of literature on the relationship between organizational strategy and human resource management systems (e.g.,

see Lawler, 1986a; Ulrich & Lake, 1990). It typically suggests that once its strategy is developed, an organization needs to focus on the kind of human resources, culture, and behavior that is needed in order to make it effective. The next step is to **design reward and other human resource management systems that will motivate the right kind of performance, attract the right kinds of people, and create a supportive climate and structure** (e.g., see Balkin & Gomez-Mejia, 1987b; Hambrick & Snow, 1989; Lawler, 1986b).

Much of the writing on strategy is conceptual and descriptive in nature. It starts from a **competitive advantage framework and focuses on how human resource management practices can enhance an organization's performance by supporting particular kinds of behavior** (e.g., see Porter, 1985, 1990; Ulrich & Lake, 1990). Depending on the actual practices that are recommended, there may or may not be evidence that the practices are used and can produce the desired results. For example, if an organization is trying to become a low-cost producer, it is often argued that incentive plans and other pay for performance plans are called for. Missing is evidence that companies in fact are using plans with particular strategic agendas in mind. One exception to this concerns the area of management compensation where there are studies showing its relationship to strategy (e.g., see Hambrick & Snow, 1989; Kerr, 1985).

There is another way in which the reward system may need to be taken into consideration in the strategy area. Before the strategic plan is developed in an existing organization, it may be important to assess a number of things, including the current reward systems, and to determine what kind of behaviors, climate, and structure they are supportive of. This step is needed so that when the strategic plan is developed, it is based on a realistic assessment of the current condition of the organization and the changes likely to be needed to implement the new strategy. This point is particularly pertinent to organizations that are considering going

into new lines of business, developing new markets, and acquiring new divisions. Often new lines of business require a different behavior and therefore a different reward system. Simply putting the old reward system in place in the new business is often not good enough and indeed can lead to failure. On the other hand, developing a new reward system for one part of an organization can cause problems in other parts because of the comparisons made between the different parts.

At this point it is impossible to go beyond the conceptual level in discussing reward systems and strategy. There are some useful typologies or menus available. These typically identify different strategies and then match them to reward system practices (e.g., see Galbraith & Kazanjian, 1986; Lawler, 1990). These are useful from an organizational design point of view but are largely untested. Until more research is done in this area, it is impossible to make any definitive statements. This is likely to be an increasingly important area for practitioners, if not for researchers. The field of strategy is developing and companies are increasingly focusing on how they can gain a competitive advantage (Porter, 1990). There is good reason to believe that human resource management practices in general and reward systems in particular are central to the implementation and effective operationalization of strategies. Thus, it is important to determine how reward system practices fit with different business strategies.

## Reward Systems and Organizational Design

The literature on organizational design increasingly uses systems theory and fit models that stress the importance of congruence between the different subsystems of the organization (e.g., see Galbraith, 1973, 1977; Nadler & Tushman, 1988). Most of these approaches in turn identify the reward system as one of the

major systems in an organization that needs to be **driven by the strategy and aligned with the other systems**. The other systems mentioned usually include the **information system, the decision structure, the approach to work design, and the human resource management system**. The literature usually goes on to argue that it is the degree of alignment that determines how effective an organization actually is. This raises the issue of what constitutes good alignment, not to mention the issue of what data exist to support this assertion.

At this point there is little research evidence to support the congruence or fit argument. Nevertheless, it is an attractive notion and one that has high face validity, particularly if system thinking is accepted. It is easy, for example, to argue that an approach to organizing that centers all decisions at the top may need a different reward system than one based on pushing decisions to lower levels (Lawler, 1990). In addition, it is easy to accept the argument that the organization probably also needs a different approach to information and control.

A substantial literature does exist that focuses on the relationship between reward systems and the degree to which participative management is practiced (e.g., see Lawler, 1981, 1990, 1992). A brief examination of the literature will serve to help focus on some of the organizational design issues that arise with reward systems. This literature argues that if an organization wishes to operate in a participative manner, it needs to change more than just its decision structure and information system flow. It needs to change all its systems, including its reward system. This line of reasoning goes back to the early writings on the Scanlon plan (e.g., Lesieur, 1958) and the writings of McGregor (1960). They argue rather convincingly that for **participative management to be practiced effectively, a different approach to pay for performance is required**. They go on to suggest that the correct approach is to pay bonuses based on group- or plantwide

performance. The argument for this essentially rests on the point that **traditional pay plans support individual excellence at the cost of team performance and that for participation to work, team performance needs to be rewarded.** The evidence on the impact of gainsharing plans (e.g., Graham-Moore & Ross, 1983, 1990) tends to support this point and will be reviewed later in this chapter. At this point it is cited merely to establish the link between reward system design and organizational design.

The more recent writings on participative management have gone considerably beyond the argument that it requires a different approach to paying for performance. It argues that all the major features of a reward system need to be changed (e.g., Lawler, 1990). For example, **it is argued that pay needs to be based more on the skills of the individual than on the jobs that they do, that fringe benefit programs should allow choice, and that pay information should be public.** Later, each of these practices will be looked at separately. The important point to remember, however, is that part of the argument in favor of them rests on systems thinking; thus, to a degree, they cannot be evaluated without studying them in their proper context.

There is little direct evidence supporting the argument that reward systems need to be structured differently for participative management to be effective. There is some evidence about the actual reward system practices of companies that appears to be supportive, however. It tends to show that participative management is being more widely practiced and that reward system practices are changing in ways that are consistent with participative management (Lawler, Ledford, & Mohrman, 1989; Lawler, Mohrman, & Ledford, 1992; O'Dell, 1987). For example, **gainsharing has become increasingly popular in the last decade, and skill-based pay plans have replaced job-based plans in many manufacturing locations practicing participative management** (Gupta,

Jenkins, & Curington, 1986; Lawler, Mohrman, & Ledford, 1992).

In summary, a substantial literature focuses on the organizational systems issues affecting the impact that reward system practices have. The problem with it is that it lacks a substantial empirical basis. Some research has looked at the effect of certain reward system practices on individuals and organizations. This is important work and will be reviewed later, but it is not entirely satisfying because it provides limited information on how the impact of reward systems is affected by the organizational context.

## Impact of Pay System

The first step in a detailed discussion of the impact of reward systems is to consider what behaviors they can affect in organizations. The theoretical research and work on reward systems has focused on six factors that are influenced by reward systems and that in turn influence organizational effectiveness.

### Attraction and Retention of Employees

Research on job choice, career choice, and turnover clearly shows that the kind and level of rewards an organization offers influence who is attracted to work for an organization and who will continue to work for it (e.g., see Mobley, 1982; Mobley, Hand, Meglino, & Griffeth, 1979). Overall, those organizations that give the most rewards tend to attract and retain the most people (Lawler, 1971). This seems to occur because high reward levels lead to high satisfaction, which in turn leads to lower turnover and more job applicants. Individuals who are presently satisfied with their jobs expect to continue to be satisfied and, as a result, want to stay with the same organization. This interpretation is generally consistent with the work on **equity theory** as well as the work

on **expectancy theory and goal setting** (Adams, 1965; Lawler, 1973; Locke & Latham, 1990).

The best performers represent a particularly interesting retention problem. To retain them a reward system must distribute rewards in a way that will lead them to feel equitably treated when they compare their rewards with those received by individuals performing similar jobs at a similar level of performance in other organizations. The emphasis here is on external comparisons because turnover means leaving an organization for a better situation elsewhere. **One way to accomplish this is to reward everyone at a level that is above the reward levels in other organizations.** This strategy has two drawbacks, however. In the case of some rewards, such as money, it can be very costly. It can also cause feelings of **intraorganizational inequity—better performers are likely to feel inequitably treated when they are rewarded at the same level as poor performers in the same organization**, even though they are fairly treated in terms of external comparisons. Faced with this situation, the better performers may not quit, but they are likely to be dissatisfied, complain, look for internal transfers, and mistrust the organization.

The answer may lie in **basing rewards on performance.** This should cause the better performers to be satisfied and to stay with the organization. It is important to note, however, **that to be satisfied not only must the better performers receive more rewards than poor performers, they must receive significantly more rewards because, as equity theory points out, they are likely to feel they deserve much more.**

Research has shown that absenteeism and pay satisfaction are related (e.g., Baumgartel & Sobol, 1959; see Steers & Rhodes, 1978, for a full review), although the relationship is not as strong as the one between pay satisfaction and turnover. When the workplace is satisfying and high paying, individuals come to work regularly; when it is not, they do not.

Several studies have shown that absenteeism can be reduced by tying pay bonuses and other rewards to attendance (Lawler, 1981; Pedalino & Gamboa, 1974; Schlotzhauer & Rosse, 1985). This approach can be costly, but sometimes it is less costly than absenteeism. It is a particularly useful strategy in situations where both the work content and the working conditions are poor and do not lend themselves to meaningful improvements. In situations where work content or conditions can be improved, such improvements are often the most effective and cost efficient way to deal with absenteeism (Hackman & Oldham, 1980). **Reward system policies are only one of several ways to influence absenteeism, but they are potentially effective if an organization is willing to tie important rewards to coming to work.** Often this is easier to do than tying rewards to performance because attendance is easily measurable and visible.

### Motivation of Employee Performance

When certain specifiable conditions exist, reward systems have been demonstrated to motivate performance (Blinder, 1990; Lawler, 1971; Nalbantian, 1987; Vroom, 1964). What are those conditions? They are rather clearly articulated in the extensive literature on **expectancy theory: Important rewards must be perceived to be tied in a timely fashion to effective performance.** In essence, the argument is that organizations get the kind of behavior that leads to the rewards their employees value (Kerr, 1975). This occurs because people have their own needs and mental maps of what the world is like. They use these maps to choose **those behaviors that lead to outcomes that satisfy their needs. They are inherently neither motivated nor unmotivated to perform effectively; performance motivation depends on the situation, how it is perceived, and the needs of people.**

Expectancy theory is made up of a series of fairly straightforward observations about behavior. Three concepts serve as the key building blocks of the theory.

- **Performance-outcome expectancy.** Every behavior has associated with it, in an individual's mind, certain outcomes (rewards or punishments). In other words, **individuals believe or expect that if they behave in a certain way, they will get certain things**. For example, individuals may have an expectancy that if they produce 10 units they will receive their normal hourly rate, while if they produce 15 units they will receive their hourly pay rate plus a bonus. Similarly, individuals may believe that certain levels of performance will lead to approval or disapproval from members of their work group or their supervisor. Each performance level can be seen as leading to a number of different kinds of outcomes.
- **Outcome attractiveness.** Outcomes have differential attractiveness for different individuals. This is true because outcome values result from individual needs and perceptions, which differ because they reflect other factors in an individual's life. **Some individuals may value an opportunity for promotion or advancement because of their needs for achievement or power, while others may not want to be promoted and leave their current work group because of needs for affiliation with others.** Similarly, **a fringe benefit such as a pension plan may have great value for older workers but little value for younger employees on their first job.**
- **Effort-performance expectancy.** Each behavior also has associated with it a certain expectancy or probability of

success. This expectancy represents the individual's perception of how hard it will be to achieve the behavior and the probability of his or her successful achievement of that behavior (Locke & Latham, 1990). For example, employees may have a strong expectancy (e.g., 90–10) that if they put forth the effort, they can produce 10 units per hour, but that they only have a 50–50 chance of producing 15 units per hour if they try. This expectancy is based **on the characteristics of the task as well as such individual differences factors as an individual's sense of efficacy** (Bandura, 1986).

Putting these concepts together, one can make a basic statement about motivation. In general, an individual's motivation to behave in a certain way is greatest when:

- **The individual believes that the behavior will lead to certain outcomes** (performance-outcome expectancy)
- **The individual feels that these outcomes are attractive**
- **The individual believes that performance at a desired level is possible** (effort-performance expectancy)

Given a number of alternative levels of behavior (e.g., 10, 15, or 20 units of production per hour), an individual will choose the level of performance that has the greatest motivational force associated with it, as indicated by a combination of the relevant expectancies, outcomes, and values. This combining process is theoretically defined as the multiplicative combination of these components such that if any one is zero there is no motivation. In other words, when faced with choices about behavior, an individual goes through a process of considering questions such as: Can I perform at that level if I try? If I perform at that level, what will happen? and How do I feel about those things that will happen? The

individual then decides to behave in a way that seems to have the best chance of producing positive, desired outcomes.

The **expectancy model also suggests that satisfaction is best thought of as a result of performance rather than as a cause of it** (Locke & Latham, 1990; Porter & Lawler, 1968). Strictly speaking, it does influence motivation in some ways. For instance, **when it is perceived to come about as a result of performance, it can increase motivation because it strengthens people's beliefs about the consequences of performance**. Also, it can lead to a decrease in the importance of certain outcomes, and as a result, decrease the motivation for those performances that are seen to lead to whatever reward becomes less important.

