

MATCHING COMPENSATION AND ORGANIZATIONAL STRATEGIES

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This study examines the impact of organizational strategies (at both the corporate and business unit level) on pay strategies, and their interactive influence on the effectiveness of the compensation system. The empirical findings are based on the survey responses of 192 human resource management executives in business units of large manufacturing firms. Corporate strategy was a significant predictor of pay package design, pay level relative to the market, and pay administration policies. Business unit strategy was a significant predictor of pay package design and pay level relative to the market. The findings are supportive of congruency notions which suggest that the effectiveness of the compensation system is partly a function of the fit between pay strategies and organizational strategies.

Issues of variation, interrelation, and fit are well developed in the strategy literature. It contains many analyses of congruence between strategy and other organizational variables—including formal organizational structure, technology, market competence, and environment