In many ways, the expectancy model is a deceptively simple statement of the conditions that must exist if rewards are to motivate performance. It is deceptive in the sense that it suggests all an organization has to do is relate pay and other frequently valued rewards to obtainable levels of performance. Not only is this not the only thing an organization has to do, as is obvious from the research on pay for performance systems, it can be difficult to accomplish.

In order for employees to believe that a pay for performance relationship exists, the **connection between performance and rewards must be visible, and a climate of trust and credibility must exist in the organization**. The reason why visibility is necessary should be obvious; the importance of trust may be less so. The belief that performance will lead to rewards is essentially a prediction about the future. For individuals to make **kind of prediction they have to trust the system that is promising them the rewards**. Unfortunately, it is not always clear how a climate of trust in the reward system can be established. As will be discussed later, some research suggests that a **high level of openness and the use of participation can contribute to trust in the pay system**.

## Motivation of Employee Self-development

Just as reward systems motivate performance, they can motivate the learning of skills and the development of knowledge (Lawler, 1990). The key here is the same as it is with performance motivation. **Individuals need to see a connection between learning specific skills and a valued reward.** Pay for performance systems may motivate learning and development because individuals perceive that they **must develop their skills in order to perform effectively**. However, if individuals feel they already have the skills, then a pay for performance system may not have this impact.

Sometimes pay for performance systems may discourage individuals from learning new skills or motivate them to learn the wrong skills. **This can happen when the skills that should be learned are not directly related to present performance and, as a result, are not likely to lead to a reward and indeed may decrease the chances of receiving a performance-based reward.**

The reward systems in most organizations are extremely hierarchical. In major U.S. corporations, for example, executives often make more than 100 times as much as lower-paid employees (Crystal, 1991). As a result, strong motivation is created to learn those skills that are perceived to lead to promotion. To counter this tendency some organizations are using **skill-based pay** when they want individuals to add new skills that do not involve promotions. They also use them when they want employees to develop a broader understanding of how the organization operates (Jenkins & Gupta, 1985; Lawler & Ledford, 1985).

## Organizational Culture

Reward systems are one feature of organizations that contributes to the overall culture and climate (Whyte, 1955). Depending on how reward systems are developed, administered,

and managed, they may cause the culture of an organization to vary quite widely. For example, they may influence the degree to which it is seen as a human resources-oriented culture, an entrepreneurial culture, an innovative culture, a competence-based culture, and a participative culture.

Reward systems have the ability to shape culture precisely because of their important influence on motivation, satisfaction, and membership (Kerr & Slocum, 1987). The behaviors they elicit become the dominant patterns of behavior in the organization and lead to perceptions and beliefs about what an organization stands for, believes in, and values.

Perhaps the most obvious link between pay system practice and culture concerns the practice of performance-based pay. The absence or presence of this policy, as well as how well it is implemented, can have a dramatic impact on the culture of an organization because it so clearly communicates to organization members what the performance norms are in the organization. Many other features of the reward system may also influence culture. For example, having relatively high pay levels may produce a culture in which people feel they are an elite group working for a top-flight organization, while introducing such innovative pay practices as flexible benefits may produce a culture of innovativeness. Finally, having employees participate in pay decisions may produce a participative culture in which employees are generally involved in business decisions and as a result are committed to the organization and its success (Lawler, 1981).

### Organizational Structure

The reward system of an organization can help reinforce and define the organization's structure (Lawler, 1981, 1990). Often this feature of reward systems is not fully considered in the design of reward systems. As a result, their impact on the structure of an organization is

unintentional. This does not mean, however, that the impact of the reward system on structure is necessarily minimal. Indeed, it can help define the status hierarchy and the degree to which people cooperate with people from other departments and within their work area. It can also strongly influence the kind of decision structure that exists.

The decision to cover a group of people with a pay for performance system is an important structural decision that causes both integration and differentiation (Lawrence & Lorsch, 1967). It can have a particularly strong impact on the degree to which people feel they share a common fate with others in the organization. It can set them off or differentiate them from others, thereby creating a kind of structural boundary that reduces cooperation and sharing with individuals and groups outside the boundaries of the pay system. If the system pays them the same, based on a measure of their collective performance, it can integrate them and cause them to cooperate and work as a team. On the other hand, if the reward system asks individuals to compete among themselves for a fixed amount of money that has been allocated for raises or bonuses, it can serve to differentiate them from each other and cause them to compete among themselves.

### Organizational Cost

Reward systems are often a significant cost factor in organizations. Indeed, the pay system alone may represent over 50 percent of an organization's operating cost. Pay systems involve direct pay and benefit costs, as well as the costs associated with managing and operating the system. In the case of some pay systems, these operating costs can be quite high. Thus, it is important in considering the impact of the reward system to focus on how high these costs are.

Recently, some economists have argued that it is important to consider how costs vary as a function of the organization's ability to

pay (Weitzman, 1984). For example, a reasonable outcome of a well-designed pay system might be an increased cost when the organization has the money to spend and a decreased cost when it does not. This can help an organization avoid layoffs and provide individuals with greater job security. An additional objective for an organization might be to have lower overall reward system costs than its business competitors.

## Establishing Base Pay

Most pay systems are founded on the idea of paying individuals based on the job they hold (Rock & Berger, 1991). The question then becomes, How does one begin to establish a basis for the compensation of different jobs. This will be discussed next, as will an alternative of paying individuals based on what their skills are worth.

### Job Evaluation

Job evaluation is a formal procedure for ordering a set of jobs or positions in an organization with respect to their inherent value or worth in achieving the organization's objectives. This procedure is usually then linked to a rate of pay prescribed for that job. While the origins of job evaluation are variously attributed to the U.S. Civil Service Commission in 1871 (Patton, Littlefield, & Self, 1964) or to the work of Frederick W. Taylor in the 1880s (Pasquale, 1969), the earliest significant applications were found in the late 1930s with the growth of the labor movement (Patten, 1988). Its use in the private sector became widespread during World War II, when the National War Labor Board permitted wage increases only to correct demonstrated "inequities" in wage structure (Livy, 1975). At about the same time, most government jobs were being classified using some form of job evaluation system (Suskin, 1977). Generally, by the

mid-1970s, estimates of the percentage of U.S. firms using some form of job evaluation ranged from 70 to 80 percent (Bureau of National Affairs, 1976).

Regardless of the specific type of job evaluation procedure used, almost all share a similar methodology. First, the jobs to be evaluated are carefully described using a thorough job analysis. Second, based on the description of the job, each job is evaluated with respect to its value or worth to the organization, and the jobs are then arranged hierarchically with respect to this evaluation. Finally, these results are used to set wage rates within the organization. The remainder of this section will focus on the second step in that process, since it is the area that has been the subject of the most research.

**Methods.** There are four major methods of job evaluation: job ranking systems, job classification systems, factor comparison systems, and point systems. The first two of these methods are generally referred to as qualitative techniques, the second two as quantitative techniques.

**Job Ranking.** Job ranking systems are the crudest of the job evaluation techniques. Based on their relative worth to the organization, jobs are ranked as a whole from the highest to the lowest. Because the rankings are based on job descriptions, not specific job facts, they are highly subjective. This procedure can be difficult to implement in a large organization where many jobs are to be evaluated.

**Job Classification.** This approach involves developing a set of job grades or classes and then fitting the jobs in the organization into these classes. First, comprehensive grade descriptions are written. These descriptions must be written generally so that many different types of jobs can be classified. Evaluators then examine job descriptions as a whole and match them to the appropriate grade description. Two difficulties with this approach are

immediately obvious. The level of generality at which grade descriptions are written may encourage individuals to exaggerate and aggrandize their duties and responsibilities to obtain higher classifications and hence higher base pay. Second, most jobs will have some duties that are contained in one grade description and some in another. The evaluator is then forced to average or to pick the closest match to the job.

**Factor Comparison Approaches.** Factor comparison job evaluations compare jobs with respect to job dimensions or job requirements that the organization has deemed deserve compensation. The skeleton of the system is formed by selecting key or benchmark jobs that have relatively stable content, are found in many organizations, and for which a prevailing wage is known. Some systems use the current wage rate for the benchmark jobs rather than the prevailing wage. These jobs are then ranked along each compensable factor, and based on these rankings, the prevailing wage is apportioned across the compensable factors. Once the skeleton of the system is assembled, other jobs in the organization are compared factor by factor to the key jobs and given the dollar value thought to be appropriate for that factor. The dollar values assigned for each factor are then summed to reflect the worth of the non-key jobs.

While cumbersome to develop and explain, this approach is relatively easy to administer as long as prevailing wage rates are constant. There are two serious weaknesses in this approach, however. First, wage rates for the key jobs must be equitably aligned both internally and externally to produce useful assessments of relative worth. Second, the apportionment of the wage of the key jobs across factors must be valid since they constitute the foundation for the entire system.

**Point Systems.** The point system is the most widely used of the job evaluation approaches.

Estimates are that over 95 percent of major U.S. corporations use this approach to evaluate at least some of their jobs (Lawler, 1990). Like the factor comparison approach, compensable factors are first determined. They are given weights or points reflecting the relative importance of each factor in determining job worth. The factors are then divided into degrees and the points associated with that factor allocated across them. The upper end of each factor scale represents the maximum points associated with that factor, the lower end either zero or some "base." Detailed descriptions of the job content and requirements of each degree are written. Using job descriptions and/or task inventories, job evaluators then assess each job with respect to how much of each factor the job contains, match that assessment to the degree descriptions, and award the number of points associated with that degree. The relative worth of the job is then reflected in the sum of the points awarded for each factor.

**Criticisms of Job Evaluation Systems.** While job evaluation approaches are probably the most prevalent methods of establishing base pay, their usefulness, like the usefulness of any management system, depends on how well they achieve their objectives (Lawler, 1990). They have been increasingly subject to criticism. For example, Belcher (1969) characterized them as based on "untested assumptions," and Mahoney (1991) described them as increasingly anachronistic. The criticisms discussed next address three different but related areas: the reliability and validity of job evaluation techniques, the unintended consequences likely to accompany them, and the congruence between these techniques and other organizational systems.

**Psychometric Properties.** The reliability of job evaluation instruments has been challenged because the evaluation process is inherently subjective (Beatty & Beatty, 1984). Investigations of the reliability of job evaluations

appear in two clusters (Welbourne & Gomez-Mejia, 1991): research in the late 1940s when job evaluation systems were achieving prominence as compensation tools (e.g., Ash, 1948; Chesler, 1948; Jones, 1948; Lawshe & Farbro, 1949; Lawshe & Wilson, 1947), and research in the 1980s as questions of equal pay for work of comparable worth were raised (e.g., reviews by Arvey, 1986; Madigan, 1985; Milkovich & Broderick, 1982; Schwab, 1980; Snelgar, 1983). The earlier studies generally report high reliabilities for the total scores and somewhat lower reliabilities for individual factor ratings. In addition, systems using few factors tend to have higher reliabilities than those using many factors. The later studies are more likely to report mixed results (Arvey, 1986). For example, Gomez-Mejia, Page, and Tornow (1982) examined seven different job evaluation methods and reported reliabilities of .44 to .80.

With respect to the validity of job evaluation techniques for producing assessments of the organizational value of jobs, Arvey (1986) characterizes the evidence as "sparse." Generally, the validation studies that do exist approach the validation process from either a convergent or a predictive validity perspective. In the first approach, a set of jobs are subjected to varying job evaluation techniques and the results compared (e.g., Gomez-Mejia, Page, & Tornow, 1982; Madigan & Hoover, 1986). In the second approach, job evaluation results are used to predict either the organization's existing wage structure or the prevailing wage rate as defined by wage and salary surveys (e.g., Dertien, 1981; Schwab & Grams, 1985). Even if the results of both approaches are consistent and supportive (which they are not), this does not establish the construct validity of job evaluation as a measure of relative worth (Gupta & Jenkins, 1991).

The first approach that looks at multiple job evaluation approaches simply demonstrates that different job evaluation techniques are measuring the same thing. Whether that

"thing" is the value of the job to the organization remains to be seen. It may simply reflect the shared stereotypes, biases, training, or experience of the evaluators (Gupta & Jenkins, 1991).

Rynes and Milkovich (1986) have argued that the "going rate" for jobs does not exist. Rather, it is the sum of a series of subjective judgments on the part of those who conduct and use salary surveys. Similarly, the hierarchy of wage rates within a firm is a product of history, negotiation, stereotypes, convenience, and rationalization. Thus, the predictive approach to validation cannot prove that a job evaluation technique actually captures the "true" value a job adds toward meeting the organization's objectives. All it establishes is that the job evaluation approach reflects the subjective judgments and biases that have been institutionalized either in the marketplace or internally in the organization.

In summary, the evidence to date leaves the construct validity of job evaluations in question. Reliability evidence is abundant, but the convergent and predictive validity data are less convincing. They are not sufficient to establish that the "true" worth or value of a job has been captured (Gupta & Jenkins, 1991).

**Unintended Consequences.** A job evaluation system is a control system. Control systems are designed to influence and direct employee behavior (Lawler & Rhode, 1976). The behaviors they influence and direct, however, are not necessarily those that are intended or those that are functional for the organization (Kerr, 1975). Job evaluation systems are no different in this respect. Lawler (1986c) has highlighted a number of unintended and organizationally undesirable employee behaviors that are often associated with the use of job evaluation systems.

First, because job evaluation systems tie pay to those activities included in the employee's responsibilities, they necessarily high-

light those activities that are outside that purview. "That's not my job" and "I'm not paid to do that" are common refrains for not doing things that further the organization's objective.

Second, because the intent of job evaluation is establishing internal equity, these systems direct employee attention to the internal relationships among jobs. Rather than paying attention to the competition in the marketplace, employees concentrate on how the pay for their jobs differs from the pay of others and how they can improve their relative pay positions.

Third, employees quickly realize that creatively written and aggrandized job descriptions and exaggerated task inventories can sometimes lead to pay increases more easily than actual changes in job duties. Thus, they produce inflated descriptions that raise their pay and the organization's costs.

Fourth, job evaluation systems implicitly or explicitly assign a heavy weight to responsibility, reinforcing the idea of a management hierarchy. Promotion, therefore, becomes the surest way to increase one's pay. In many modern organizations that require technical excellence or a broad-based understanding of the organization, the *linear career orientation* engendered by job evaluation approaches works at cross-purposes with organizational objectives (Fuller, 1972). The development of career ladders and maturity curves for scientists as alternative base pay structures for some groups of employees attests to the failure of traditional job evaluation methods to reward employees for electing career paths where they could only look forward to static or potentially declining levels of compensation.

**System Congruence.** Mahoney (1991) argues that the notion of work is undergoing a fundamental shift. Viewing work as a set of standardized, programmed tasks appropriate to the industrialization of the early 20th

century is inappropriate in a time of internationalized markets, rapid technological and product developments, and emphases on quality and timeliness. The demands of this new environment require new organizational systems for designing work, authority structures, and organizations. The compensation system must be congruent with these new systems.

**Job evaluation systems that reinforce power relationships and pecking orders based on pay may impede the success of organizations that need technical knowledge and innovation often found at the bottom of the organizations** (Lawler, 1986c). Similarly, successfully managing organizations that require flexibility and adaptability from their employees to meet changing environments is at odds with job evaluation systems based on prescriptive descriptions.

Job evaluation systems that reinforce organizational hierarchies also make the use of participative management systems more difficult (Lawler, 1990). Employee participation has an inherent dimension of equality. To the extent that the job evaluation system forces differences in pay and, by implication, worth, the success of a participative system is jeopardized.

Organizations are adopting team-based approaches to organizing to meet the new organizational realities (Lawler, Mohrman, & Ledford, 1992). The unit of management in these organizations is the team. Tasks, duties, and responsibilities are assigned to a team, not an individual. While they are performed by individuals, individual responsibility shifts among team members as internal needs and external demands shift. **Traditional job evaluation, with its focus on the job performed by an individual, is fundamentally incompatible with this organizational design.** In theory, the logic of job evaluation could be applied to a team as a whole rather than to the individual team member with all team members paid at the same rate. But this leads to the

same problem discussed earlier with respect to job evaluation plans that focus on individuals: evaluating the relative importance of the contribution of one team versus another (Gupta & Jenkins, 1991). Whatever the strategy taken, the end result bears little resemblance to the original notion of job evaluation as conceived by Taylor and others.

**Organizations using traditional job evaluation techniques leave little room for rewarding individual variations in behavior.** The jobs for which individuals are paid are clearly specified, as are the ways the jobs are to be performed. Mahoney (1991) notes that job evaluation systems are appropriate where jobs are standardized and unvarying and where differences in performance are difficult to attribute to individuals. **In many organizations, however, differences among individuals and teams are large and observable. Rewarding these differences means focusing on the individual, which is in fundamental opposition to the basic tenet of job evaluation systems, that of paying the job.**

**Conclusion.** There is always likely to be a role for job evaluation in the administration of compensation. It can provide an internally justifiable wage structure for organizations that are structured around relatively stable collections of tasks. As organizations restructure to meet the new demands of a rapidly changing environment, however, it is less likely to be used because it fails to recognize differences in individual capability and it reinforces a hierachial approach to management.

### Skill-based Compensation Systems

The classic works of Katz and Kahn (1966) and Emery and Trist (1965), which apply the logic of open-systems theory and sociotechnical-systems theory to organizations, focus attention on the way work is designed and arranged. They focus particularly on the role of groups and on the design of work for groups or teams

that are given the responsibility for the production of a whole product (Lawler, 1978; Walton, 1980). In these self-managing teams, members are expected to function interdependently to accomplish this end. The rotation of individuals among tasks or jobs within a team is expected to be frequent, each team member assuming responsibilities as needed and as he or she is able. Thus, team members are expected to become flexible members of the group by becoming skilled in all or most of the tasks that fall within the group's purview.

The self-managing team approach was first used in a number of new plants, but it is now widely used (Lawler, Mohrman, & Ledford, 1992). When combined with other management practices and a management style that stresses employee participation, growth, and development, it can produce a high-involvement work culture (Lawler, 1986a, 1992).

Given the underlying premises of the job evaluation approaches and the problems associated with their use, a different approach to establishing base pay is needed in organizations that use teams and high-involvement management. Skill-based pay or pay-for-knowledge compensation systems seem to be the preferred approach (Lawler, 1990). **Rather than paying individuals for the specific job they are performing, they are paid at a rate based on the repertoire of jobs or tasks they can perform—that is, their knowledge and mastery of different jobs in the organization.**

Pay-for-knowledge or skill-based compensation systems can be grouped into two broad types: **multiskill-based or breadth systems**, where pay levels are linked to the number of different skills a worker learns and can perform in the organization; and **increased knowledge or depth-based systems**, where pay levels are linked to increased knowledge and skill within the same general job category.

Under a multiskill-based pay system, a new employee is paid a starting rate when

first hired. When the employee masters a skill or task, a pay increase is awarded. As new skills or tasks are mastered, additional pay increases are given until the individual masters all the tasks required in the work team or all the tasks in the plant.

Organizations have tried a number of variations on this basic theme. Sometimes the pace at which employees can learn new skills is restricted. In some instances, the proficiency with which a mastered skill is performed is used as a basis for awarding the increment associated with learning that skill. Sometimes the increments associated with all tasks are the same; sometimes the increments vary with the complexity of the task or the average time required to learn the task. Whatever the particular details, multi-skill-based pay plans tie individual pay levels to the number of skills or tasks the individual employee can perform.

**Increased-knowledge-based systems**, on the other hand, base individual pay on the depth of knowledge in a particular skill area. As individuals specialize in one skill area and acquire greater knowledge or proficiency in that area, increases in pay are awarded. Technical ladders in R & D organizations and organizations with apprenticeship systems in the skilled trades represent familiar forms of these systems. Less familiar are the depth-based systems in high-involvement organizations, where a worker chooses to specialize in a particular skill area, gaining expertise in that particular job and then acting as a trainer, a resource to others learning that skill, and as the technical expert when problems arise.

While no experimental evidence on the impact of skill-based approaches to base pay exists, a number of recent empirical case studies (Gupta et al., 1986; LeBlanc, 1990; Ledford, 1985; Ledford & Bergel, 1990; Ledford, Tyler, & Dixey, 1990; Tosi & Tosi, 1986) and theory pieces (Jenkins & Gupta, 1985; Lawler & Ledford, 1985; Ledford, 1991; Tosi, 1986)

suggests they can offer advantages over traditional job-evaluation approaches for both employers and employees.

**Advantages for the Organization.** The single biggest advantage of skill-based pay systems in a production setting is increased flexibility (Jenkins & Gupta, 1985). Because workers know more than one job, they can move with ease from one task to another as the need arises. As market and product demands change, workers can move from one set of jobs to another. As employees are absent, their roles can be filled temporarily by other team members, reducing the need to overstaff for absenteeism, fluctuations of supply and demand, and day-to-day uncertainties. Because in skill-based pay systems human resources tracks organizational needs more closely, organizations can enjoy leaner staffing and reduced overall labor costs.

Organizations using skill-based pay systems also report higher quality output (Gupta, Jenkins, & Curington, 1986). Because workers are multiskilled, they have a better idea of how the different tasks fit together, and thus they have a greater understanding of the importance of quality in their performance. In addition, because one of the skills frequently learned in multiskill systems is quality assurance, workers know the quality-assurance requirements for the task and can distinguish between acceptable and unacceptable products. Furthermore, as Jenkins and Gupta (1985) note, because of the frequent movement and rotation among jobs, operators producing low-quality output today may find they produced tomorrow's headaches when they move to quality assurance or to rework and repair.

Absenteeism and turnover tend to be lower in organizations using skill-based pay. For example, in a study of plants using skill-based pay systems (Gupta et al., 1986), 74 percent of the companies in the sample

believed that their absenteeism rates were lower than they would have been without the skill-based pay system, and 69 percent reported that their voluntary turnover rates were lower. Many employees are more satisfied under these systems because they have a greater degree of control over their own lives and rates of pay. Also, because employees have a greater understanding of the entire operation in their organization, their intrinsic satisfaction may increase, and they are better able to see the importance of their attending work regularly. Turnover is decreased in part by the increased satisfaction experienced by employees in these organizations and in part because, in March and Simon's (1958) terms, the ease of movement has been decreased with the addition of firm-specific training (Becker, 1975; Oi, 1983). Finally, these systems often produce higher than market pay rates.

As employees become more broadly knowledgeable about the operations of the organization by working in different parts of it, the potential for them to become more self-managing is enhanced. They are in a position to control their own behavior, cooperate with others in the organization, solve problems, and participate in decisions about how the organization operates. The more self-managing employees become, the fewer the levels of management that are needed and, in fact, the fewer managers, supervisors, staff, and support personnel that are needed. In the Gupta et al. (1986) study, 61 percent of the companies responding said they would need more first-line supervisors without a skill-based pay system; 63 percent said they would need more skilled trades employees; 32 percent said they would need more managers.

**Advantages for Employees.** From the perspective of employees, a number of advantages may be gained from skill-based pay systems. Perhaps the most noticeable is an increase in satisfaction. Research has shown that employee satisfaction levels are generally

higher in skill-based pay companies than they are in similar companies using traditional pay systems (Lawler, 1990; Ledford, 1991). Because employees in skill-based pay plans are generally paid more than they would be under traditional compensation systems, this may reflect the strong correlation between pay satisfaction and pay level (Lawler, 1971). It is also possible that the increase in satisfaction derives from a feeling by employees that they are being treated as individuals.

Increases in the intrinsic motivation to perform undoubtedly result from the enhanced job enrichment inherent in skill-based pay systems (Jenkins & Gupta, 1985). As individuals rotate through different jobs in the organization, either learning new skills or exercising the increased flexibility in assignment they possess, there is a natural increase in job variety, autonomy, task identity, and task significance, with a consequent increase in motivation (Hackman & Oldham, 1980).

Another employee benefit of these systems is increased feelings of self-worth and self-esteem. The organization is demonstrating its regard for employees by investing resources in them and providing them the opportunity to learn and grow. As people's talents develop, they feel better about themselves.

The increased flexibility and leaner staffing that skill-based pay plans promote may also create increased job security for employees. The organization is able to maintain a more stable work force, redeploying people in times of low or shifting demand.

**Costs.** The advantages of skill-based pay systems do not come without costs. First, the pay rates that these systems produce tend to be higher on average than they would be under a traditional pay system. By rewarding skill acquisition, these systems encourage employees to become more valuable to the organization by mastering new skills. As employees master new skills, their average hourly pay increases.

Second, because the systems encourage employees to learn multiple skills, the organization must make a larger investment in employee training than is the case in traditional systems. This investment can be substantial, involving hiring and paying trainers, lost time from work during training, and costs of less than fully competent individuals performing tasks. To some extent the training costs are mitigated because training is often provided by members of the work team as a normal part of the job, but the performance losses are real, at least in the short-run. In addition, because the work force is in flux, additional burdens are placed on the human resource management system, which must coordinate the movement of employees from job to job and insure a proper balance between production and employee skill acquisition. It is especially important that the planning system support the goals of the pay system. The human resource planning systems must encourage movement of employees across jobs and emphasize job rotation. Otherwise, employees quickly become frustrated and distrustful when they are ready to master a new skill and the opportunity to do so is not available to them.

Third, skill-based pay systems place extra demands on the performance appraisal system. Employees must be evaluated more frequently than in traditional systems, they must be evaluated for their ability to do multiple jobs, and at times they must be evaluated by multiple appraisers. Because of the increased empowerment of employees, inadequacies in the performance appraisal system are likely to become obvious, and pressure is likely to be brought by employees to rectify these inadequacies. Deficiencies in the performance appraisal system will also have the effect of certifying less than fully skilled individuals, producing well paid jacks-of-all-trades but masters-of-none.

Fourth, the administrative burden is greatly increased with skill-based pay

systems. The pay rates change much more frequently and less predictably in skill-based pay systems than in traditional systems. Records must be maintained to keep track of which employees can do which jobs so that full advantage of the system can be realized.

Fifth, because the system abandons the traditional notion of paying the job and focuses on paying the individual, market comparisons become more difficult. When individuals perform jobs only part of the time and in different combinations, it is often impossible to find benchmark jobs in other organizations in order to peg pay rates. Furthermore, as multiskilled employees are worth more to the organization than are single-skilled employees, simple market comparisons are inappropriate on their face.

As skill-based pay systems mature, another difficulty develops. When a skill-based pay system is young, there are many skills for employees to learn. But as the system matures, the more ambitious employees may have mastered all available skills, with no place to go. While *topping out* occurs in traditional pay systems when individuals reach the top of their pay grades, it generally occurs much later in an employee's career. This problem is exacerbated by the fact that in skill-based pay systems employees may learn to expect more frequent pay raises than in traditional pay systems.

Ensuring that employees remain proficient in the skills they learn can also present problems for the organization. When organizations are faced with pressure to produce, employees may not be allowed to move as freely from job to job. Skills that are not used for extended periods of time may atrophy, and the organization thus may compensate individuals for skills they either no longer possess or cannot perform as effectively as when originally learned.

Finally, when organizations introduce technological innovations or other changes

that make previously acquired skills no longer valuable to the organization, they must fashion fair and equitable methods to adjust employees' wages without penalizing them for decisions made by management. One approach is to freeze the employee's rate until new skills are acquired to replace the obsolete skills.

**Development and Implementation.** Setting up a skill-based pay system is not easy. There is very little institutionalization of these programs. Traditional job evaluation systems such as the point system or the Hay plan are more or less the same from one organization to the next and share a well-understood technology for their development and installation. Each skill-based pay plan is specific to the organization that uses it. Jenkins and Gupta (1985) note that there are probably as many variations of skill-based pay systems as there are organizations using them. While no handbook exists specifying the "correct" way to design a skill-based pay system, Ledford (1990) and Lawler (1990) have enumerated a set of issues potential adopters must address and have designed steps to make a successful plan more likely.

The first issue to be considered is how the skill-based pay system will fit with the organization's culture, its other management and technological systems, and its business objectives. Generally, skill-based pay systems are most effective when organizations have or are moving toward a participative organizational culture. The breadth of experience and skill that skill-based pay systems produce in employees provides them a perspective for organizational decision making. This perspective enhances employee problem-solving skills and cooperation, an important advantage where technological interdependence is high and teams are used.

Second, the organization must identify the skills required for effective operation through careful analysis of the tasks needing to be

performed in the organization. These tasks are then grouped or clustered into sets of skills (often called skill blocks) for which the organization is willing to pay more money. This step is critical to the ultimate success of the plan; the structure of the skill blocks determines (a) how well the pay plan fits the organization's technology and (b) the skeletal structure that provides the basis for most of the plan's detail (e.g., pay levels, certifications, training modules, etc).

Third, the organization must identify the optimal skill profiles for all employees in the organization. The organization must specify how many employees with what combination of skills are needed to accomplish the organization's business objectives. In so doing, the organization must consider its technological constraints. For example, manufacturing cells that are self-contained units making a set of products for a specific market require employees who possess all the skills used within the cell, but not necessarily those in other cells. In contrast, workers in continuous process technologies (such as those used in food processing and pharmaceutical production) are highly interdependent and must respond quickly to problems that may appear anywhere in the process. Thus, the organization needs employees who possess skills to work throughout the facility.

Fourth, the organization must develop a mechanism for pricing each skill and skill block. In some cases, the skills can be identified and priced by going to the labor market and determining the hiring rate for individuals with specific skills. In others, the value added by the skill can serve as a guide. Regardless of the specific details of pricing the skill, this is one issue that cannot be sidestepped because it will form the basis for both internal and external equity assessments on the part of the employees.

Fifth, the organization must develop a set of rules about the sequence in which skills can be learned and the rate at which they can be

learned by employees. Because employees' wages are determined by the number of skills they possess, they are naturally concerned with what they must do to acquire additional skills. Having too many employees learning new skills at the same time necessarily means that the organization is operating at a sub-standard level. Having too few employees learning new skills reduces the flexibility that organizations want from these systems. These access rules also have implications for the kinds, amounts, and timing of the training needed to impart the skills.

Sixth, the organization must develop methods and procedures to determine when and whether an employee has acquired a new skill. This is often the most contentious issue in skill-based pay systems. The criteria and methods used to determine skill assessment must be developed in light of the nature of the job that is under consideration. It is generally believed that a work sample test in which the employee performs the tasks relevant to the skill is the best approach to skill certification. On the other hand, some skills, particularly those involving cognitive skills (e.g., reporting and logging procedures), may be assessed more effectively using paper-and-pencil tests.

When the testing of employees for skill certification is conducted (on demand or at set intervals) and how long employees must wait to be retested if they fail the certification must also be determined ahead of time. In addition, the organization must make a determination of who conducts these skill assessments and certifications. In traditional pay systems, the responsibility for pay decisions usually lies with management. In high-involvement organizations, however, the responsibility may reside with co-workers and teams as well.

**Finally, the organization must develop policies and procedures for decertification, that is, for situations in which individuals will no longer be paid for skills they previously mastered.** This could occur, for instance, if

there were changes in the technology the organization used to produce its goods. It could also occur if the organization's product or service became obsolete. It could occur with the move of individuals from one work area to another, eliminating the need to possess those skills. Furthermore, some skills may atrophy or be lost if they are not used regularly. Since it is not in the organization's interests to pay for unneeded skills, procedures for decertification must constitute integral components of the pay system design.

Overall, developing a pay system that pays employees for the skills they possess requires considerable thought and system development. If properly done, however, pay can be used to reward individuals for developing the skills that help the organization function effectively, while at the same time furthering employee growth, development, and satisfaction. Compared to the amount of research on job evaluation, relatively little research has been done on skill-based pay. It is clearly an area where more research is needed.

### Pay for Individual Performance

The idea of paying for performance is so widely accepted that almost every organization says that it pays for performance. A survey of 557 large U.S. corporations found that 80 percent of them rate pay for performance as a very important compensation objective (Peck, 1984). The major reason for the popularity of paying for performance is the belief that it can motivate job performance and increase organizational effectiveness. The research evidence clearly supports this view.

There has been, and continues to be, considerable evidence that pay can be a particularly powerful incentive (Blinder, 1990; Jenkins, 1985; Lawler, 1971; Locke et al., 1980; Nalbantian, 1987). Studies show productivity increases of between 1 and 35 percent when pay for performance systems are put into place

TABLE 1

#### Characteristics of Individual Pay for Performance Approaches

	Incentive Pay	Merit Pay
Payment Method	Bonus	Changes in base pay
Frequency of Payout	Weekly	Annually
Measures	Output, productivity, sales	Supervisor's appraisal
Coverage	Direct labor	All employees

(Lawler, 1990). Although pay for performance is often treated as a single approach, there are, in fact, many different approaches to paying for performance (e.g., see Blinder, 1990; Jenkins & Gupta, 1982; Lawler, 1990) that have very different consequences. They can be easily classified based on the level of performance on which they focus: individual, organizational subunit, or total organization. Within each of these general approaches, there are literally hundreds of different approaches to relating pay to performance.

The focus in looking at the different approaches to paying for performance will be on their impact on individual and organizational behavior. Pay for performance systems are not stand-alone systems; their impact is partially determined by the organizational context in which they operate. Thus, as different approaches to pay for performance are reviewed, consideration also will be given to how they fit with different management styles and organizational designs.

There are two common approaches to paying for individual performance. One, *incentive pay*, has been declining in popularity for decades; the other, *merit salary increases*, remains very popular (e.g., see Lawler, Ledford, & Mohrman, 1989; O'Dell, 1987). They are similar in that they measure and reward individual performance. They are different in how they measure performance and in how they

adjust an individual's pay according to performance. This is shown in Table 1, which summarizes the characteristics of the two approaches.

#### Incentive Pay

Incentive plans pay employees bonuses based on the number of units produced. They are perhaps the most direct way to relate pay to performance. There is a great deal of evidence that *incentive pay can motivate individual behavior; indeed, much of this research is decades old* (e.g., see Lawler, 1971). There is also good reason to believe it can attract and selectively retain good performers because they end up being paid more.

The literature on pay incentive plans is full of detailed descriptions of the counterproductive behaviors that piece-rate incentive plans produce (e.g., see Whyte, 1955). Most of the earlier accounts are from the manufacturing world, but the same kind of issues arise when salespersons and other service personnel are put on incentive pay (e.g., Babchuk & Goode, 1951). In many respects, these behaviors are caused not so much by the concept itself, but by the way it is managed. Nevertheless, it is difficult to separate the practical problems with particular plans from the general idea of incentive pay. A brief review of the major problems with incentive plans follows.

**Beating the System.** Numerous studies have shown that when piece rate plans are put in place an adversarial relationship frequently develops between system designers and employees (Lawler, 1971). Employees engage in behaviors to get rates set so as to maximize their financial gains relative to the amount of work they have to do. They work at slow rates to mislead the time-study expert studying their jobs. They hide new work methods or new procedures from the time study so the job will not be restudied. In addition, informal norms develop about productivity, and employees set limits on their production. Anyone who goes beyond this limit is socially ostracized and even physically punished. Unfortunately for the organization, this limit often is set far below what people are capable of producing.

Other forms of gaming include producing at extremely low levels when the rates are set at levels that the employees consider too difficult to reach and using union grievance procedures to eliminate rates that are too difficult (Whyte, 1955). Another version involves doing only what is measured. In the case of production workers, this may mean not doing clean-up and material-handling work. In the case of salespersons, it may mean not doing customer service activities and tying up customers so that other salespersons cannot get the sale.

**Divided Work Force.** Since many support and nonproduction jobs do not lend themselves to incentive pay, a typical organization with incentive pay has only part of the work force on it. This often leads to a counterproductive we/they split that can lead to noncooperative work relationships (Lawler, 1990). This split is not a management-worker split, but a worker-worker split that horizontally divides the organization. It can lead to incentive employees complaining about materials handling, maintenance, and other employees on whom they depend for support. This split can also influence the kind of career paths people choose.

Often, individuals will bid for and stay on incentive jobs even though they do not fit their skills and interests. The higher pay of incentive jobs may additionally cause individuals to be inflexible when asked to change jobs temporarily, and cause them to resist a new technology that calls for a rate change.

**Maintenance Cost.** Because incentive plans by themselves are relatively complicated and need to be constantly updated, a significant number of people are needed to maintain them. Maintaining incentive systems is further complicated by the adversarial relationship that develops between workers and management. Since employees try to hide new work methods and avoid changes in their rates (unless, of course, it is to their advantage), management must be extremely vigilant in determining when new rates are needed. In addition, when a technological change is made or a product is introduced, new rates must be set. While no good estimates exist of how expensive it is to maintain an incentive pay plan, it is likely that the costs vary widely from situation to situation, and in some cases are high.

**Organizational Culture.** The combined effects of dividing the work force into those who are and are not on incentive pay and the adversarial process of rate setting can create a hostile, differentiated organizational culture (Whyte, 1955). In particular, they produce a culture of low trust, lack of information sharing, conflict between groups, minimal support for joint problem solving, and employee inflexibility because individuals want to protect their pay rates. Overall, incentive pay generally works against creating a climate of openness, trust, joint problem solving, and commitment to organizational objectives.

**Small Group Incentive Plans.** Closely related to individual incentive plans, but

much less popular, are small group incentive plans (Lawler, Mohrman, & Ledford, 1992). They differ in that small group plans tend to fit situations where outcomes are based on the performance of small employee groups and individual performance is not easily measurable. They are usually less effective in motivating performance because pay is less directly related to the performance of individuals. They can, however, be quite effective if the groups are kept small (Lawler, 1971). In general, they suffer from all the same problems as the individual incentive plans do because they too are based on a top-down management process, engineered standards, and adversarial relationships.

**Conclusion.** The decades of research on incentive pay clearly demonstrates its strengths and weaknesses. It makes it clear that the installation of incentive pay is, at best, a mixed blessing. Although incentive pay may improve productivity, the counterproductive behaviors, maintenance costs, division of the work force, and poor culture it leads to may make it a poor choice. Many organizations have dropped it or decided not to put it in place simply because they have decided that the negative effects and maintenance costs outweigh the potential advantages that come from the increases in performance it typically produces.

Incentive pay clearly fits some organizational situations better than others. It best fits situations (a) where the work is designed for individuals or, in some cases, for small groups; (b) where the work is simple, repetitive, and easy to measure comprehensively; (c) where the nature of the work is stable, so that the work can be carefully studied, and there is rarely the need to revise standards and payment approaches; and (d) since more than any other system, it differentiates the organization to create isolated individuals or small groups who often feel in competition with each other,

where the need for integration is negligible or where other mechanisms can be used to produce it (Lawler, 1981).

Finally, incentive pay has usually been associated with the control approach to management, and it may be this fact that it has produced so many problems. It is possible that if it is used with a more involvement-oriented management style that stresses fairness, due process, and participation, incentive pay might be more effective (Lawler, 1990). It clearly has the power to motivate performance when individuals believe a fair and clear relationship exists between pay and performance.

### Merit Pay

Merit pay is the most widely used approach to paying for performance (e.g., see Lawler, Ledford, & Mohrman 1989; O'Dell, 1987). Merit pay systems typically give salary increases to individuals based on their supervisor's appraisal of their performance. Their purpose is to affect motivation and to retain the best performers by establishing a clear performance-reward relationship. In light of their popularity, it is surprising that so few studies have examined their impact on performance experimentally. Of the 77 studies reviewed by Heneman (1990), only 6 looked at the performance impact of the installation or removal of a merit system. Despite the widespread adoption of merit pay, there is considerable evidence that in most organizations merit pay systems fail to create a clear relationship between pay and performance (see Heneman, 1984, 1990; Milkovich & Wigdor, 1991). As a result, they also fail to produce the positive motivational effects that are expected of them. There are a number of reasons why merit pay systems often do not effectively relate pay and performance.

**Poor Performance Measures.** Fundamental to an effective merit pay system are credible comprehensive measures of performance.

Without these, it is impossible to relate pay to performance in a way that is motivating. Considerable evidence suggests that in most organizations performance appraisal is not done well and as a result, good measures of individual performance do not exist (e.g., see DeVries, Morrison, Shullman, & Gerlach, 1981; Meyer, Kay, & French, 1965; Milkovich & Wigdor, 1991; Mohrman, Resnick-West, & Lawler, 1989). There is also substantial evidence that even if good measures of performance exist, they often are distorted, ignored, or misused to accomplish other ends (Longnecker, Sims, & Gioia, 1987; Mohrman & Lawler, 1983; Murphy & Cleveland, 1991). In the absence of good objective measures of individual performance, most organizations rely on the judgments of managers. These judgments are often seen by subordinates as invalid, unfair, and discriminatory (Mohrman, Resnick-West, & Lawler, 1989). Because the performance measures are not trusted, when they are the basis for pay little is done to create the perception that pay is based on performance (Lawler, 1981).

Several studies have found that when pay is related to performance appraisal results the nature of the appraisal is changed for the worse (e.g., see Meyer, Kay, & French, 1965). Particularly troublesome is the finding that pay discussions tend to inhibit the discussion of development and learning. There is one study by Prince and Lawler (1986), however, that suggests that discussing salary during a performance appraisal has either no negative effects or small positive effects on how well the appraisal is done and how satisfied the participants are with it. It too, however, concludes that discussing pay makes it difficult to discuss development and suggests a separate meeting to consider it.

**Poor Communication.** The salaries of most individuals in organizations are kept secret (Lawler, 1981). In addition, some organizations keep many of their pay practices secret. For example, it is common for organizations

to keep secret such things as the amount of salary increases and what the highest and lowest raises are. Thus, the typical employee is often in the position of being asked to accept as an article of faith that pay and performance are related. Given pay secrecy, it is simply impossible to determine if they are. In situations of high trust, employees may accept an organization's statement that merit pay exists. Trust, however, depends on the open exchange of information; with secrecy, it is not surprising that many individuals are skeptical.

**Poor Delivery Systems.** The actual policies and procedures that make up a merit pay system often lead to actions that do little to relate pay to performance (Lawler, 1990). In addition, the policies and procedures are often so complex that they do more to obfuscate than to clarify the relationship between pay and performance. The typical merit salary increase is particularly poor at actually relating pay and performance because it allows for only small changes in total pay to occur in one year. All too often only a few percentage points separate the raises given good performers and those given poor performers. This is particularly likely to be true in periods of low inflation because salary increase budgets are usually small.

Employees view pay increases as motivating only if they are large enough to be perceived as meaningful (Lawler, 1981). How large is large enough? The idea of a pay raise threshold has been of interest for over two decades (see Zedeck & Smith, 1968) and has drawn heavily on psychophysical concepts, most notably Weber's law (Gescheider, 1976).

Eleven studies have attempted to investigate the notion of a pay raise threshold (Bowen, Worley, & Lawler, in press; Champlin & Kopelman, 1991; Corbett & Potocko, 1969; Futrell & Schul, 1980; Futrell & Varadarajan, 1985; Heneman & Ellis, 1982; Hinrichs, 1969; Krefting & Mahoney, 1977; Rambo & Pinto, 1989; Varadarajan & Futrell, 1984; Zedeck & Smith, 1968). These studies have produced

estimates of just noticeable pay raises ranging from 1.8 percent to 11.5 percent. Peck (1984) reported that in 1982 merit increases ranged from 5.0 percent to 14.3 percent, with a median increase of 8.8 percent. If the value of a just meaningful pay raise is estimated at the midpoint of the range of values in the empirical investigations it comes out to 6.7 percent. This suggests that in many years, large numbers of employees receive merit increases that are not noticed or significant psychologically.

While there have been no empirical investigations of the impact of less than noticeable pay raises on employee motivation, it is reasonable to assume that they do not serve to enhance pay for performance perceptions. Furthermore, when organizational pay policies dictate that pay increases be based on factors other than performance, differences in increases between employees at different performance levels may be further reduced, again weakening pay for performance perceptions.

Salary increase systems further compound the problem of relating present pay levels to present performance by making past merit payments part of the individual's base salary so that it becomes an annuity. Indeed, employees' current salary levels seem to be viewed by supervisors and employees as entitlements. An individual can be a poor performer for several years after being a good performer and still be highly paid. The less senior good performer, on the other hand, has to perform well for a number of years in order to achieve a relatively high pay level. Furthermore, as Schwab and Olsen (1988) demonstrated in a Monte Carlo simulation, the unreliability of the performance measure weakens the relationship between actual pay and actual performance over time when the merit payments become part of the employee's base salary.

This can have disastrous effects for retaining outstanding performers. Because they are unable to increase their pay quickly, they often find it best to look for jobs elsewhere.

The annuity feature leads to one other problem, topping out. After a long period on a job, individuals often reach a point where they are at the top of the pay range for their job. The effect is to eliminate pay as a motivator because it cannot be adjusted to reflect performance.

**Poor Managerial Behavior.** Managers do a number of things that adversely affect the perceived and actual connection between pay and performance. Perhaps the most serious is the failure to recommend widely different pay increases for their subordinates when large performance differences exist (Kopelman, Rovenpor, & Cayer, 1991). Some managers are unwilling to recommend very large and very small pay changes, even when they are warranted (Heneman, 1984). One reason for this seems to be the unpleasant task of explaining why someone got a low raise.

## Conclusion

The impact of tying the pay levels of individuals to performance is a complex one that has been the subject of considerable research. Table 2 highlights the advantages, disadvantages, and fit issues involved in both incentive and merit pay.

The existence in most organizations of any one of the common problems that plague the administration of merit pay programs, however, is usually enough to destroy the belief that pay is related to performance and, as a result, eliminate the motivational impact of merit pay. In reality, the merit pay systems of most organizations typically suffer from all or most of these problems. As a result, the policy of merit fails to improve performance.

The problems with merit pay raise the question of whether it should be used. A number of the leading figures in the Total Quality movement have concluded that it should not (e.g., see Deming, 1986; Mohrman, 1990). They list many criticisms, but perhaps the most telling is that merit pay focuses

TABLE 2

**Individual Pay for Performance**

	<i>Incentive Pay</i>	<i>Merit Pay</i>
Performance Motivation	Clear performance-reward connection	Little relationship between pay and performance
Attraction	Pays higher performers more	Overtime pays better performers more
Culture	Divides work force, adversarial	Competition within work groups
Organizational Structure	Many independent jobs	Helped by measurable jobs and work units
Management Style	Control	Some participation desirable
Type of Work	Stable, individual easily measurable	Individual unless group appraisals are done
Measures	Maintenance of measures costly	Requires well-developed performance appraisal system

attention on individual performance when, in fact, poor performance is often the result of poor organizational systems and processes. There is evidence that merit pay can have a positive impact when it fits the situation and is properly administrated (e.g., see Heneman, 1984; Kopelman, Rovenpor, & Coyer, 1991). Like incentive pay, it focuses on individuals and, as a result, does little to integrate the members of the work force. Indeed, the typical approach of allocating a salary increase budget to be divided among a small group of employees clearly sets up a competition among them for the larger raises. This can be a serious problem if the organization needs employees to cooperate in order for it to be effective.

The research on individual incentive systems suggests they should be approached with a great deal of caution. As shown in Table 2, they can be a positive motivator but they do not fit most situations. Thus, they are likely to be used less in the future and ultimately may be applied only to individual sales jobs, repetitive clerical jobs, and simple, repetitive manufacturing jobs.

**Pay for Organizational Performance**

Bonus payments based on the performance of an organization and stock ownership are old

TABLE 3

**Characteristics of Organizational Pay for Performance Approaches**

	<i>Gainsharing</i>	<i>Profit Sharing</i>	<i>Ownership</i>
Payment Method	Bonus	Bonus	Equity changes
Frequency of Payout	Monthly or quarterly	Semiannually or annually	When stock is sold
Measures	Production or controllable costs	Profit	Stock value
Coverage	Production or service unit	Total organization	Total organization

and potentially quite effective ways to improve organizational performance. Proponents argue that they can improve motivation, build a work culture in which people are committed to and care about the organization's effectiveness, and finally, adjust the labor cost of an organization to its ability to pay (Weitzman, 1984). There is no question that in some instances, organizations have been able to accomplish just these outcomes as a result of tying the pay levels of individuals to organizational performance.

**Approaches**

It is far from simple, however, to design an effective approach. There are literally thousands of approaches to paying for organizational performance, and there are many complex organizational issues that must be dealt with if any plan is to be successful (Lawler, 1990). Historically, there have been three major approaches to paying for organizational performance. The oldest is the approach of paying bonuses based on the profitability of the organization. This is undoubtedly the most widely accepted approach worldwide and, as will be discussed later, has important advantages as well as very important limitations. Closely related to profit sharing are stock ownership plans that give individuals all or part

of the ownership of the organizations for which they work. They are similar in that they use existing measures of performance. They treat employees like investors, rewarding them when the organization does well in equity markets and reducing their wealth when the organization does poorly (Rosen & Young, 1991).

Less common but increasingly popular is gainsharing (Lawler, Ledford, & Mohrman, 1989; Lawler, Mohrman, & Ledford, 1992; O'Dell, 1987). Gainsharing differs from profit sharing in two respects. First, it is combined with a participative approach to management, and second, it typically measures controllable costs or units of output, not profits or stock price, in its approach to calculating a bonus (Lawler, 1990). Table 3 gives an overview of the characteristics of the three major organizational pay for performance systems. In the discussion that follows, consideration will first be given to what is known about gainsharing, then profit sharing and ownership plans will be considered.

**Gainsharing.** Gainsharing, a term originally coined by F. W. Taylor (Graham-Moore & Ross, 1990), has been used successfully for at least 50 years in hundreds of organizations (Bullock & Lawler, 1984; General Accounting Office, 1981; Graham-Moore & Ross, 1990;

O'Dell, 1981, 1987). Companies and employees have profited from gainsharing—companies in the form of reduced costs and employees in the form of bonus payments and improved job satisfaction. The original and best known gainsharing plan is the Scanlon Plan. Other gainsharing plans include Improshare and the Rucker Plan (for detailed descriptions of these plans, see Graham-Moore & Ross, 1983, 1990). In addition to these plans many companies have their own custom-designed gainsharing plans.

In the typical gainsharing plan, financial gains in organizational performance are shared on a formula basis with all members of the organization. A historical base period is established and is used as the basis for determining whether gains have occurred; hence the name *gainsharing*. Typically, only costs controllable by employees are measured for the purpose of computing the gain. Unless a major organizational change takes place, the historical base stays the same during the entire history of the plan; thus, performance is always compared to the time period before starting the gainsharing plan. When performance is better than in the base period, a bonus pool is funded. When it falls short, no bonus pool is created. In a typical plan, at least half of the bonus pool is paid out to the employees, while the rest is retained by the company. Payments are typically made on a monthly or quarterly basis, with all employees getting equal percentages amounts.

No one has an accurate estimate of how many gainsharing plans there are in the United States and Europe. There are probably at least a thousand, and there seems to be little doubt that their popularity has increased tremendously in the last 10 years. One recent survey in the United States indicated that about 13 percent of all firms have them and over 70 percent were started in the last 5 years (O'Dell, 1987).

Until 10 years ago, gainsharing was used primarily in small manufacturing organizations. Much has been written in the United

States about the success of older gainsharing programs in smaller companies such as Herman Miller, Lincoln Electric, and Donnelly Mirrors (Graham-Moore & Ross, 1983; Moore & Ross, 1978). All three of these plans are over 30 years old. During the 1970s, large companies such as General Electric, Motorola, Rockwell, TRW, Dana, and Firestone began installing gainsharing plans in some manufacturing plants. The trend of large corporations defining organizational units that have their own gainsharing is continuing and resulting in the adoption of more gainsharing plans (Lawler, Mohrman, & Ledford, 1992). The increased popularity of gainsharing is significant and relates to an important feature of most gainsharing plans. They are more than just pay incentive plans; they are both a way of managing and an organizational development technology. To be specific, they are a participative approach to management and are often used as a way to install participative management (Frost, Wakeley, & Ruh, 1974; Lawler, 1986b, 1990).

*The Participative System.* From the beginning, Joe Scanlon, the creator of the Scanlon Plan, emphasized that gainsharing fits a participative management style. In the absence of a change in employee behavior, there is no reason to expect a payout from the kind of formula that is typically developed in gainsharing plans. A payout requires an improvement in performance, and that improvement requires more effective behavior on the part of employees. Some improvement may be gained simply from the motivation that is tapped by tying pay to performance. This is particularly true in situations where the work is not highly skilled or interdependent and, as a result, effort is directly related to performance. In other situations, however, there are several reasons why a gainsharing plan without a participative system is unlikely to produce an appreciable improvement in performance.

First, the motivational impact of the plan may not be large because most gainsharing plans aggregate the performance of a number of people. As a result, the plan has only a small impact on the perceived relationship between individual performance and pay. The formula used is relevant here. Some plans use very simple formulas that focus on the relationship between labor input and productivity (e.g., Improshare); others use a more comprehensive set of cost measures (e.g., the Rucker plan). Simple labor-based plans are more likely to affect motivation directly because with them employees can see a more direct relationship between their efforts and their bonuses.

Second, in many cases, simple effort and good intentions are not enough to improve the operating results. What is needed is a combination of people working harder, working more effectively together, sharing their ideas, and working smarter. For this to happen, it often takes a formal participative system that converts the motivation to improve performance into actual changes in the operating procedures of an organization. In the absence of new procedures or systems to accomplish these changes, they rarely seem to occur.

In traditional gainsharing plans such as the Scanlon Plan, the key to the participative system is a formal suggestion system with written suggestions and shop floor committees to review the suggestions (Frost, Wakeley, & Ruh, 1974). Often there is also a higher level review committee that looks over those recommendations that involve several parts of the organization and/or large expenditures. This system of committees is one way of trying to assure that new ideas will be seriously considered and, where appropriate, implemented.

Recently, some organizations have combined gainsharing with self-managing teams and other participative management practices to produce an approach that is best called high-involvement management (Lawler,

1986a, 1992). In this approach, employees make the most of the operating decisions and get rewarded for their organization's effectiveness through the gainsharing plan. This approach gives employees a chance to influence the things that determine the operating results of the organization, which is necessary if bonuses based on operating results are to influence motivation.

*Research Results.* The most important thing that research has shown about gainsharing plans is that they usually work (GAO, 1981). We know something about the frequency with which they work: There is evidence to suggest that they work in a relatively high percentage of cases (about 70% according to Bullock & Lawler, 1984). Lawler (1971, 1990) has summarized some of the common results that have been found in research studies of gainsharing plans:

- Coordination, teamwork, and sharing of knowledge are enhanced at lower levels.
- Social needs are recognized via participation and reinforcing group behavior.
- Attention is focused on cost savings, not just quantity of production.
- Acceptance of change due to technology, market, and new methods is greater because higher efficiency leads to bonuses.
- Attitudinal change occurs among workers, and they demand more efficient management, better planning, and good performance from their co-workers.
- Employees try to reduce overtime—to work smarter.
- Employees produce ideas as well as effort.
- When unions are present, more flexible administration of union-management relations occurs.

- When unions support the plan, they are strengthened because better work situations and higher pay result.
- Unorganized locations tend to remain nonunion.

There are also things that gainsharing plans do not do as well as other approaches to paying for performance. Perhaps the most important is differentially attracting and retaining the best performers. Because gainsharing plans do not pay better performers more, they do not necessarily motivate them to stay. Gainsharing plans do vary pay costs somewhat with the organization's ability to pay, but not as effectively as profit sharing since a gainsharing plan can produce a bonus even when the organization is not profitable. Finally, gainsharing plans contribute to both integration and differentiation. They integrate the units they cover in both a vertical and horizontal respect since they treat everyone the same. On the other hand, they tend to differentiate them from the rest of the organization.

Much is known about structuring gainsharing plans. There are a number of books and articles that describe in some detail how to put together formulas, introduce plans, and manage the process side of operating a gainsharing plan (e.g., Belcher, 1991; Graham-Moore & Ross, 1983; Moore & Ross, 1978). As a result, there is quite a bit of how-to-do-it knowledge. This is particularly true with respect to the Scanlon Plan. Indeed, a careful reading of the literature on this plan can make it possible for an organization to develop and install a plan without the help of a consultant. The research evidence also shows that certain situational factors favor gainsharing plans (Lawler, 1981). They include:

- Organization size.* The plan is based on employees seeing a relationship between what they do and their pay. As organizations get larger, this is harder to accomplish. Most successful gainsharing plans

cover fewer than 500 employees. They also tend to cover operating units that can operate relatively independently of other organizational units.

*Performance measurement.* In some organizations, a good performance measure and a reasonable performance history simply do not exist and cannot be established. This is often true in organizations where rapid technological and market changes occur. For these organizations, gainsharing plan formulas are difficult to develop.

*Measurement complexity.* Often performance can be measured only in very complex ways. The more true this is, the more difficult it is to make a plan work, because no clear, easily understood connection between an individual's behavior and rewards can be established.

*Worker characteristics.* Gainsharing depends on employees wanting to participate and wanting to earn more money. Most individuals have these goals, but not all do. Unless a substantial majority in organizations want the benefits the plan offers, it cannot succeed.

*Communication.* For gainsharing to work, employees must understand it and trust it enough to believe that their pay will increase if they perform better. For this belief to exist, a great deal of open communication and education is needed. If an organization does not have these already, they must be started if the plan is to succeed.

*Management attitudes.* Unless managers are favorably disposed to the idea of participation, gainsharing is unlikely to fit the management style of the organization. In some organizations, the plan has been tried simply as a pay incentive

plan without regard to management style, and it has failed because of a poor fit.

- Supervisory skills.* Gainsharing requires supervisors to change. They are forced to deal with many suggestions and their competence is tested and questioned in new ways. Unless supervisors are prepared for and accept these changes, the plan can fail. This point goes along with the general point that management must be prepared to manage in different ways.

As this list demonstrates, gainsharing does not fit every situation. Since they often have most of these favorable conditions, it is easy to see why for so long the installation of gainsharing plans was limited to manufacturing situations. Although much remains to be learned about how such plans should be installed in nonmanufacturing environments and in the public sector, it appears there are ways they can be designed to work in these settings (Graham-Moore & Ross, 1983; Schlesinger & Heskett, 1991). Indeed, it may be a more broadly applicable approach than has been assumed.

**Profit Sharing.** Profit sharing is better known, older, and more widely practiced than gainsharing (Lawler, Ledford, & Mohrman, 1989). In the United States, for example, data indicate that at least one-third of all organizations have some form of profit sharing (O'Dell, 1987). Some definitions of profit sharing include it as a form of gainsharing; it is different, however, in two respects. It often does not have a participative management component, and it does not use formulas that only measure increases in employee-controlled financial or productivity-related performance.

Given its popularity, it is surprising that so little psychological research has been done on profit sharing. Gainsharing, despite

being less popular, has been much more extensively researched. This may reflect the fact that profit sharing is associated with participative management theories. What evidence there is suggests that profit-sharing plans typically are much less effective than gainsharing plans in influencing motivation and in producing the kind of social and cultural outcomes that were listed earlier as resulting from gainsharing plans (e.g., see Blinder, 1990). This is particularly true in large organizations where the line of sight and line of influence from individual performance to corporate profits is virtually nonexistent. Large size often compounds the problem of tying present rewards to controllable performance to the point where it is hard to see that there can be any impact on motivation. In the typical profit-sharing plan, the line of influence problem is further compounded because most firms (estimates are about 85%) defer profit-sharing bonuses by putting them into retirement plans (Blinder, 1990; Lawler, 1990; Metzger, 1964).

Before dismissing profit sharing as totally useless from an organizational effectiveness point of view, it is important to note that there are three things even a deferred profit-sharing plan in a large corporation can accomplish. First, there is the potential symbolic and communication value of paying employees based on organizational performance. It can effectively point out to employees that they are part of a larger organization and that cooperative effort is needed. Since corporate executives are often rewarded on the basis of profit sharing, it can also help to assure that there is an alignment between the rewards received by top management and those received by people throughout the organization (Foulkes, 1991). This can help avoid the all-too-common problem of executives getting large bonuses while lower level employees receive none, thus creating a counterproductive vertical differentiation in the organization (Crystal, 1991).

Second, some companies, most notably Hewlett-Packard, have effectively used their profit-sharing plans as vehicles for educating employees about the financial performance of the business. When employees understand the financial performance of the business and are actually sharing in the profits, it brings alive for them the issue of what profits mean and how they are calculated. This in turn can increase their interest in learning about profits and organizational effectiveness and have an effect on the organization's culture.

Third, perhaps the most important advantage profit sharing offers is that it makes the labor costs of an organization variable and adjusts them to the organization's ability to pay (Weitzman, 1984). When profits go down, labor costs go down; and thus, rather than being fixed, labor costs, at least in part, become variable. This is a particularly desirable feature for organizations that are in cyclical or seasonal businesses. In most western countries, changes in labor costs are handled through increases and decreases in the size of the work force. This is a necessity when wages are high and fixed because there is no other way to control labor costs to reflect the company's ability to pay. With profit sharing, it is possible to reduce costs significantly without reducing the number of employees. Most Japanese firms have used this approach to adjusting labor costs for decades. As is the case in Japan, it can allow an organization to make a much stronger commitment to employment stability and help it gain the advantages that are inherent in having a stable work force.

**Employee Ownership.** A number of plans exist that help get some or all of the ownership of a company into the hands of employees. These include stock option plans, stock purchase plans, and employee stock ownership plans (ESOP's). There is little question that stock ownership plans are increasingly popular and are being researched more. According to one study, some 11 million

employees in over 8,000 businesses now own at least 15 percent of the companies employing them (Quarrey, Blasis, & Rosen, 1986; Rosen, Klein, & Young, 1986). It is difficult to generalize about the impact of ownership plans because they vary widely in how much ownership employees receive, and their impact is likely to depend on the organizational situation.

Much of what has been said about the impact of profit sharing and gainsharing plans is relevant to the impact of ownership. In some situations there is reason to believe that ownership can have much the same impact as an effective gainsharing plan (Klein, 1987). In small organizations in which participative management is practiced it has a good chance of increasing organizational performance (Blinder, 1990; O'Toole, 1979; Rosen, Klein, & Young, 1986). The key is combining it with employee involvement since it typically produces a weaker line of influence than does gainsharing (Blinder, 1990; Conte & Tannenbaum, 1980).

In a large organization with little employee ownership it may positively impact the structure by creating integration across the total organization if, of course, all employees are included in the ownership plan. Unlike profit sharing, it does not adjust costs to reflect the organization's ability to pay unless it includes an approach in which stockholders directly share in profits. It can help organizations raise capital and finance themselves. Indeed, most plans are probably installed because of the tax and financing advantages they offer (Blasis, 1988). Ownership can have a more positive impact on attraction and retention than does profit sharing. In particular, if ownership is not easily saleable, it can help to lock someone into the organization both financially and psychologically.

Overall, based on the limited available research, there is reason to believe that ownership strategies can have a positive effect in a number of situations. Their usefulness, however, is likely to be highly situationally

determined. For instance, in the case of small organizations, they might make profit sharing and gainsharing unnecessary, and if combined with an appropriate approach to employee involvement, they can contribute substantially to employee motivation. In a large organization they may contribute to a positive culture and to the integration of the organization. There is a need for considerable additional research on a number of issues, including the impact of the many different approaches to structuring ownership and how the impact of ownership is affected by characteristics of the organization.

### Theory and Predictions

Existing theory and research can be combined to make some testable predictions about the impact of any pay for performance system (Lawler, 1988b). As mentioned earlier, congruence theory assumes that an organization's effectiveness is related to the degree to which the different systems in an organization fit or are congruent with each other (e.g., see Galbraith, 1973). This calls for a congruence among the way information, power, knowledge, and rewards are distributed in the organization (Lawler, 1986a).

Organizational pay for performance plans move rewards for organizational performance downward so that part of all employees' rewards depend on it. The implicit assumption is that this will change employee behavior in ways that will increase organizational performance. The major way it can change behavior is by affecting motivation since it does little to reward training and developing new skills. It follows from what was discussed earlier about motivation that organizational plans will increase organizational performance to the degree that they do the following:

- Establish the belief that rewards are based on organizational performance
- Provide communication about organizational performance to all employees

- Establish ways for employees to influence organizational performance as it is measured by the reward system
- Create opportunities for employees to learn how to contribute to organizational performance and how to interpret measures of performance

These four conditions can best be viewed as combining multiplicatively and varying from zero to one. Viewing them as combining in this way is critical because it means that if any of them is completely absent, organizational performance will not improve as a result of installing gainsharing, profit sharing, or stock ownership plans. As is frequently noted, they work only when individuals are motivated to perform differently. If one or more of these is missing, a pay change will not affect motivation because no link or line of sight and influence will exist between the reward and the inputs (i.e., effort, ideas) that most employees in an organization can control.

Working harder can improve individual performance, but it may have no or a relatively small impact on organizational performance unless the organization already has good work methods and systems. Often improvements in organizational performance require major system and method improvements; without them, increased effort may be wasted and employees frustrated. It is also important to note again that organizational pay for performance systems may not have a major impact on effort. Particularly in large organizations, they do little to increase the relationship between effort and rewards; thus, their impact on motivation may be small or nonexistent.

As has been shown by research, gainsharing, profit sharing, and ownership are more effective when combined with participative management (Blinder, 1990; Hammer, 1988). This follows from motivation and congruence theory because in the absence of a participative management approach that

**gives employees a chance to increase organizational performance in ways other than working harder, it is difficult for them to see how they can influence organizational performance.**

Participative management can put into place two key elements: the ability to influence organizational performance in ways other than putting more effort into immediate job performance, and an understanding and trust of the relationship between improved organizational performance and a bonus or the value of stock. In the absence of these, it is unlikely that a perceived connection between improved individual performance and a pay reward will exist. The one exception to this may be the case of a very small organization. There a relationship between individual effort and organizational performance may be evident in the absence of a participative management style. In the case of a small organization, an organizational pay for performance plan might establish a line of influence and work as an incentive much like small group pay incentive plans do.

Turning to the specifics of particular plans, the congruence argument suggests that the type of participative approach used needs to be matched to the type of pay plan used. Most gainsharing plans advocate suggestion programs of some type. Although suggestion approaches give employees some additional power, they are very limited in the amount of power, knowledge, and information they move downward in the organization. They are, in essence, a parallel structure that does little to change the core operating style of the organization (Lawler, 1986a, 1988a, 1992). In this respect they differ appreciably from such approaches as work teams or semiautonomous work groups that push a considerable amount of power and knowledge to the lowest levels of the organization (Hackman & Oldham, 1980). Teams can give employees a chance to influence a number of the decisions that directly influence organizational performance (Lawler, 1986a).

The combined congruence-expectancy theory argument leads to some interesting predictions about which approach to participative management is needed to support different pay for organizational performance approaches. The Improshare formula is the simplest gainsharing formula since it looks only at hours of work relative to units produced. Because it is simple and straightforward, it is not difficult to establish a line of sight: Employees know if they produce more product by either working smarter or harder they will earn more. Little extra communication and education are needed. Further, individuals do not need to influence many of the decisions that are made in organizations in order to reduce the amount of labor that goes into a product—they can simply work harder or smarter. In short, the Improshare plan has a chance of working as an incentive plan in the absence of a great deal of participation if there is a reasonable level of trust, the organization is relatively small, and the production process is relatively simple. Therefore, the use of quality circles or some other suggestion programs can provide a reasonable vehicle for reducing labor hours through better work methods.

The situation is quite different for gainsharing formulas that look at multiple costs and involve complex computations and for profit-sharing and ownership plans. Like profit-sharing plans, these plans cover a number of costs, and the payments they produce are influenced by a wide range of factors, often including such things as purchasing and pricing decisions. If employees are to influence their rewards, a level of participation that goes far beyond quality circles and written suggestions is needed. They require at least the kind of participation that is present in self-managing teams and high-involvement plants. Profit-sharing plans and stock-ownership plans are a simple extension of this argument. For them to be effective as motivators, a high level of employee involvement is essential.

Other congruence issues come into play with respect to plan choice. The plan needs to fit the type of work the organization does. A labor-only gainsharing formula, for example, fits only those operations where labor costs are dominant and can be reduced. Situations where other costs are important need more complex formulas that reflect other key operating costs. In the absence of a more complex formula, there is the real danger that employees will focus only on reducing the measured costs and that unmeasured costs will increase.

In summary, the congruence approach does not argue for a particular approach to relating pay to organizational performance. Instead it suggests that the plan must measure and reward those things that employees influence, understand, and receive communications about. The prediction is that a pay plan will work best when the approach matches the participative management approach used. Simple plans will work with suggestion programs, while profit-sharing and ownership plans require the use of more participative approaches such as teams. This point is consistent with the finding that gainsharing plans generally have more impact than profit-sharing plans (Lawler, 1981; O'Dell, 1987). The latter are typically based on difficult-to-influence measures and often are not combined with an appropriate level of participative management. This point may also help explain the success of the Scanlon Plan and the Improshare Plan. These plans tend to combine a limited amount of participation with a formula that typically measures only one or a few costs directly controllable by the employee.

The arguments so far suggest that an organization's decision to adopt a particular approach to paying for organizational performance needs to be based on a contingency model. It seems clear that the type of plan that is adopted needs to fit the kind of technology and effectiveness issues that the organization faces. For example, organizations that

use relatively simple manufacturing technologies and need to reduce their labor costs probably can accomplish a great deal by adopting a simple gainsharing plan. On the other hand, a complex-knowledge work organization that needs to focus on customer satisfaction and on a number of costs is in a different situation. It may need a complex gainsharing plan, a profit-sharing plan, an ownership plan, or some combination of the three. It may need to use a participative management approach that combines teams, open information, and task forces to study major business issues.

The congruence argument also suggests some predictions about the process of developing and installing these plans. The effectiveness of the plan should increase if an organization uses a process that is congruent with the way the organization should operate after the plan is installed. This means it should be a participative process with open communication and an emphasis on education in most cases. This type of process should help the plan be effective for a number of the reasons mentioned earlier. In addition, it should help the organization learn how to manage participatively. The development of the pay plan in effect becomes a learning experience about how to manage participatively. Participation in the design process probably is not as important in the case of the Improshare Plan as it is for more complex plans. With ownership, for example, participation in the design would seem to be necessary in order to develop both understanding and trust.

## Conclusion

The research evidence suggests that employee ownership, gainsharing, and profit sharing can all be useful practices for many organizations. Table 4 summarizes the major advantages and limitations each approach. They ought not to be looked at as competing approaches, but as often compatible approaches that accomplish different objectives (Lawler, 1990). Profit

TABLE 4

## Organizational Pay for Performance

	<i>Gainsharing</i>	<i>Profit Sharing</i>	<i>Ownership</i>
Performance Motivation	Some impact in small unit	Little pay-performance relationship	Very little pay-performance relationship
Attraction	Helps with all employees	Helps with all employees	Helps lock in employees
Culture	Supports cooperation, problem solving	Knowledge of business	Sense of ownership
Organization Structure	Fits small stand-alone work units	Fits any company	Fits most companies
Management Style	Some participation	Works best with participation	Works best with high levels of participation
Type of Work	Helps most with interdependent types	All types	All types
Costs	Ongoing maintenance needed, operating costs variable	Relates costs to ability to pay	Cost not variable with performance

sharing can have the desirable effect of creating variable costs for an organization, thus allowing it to adjust its costs to its ability to pay. Stock ownership can help with organizational financing and help retain employees. Ownership and profit sharing can also affect the communication pattern and culture of an organization in ways that emphasize the performance of the total organization. Gainsharing, on the other hand, if correctly designed, can provide motivation and produce a culture in which people are committed to seeing their organizational unit operate effectively.

The ideal combination for many large corporations would seem to be a corporate-wide profit-sharing plan, a stock ownership program, and gainsharing plans in major operating plants or units. The combination of gainsharing and profit sharing deals directly with the need to have variable costs and the need to motivate employees. Gainsharing

alone does not do this because it tends to be based on subunits of the organization and measures that do not include all the operating costs of the firm. Thus, the possibility exists for a gainsharing plan to pay out a bonus when the organization is performing poorly or for no bonuses to be paid even when the organization as a whole is performing well. From the motivational point of view, this is quite acceptable if the employees are performing well against the things they are measured on and can control. It fails, however, to integrate the total organization in the way an effective profit-sharing plan or an effective stock ownership plan can; employees may erroneously feel that the organization is in good shape if they are receiving a bonus. The addition of a profit-sharing plan and/or an ownership plan can help the organization call attention to the organization's ability to pay, something a gainsharing plan may not always do.

## Executive Compensation

The reward practices at the top levels of an organization often differ from those at other levels. Senior managers are not only paid much more than others, they are also paid differently (Crystal, 1978, 1984, 1991; Ellig, 1982). This has led to some research and theory concerning what determines executive compensation, but relatively little research on what difference it makes with respect to individual and organizational performance (Finkelstein & Hambrick, 1988; Gerhart & Milkovich, 1990).

**Executive compensation is a potentially important area of research simply because of the importance of the individuals it affects—executives.** Their potential impact on the overall performance of an organization is great, and there is reason to believe that how they are treated can broadly affect the organization because it helps establish the culture and performance objectives for the organization. Executive compensation has been a research focus for economists, organizational theorists, and psychologists, although a limited amount of research has been done. Indeed it is one area where true multidisciplinary research can be done since disciplines approach the topic from very different theoretical perspectives.

## Determinants

A number of studies have explored the relationship between type of firm, type of industry, and characteristics of executives and compensation amounts. The research has found some predictable relationships (see Gomez-Mejia & Welbourne, 1988, 1989, for reviews). There is abundant research linking firm size to CEO compensation levels. **The larger the firm, the higher the level of executive compensation** (Finkelstein & Hambrick, 1988). No definite explanation exists for this relationship, but a good guess is that it is due at least partially

to the widespread use of job evaluation and salary survey data that considers the size of jobs as an important factor. It may also be due to the desire of firms to have different pay levels for different management levels, which in turn leads to higher pay for individuals at the top of taller, larger organizations.

Research has also looked at the relationship between firm performance and amount of executive compensation. It has been argued that there should be relationships since executives are responsible for firm performance. They also often have compensation packages that include bonuses and stock plans that are tied to company performance (O'Reilly, Main, & Crystal, 1988). Although the case for a relationship seems compelling, the evidence shows only a very weak relationship between total compensation levels and firm performance (Finkelstein & Hambrick, 1988; Gerhart & Milkovich, 1990). Typically the relationship is higher between year to year changes in compensation and performance than it is between total compensation level and performance. No simple explanation for this low relationship exists. It is probably the consequence of a number of factors, including the fact that a good deal of an executive's pay is not dependent on performance, the problems with measuring performance, and the unique power position of executives. Because of their power in the organization, executives may well be able to create their own favorable compensation packages (Crystal, 1991).

Compensation levels have been found to be related to industry (Crystal, 1984). Some industries simply pay better than others. No good theoretical explanation exists for these differences. Some research has focused on the relationship between the personal characteristics of executives and compensation levels. The logic is that individuals with greater experience, tenure, education, and skills should have a higher market value. Overall the evidence does not show a strong relationship

between personal characteristics and pay level (Gomez-Mejia, Tosi, & Hinkin, 1987).

Several studies have shown that an organization's approach to executive compensation may be related to its structure (Balkin & Gomez-Mejia, 1987b; Kerr, 1985; Napier & Smith, 1987). In general, studies have found weak relationships between types of compensation and organizational characteristics. Kerr (1985) did find that firm growth orientation is related to type of compensation—more growth-oriented firms seem to use greater amounts of risk-oriented compensation and to base it more on economic performance. The diversity of the businesses of a firm has also been considered as a predictor of compensation approach. Some support has been found for the argument that diversity makes a difference, as is predicted by some organization theorists (Galbraith & Kajzarian, 1986).

Overall, the research on executive compensation provides some information on which executives are likely to be paid the most. It generally fails, however, to provide an explanation for the very large differences that exist between the pay of executives and the pay of other organization members. Finkelstien and Hambrick (1988) have offered some reasons for this, as have O'Reilly, Main, and Crystal (1988). There seems to be no single factor that accounts for it; rather, it is the historical product of a number of factors, some of which are unique to the United States. The uniqueness of the United States is particularly noticeable, as executive compensation levels are particularly high in the United States.

Executive compensation in the United States is public by law, and it is typically set by the board of directors. Because of these two factors, the issues of social comparison and power over the board must be considered in any analysis of executive compensation levels. Because pay is public, comparisons are easy to make and market rates are well known. Given the competitive nature of those individuals in

executive positions, it follows that they would place great importance on how their pay compares to that of other executives (O'Reilly, Main, & Crystal, 1988).

Comparisons do not inherently lead to high levels of executive compensation, but when combined with executive power, they can. Power is where corporate boards come into play. They control pay but may be strongly influenced by the senior executives of the firm. Many senior executives sit on the boards of their firms and influence which outsiders sit on the board. In addition, they sit on the boards of those firms whose executives sit on the board of their firm (Schoorman, Bazerman, & Atkins, 1981). Thus, boards end up with overlapping memberships such that it can be hard for them to say no to higher and higher pay levels (Crystal, 1991; Hill & Phan, 1991; O'Reilly, Main, & Crystal, 1988). In the absence of government regulations and stockholder activism, there is little effective pressure toward reducing the level of executive compensation.

### Consequences

Executive compensation, like compensation at other levels in the organization, is predicted to have an effect on individual behavior (Finkelstein & Hambrick, 1988). In particular, it should affect membership behavior, motivation, and skill development. There has been little research on how it affects behavior. In some respects, this is not a serious problem because there is so much general research on the effects of rewards on motivation and behavior. There are, however, some unique pay practices at the executive level, and thus the possibility exists for interesting research to be done at this level. For example, executives often are paid in special ways that are designed to prevent turnover (e.g., golden parachutes), and of course they are given unusual forms of incentive pay (e.g., phantom stock).

Perhaps most interesting at the executive level is how different forms of compensation influence the direction of effort. There is some evidence that type of executive compensation influences such things as how much executives invest in long-term research and development (Rappaport, 1978). Studies have found that long-term pay incentive plans lead to increases in capital expenditures and that contingent pay can reduce nonpecuniary expenditures (Larcker, 1983).

Little attention has been paid to the impact of executive pay practices on groups other than the executives themselves. Potentially, it has a significant impact on stockholders as well as on the rest of the organization. There is some evidence that stock prices react positively to executive compensation packages that tie pay to firm performance (Brickley, Bhagat, & Lease, 1985).

Lawler (1990) has argued that because of the visibility, symbolic importance, and direct effect on executive behavior, executive rewards can have a significant impact throughout an organization. In addition to influencing how much effort individuals invest in trying to obtain an executive position, reward levels can influence how much social distance exists between executives and others in the organization. Lawler also argues that how executive compensation is structured and administered can influence the credibility of executives, their ability to lead the organization, and how effectively pay for performance systems operate at other levels in the organization.

Overall it is surprising how little is known about the impact of executive rewards. The research has focused more on what causes the reward levels and reward systems than on their consequences. This is understandable since executive compensation levels routinely exceed several million dollars a year. However, perhaps more important and less frequently studied is the issue of what, if any, difference it makes.

### Type of Reward

The kind of financial rewards that organizations give to individuals can vary widely. Pay comes in many forms varying from stock to medical insurance. Organizations can choose to reward people almost exclusively with cash, downplaying fringe benefits, perquisites, and status symbols—or they can do just the opposite.

The major advantage of paying in cash is that the value of cash in the eyes of the recipient is universally high. When the cash is translated into fringe benefits, perquisites, or other trappings of office, it may lose its value for some people and, as a result, be a poor investment if the intention is to give a valued reward (e.g., see Lawler, 1971; Nealey, 1963). However, certain status symbols and perquisites may be valued by some individuals beyond their actual dollar cost to the organization and thus represent good buys. Finally, there often are climate and organizational structure reasons for paying people in the form of perquisites, and status symbols. Unfortunately, there is relatively little research on the overall value and impact of nonfinancial status rewards; this clearly is an underresearched area.

Certain benefits, such as health care, can best be obtained through mass purchase, and therefore individuals may want the organization to provide them. Organizations increasingly have done just this over the last 40 years. One estimate is that benefits increased from 19 percent to 43 percent of cash compensation between 1950 and 1980 (Bloom & Trahan, 1986). No research has been conducted to determine the impact of this increase on issues of organizational culture, membership, and performance. It clearly represents, however, a significant increase in an organization's cost of doing business. From a cultural point of view, it may well have contributed to a more paternalistic culture since it makes individuals more dependent on their

work organizations for important benefits in addition to cash compensation.

One interesting development in the area of compensation is the flexible or cafeteria style benefit program (e.g., see Fragner, 1975; Lawler, 1981). The potential value of this approach was established in early work by Nealey (1963), but it was not adopted by organizations until about a decade later (Lawler, Mohrman, & Ledford, 1992). In a flexible benefits plan, individuals are allowed to choose their own reward package so that it is sure to fit their needs and desires. The theory is that this will lead to organizations getting the best value for their money because they will give people only those things that they desire. It also has the advantage of treating individuals as mature adults rather than as dependent people who need their welfare looked after in a structured way.

The flexible approach has been tried in a number of organizations. Lawler, Ledford, and Mohrman (1989) found that 34 percent of the Fortune 1000 had plans in 1987. While little research has been done on flexible plans, the results so far have been favorable in several respects (Gifford & Seltz, 1988). It seems to offer a strategic cost benefit advantage in attracting and retaining employees (Bloom & Trahan, 1986). It does so because it gives employees the benefits they want, while relieving companies of buying benefits that are not cost effective from an attraction and retention point of view.

In addition to cost effectiveness considerations, the choice of what form of rewards to give individuals probably should be driven by a clear sense of what type of culture the organization wishes to have. For example, the idea of a flexible compensation package is congruent with a participative and open organizational culture that treats individuals as mature adults and wants to attract talented mature individuals (Lawler, 1990). A status symbol, non-cash-oriented approach may, on the other hand, appeal to people who are very

status oriented, value position power, and need a high level of visible reinforcement for their position. This would seem to fit best a relatively bureaucratic organization that relies on position power and authority in order to carry out its actions.

### Process Issues

A useful dichotomy in thinking about the design of reward systems is the process/content one. All organizational systems have a content or structural dimension as well as a process dimension (Lawler, 1981). The structural or content dimension of a reward system refers to the formal mechanisms, procedures, and practices (e.g., salary structure, performance appraisal forms), in short, the nuts and bolts, of the system that have already been discussed. The process side refers to the communication and decision process parts of the system. One key process issue involves the degree of openness with respect to information about how the reward system operates and how people are rewarded. A second issue involves the degree of participation allowed in the design of the reward system and the ongoing administration of it.

### Communication Policy

Organizations differ widely in how much information they communicate about their reward systems. At one extreme, some organizations are very secretive, particularly in the area of pay. They forbid people from talking about their individual reward levels, give minimal information to individuals about how rewards are decided upon and allocated, and have no publicly disseminated policies about such things as market position, approach to gathering market data, and potential increases for individuals. In the middle are organizations in which pay ranges and median pay levels are

shared and the budgets for pay raises are given. At the other extreme, some organizations are so open that everyone's pay is a matter of public record, as is the overall organization pay approach (Burroughs, 1982; Lawler, 1981). In addition, all promotions are subject to open job posting, and in some instances, peer groups discuss the eligibility of people for promotion. This is true of some government organizations and many new high involvement plants (e.g., see Lawler, 1978; Walton, 1980).

The arguments that are mounted in favor of secrecy tend to be very similar to those that argue in favor of openness. Both claim that communication affects satisfaction and motivation; they disagree, however, on whether openness has a positive or negative effect on them. There has been some research on the issue of how communication affects satisfaction. This research has focused on secrecy's impact on the accuracy of the pay comparison process. Lawler (1972) found that when secrecy exists, individual managers tend to overestimate the pay of their peers and subordinates but underestimate the pay of their bosses. He uses this finding to argue that secrecy may lead to lower satisfaction because it leads to misperceptions that make pay comparison less favorable for the receiver. This follows from the finding that pay satisfaction is, in part, based on how one's pay compares to that of similar others.

The arguments in favor of secrecy tend to reason that if pay is secret, unfavorable comparisons cannot be made, and thus satisfaction will be high. The problem with this argument is that there is no evidence that secrecy prevents comparison. At this point there is not much direct research on how secrecy affects satisfaction. One field experiment by Futrell (1978), however, provides some data. One year after moving from a closed to an open pay system, workers reported higher levels of pay satisfaction than before the change. The best answer to the ques-

tion of how communication affects pay satisfaction probably is that it depends on such things as the actual pay rates in the organization, the basis of the pay system, and the general management style of the organization.

The issue of how secrecy affects motivation is a complex one. The argument in favor of openness essentially reasons that it is necessary in order to establish a clear performance-reward relationship. There is evidence that individuals overestimate the amount of the merit pay rewards received by other individuals, which makes their own merit pay rewards look smaller (Lawler, 1972). Although there is no conclusive evidence, it can be argued that this misperception is harmful to both satisfaction and motivation. It has been argued that secrecy leads to more willingness among managers to base pay on performance because they do not have to offer an explanation to the person who gets a low payment. For example, in two laboratory investigations, Leventhal, Michaels, and Sanford (1972) and Peters and Atkin (1980) manipulated pay secrecy. Both studies found that the differences in merit increases between high and low performers were smaller in open pay systems than in systems with pay secrecy. Although this result makes some sense, little field research has been done that directly bears on it.

Research on individual preferences with respect to making pay public generally supports the view that individuals do not want to have pay completely in the open. For example, managers in one organization favored having everything made public about their performance-based bonus payments except the actual amount received by individuals (Lawler, 1981). It appears that individuals want to know everything except who got what amount of money. Overall, the evidence is so sparse that it is difficult to reach an empirically based conclusion concerning the

effects of communication on employee motivation and satisfaction.

### Participation in Pay System Design

Two of the original studies on participation in pay system design provide clear evidence that participation can make a difference in the impact of a pay plan. In the first study, two work groups were observed. In one group, productivity was very high and had continued to go up for more than ten years (Cammann & Lawler, 1973; Lawler & Cammann, 1972). In the other group, productivity was low and had remained relatively stable for years. Both groups did the same kinds of jobs, and both had similar pay incentive plans. In the second study, identical incentive plans designed to motivate attendance were installed in a number of work groups (Lawler & Hackman, 1969; Schefflen, Lawler, & Hackman, 1971). In some groups, the plan was highly successful in reducing absenteeism, but in others it was only moderately successful.

In the attendance-bonus study, the one characteristic that distinguished the groups where the plan worked from those where it did not was decision making. The plan was designed and developed by the employee groups where it worked, but it was imposed on those groups where it was less effective. In the incentive study, the group where the plan worked had a long history of employee participation in decision making, and employees had actually voted on the plan when it was put into effect years earlier. In the other group, no history of participation existed, and the plan had simply been designed by management and imposed on the employees.

Lawler (1981) and Jenkins and Lawler (1981) provide evidence on the use of employee task forces to design pay systems. In three cases, task forces successfully designed and implemented a plan. Thus, it seems that,

like direct participation, participation through task forces can have a positive impact on pay plans.

The success of participative design efforts raises the question of why participation makes a difference. In some situations, it may lead to the design of a better plan because it involves a high level of information exchange. In some of the studies, however, this cannot account for the differences because similar plans produced different results. In these studies it must be because participation contributed to the amount of information employees have about the plans and to their feelings of control over and commitment to what was decided (Vroom, 1964).

### Participation in System Administration

The logical extension of the practice of having individuals participate in the design of performance-based pay systems is to have them participate in the making of day-to-day pay decisions. There has been some experimentation with having peer groups and low-level supervisory people handle the day-to-day decision making about who should receive pay increases and how jobs should be evaluated and placed in pay structures (Jenkins & Lawler, 1981). There also have been isolated instances of peer executives assessing each other allocating pay (Lawler, 1981).

The most visible examples of peer group decision making are in the new participative plants that use skill-based pay (e.g., see Gupta et al., 1986; Walton, 1980). In these plants, typically the work group reviews the performance of the individual and decides whether he or she has acquired the new skills. Interestingly, the little evidence there suggests that this has gone very well. In many respects this result is not surprising since the peers often have the best information about performance and thus are in the best position to make performance assessments. Peer ratings are often valid and have been the subject of considerable

research (Kane & Lawler, 1978). The problem in traditional organizations is that peers may lack the motivation to give valid feedback and to behave responsibly; thus, their expertise is of no use. In more participative systems, this motivational problem seems to be less severe, and as a result, involvement in decision making seems to be more effective.

Overall, there is evidence that some participative approaches to reward system design and administration can be effective. The key seems to be articulating the practices in the area of reward systems with the general management style of the organization. In more participative settings, there is good reason to believe that participative approaches to reward-system decision making can be effective because of their congruence with the overall management style and because the skills and group norms to make them effective are already in place. In more traditional organizations, the typical top-down approach to reward-system design and administration probably is better. Much more research is needed in this area before we can begin to sort out the impact of participation and understand when, where, and how it is best used.

### Future Research

The research on pay in organizations can best be described as uneven. Some topics are extremely well researched, while others are barely touched upon. Some studies are well done, while others are not. Particularly noticeable by their absence are well-executed studies that look at the impact of pay practices while taking into consideration the nature of the organization in which the practices operate. The existing literature allows some general conclusions about the impact of a wide variety of pay systems, but it also suggests strongly that their impact depends on a number of key organizational factors. Management style, organization size, and work

design, for example, all appear to moderate the impact of a variety of pay systems.

Hopefully, future research will be more likely to study those pay practices that are relatively underresearched, and it will be more sensitive to issues of organizational context. This in turn could, and should, lead to the development of theories that are more organizational in their orientation. Most of the useful current theories concerning pay systems focus on individual behavior and the impact of pay on it. More theories are needed that focus on the relationship between pay systems and organizational behavior and performance. These theories are likely to develop only if more attention and research is focused on the organizational context in which pay and reward systems operate.

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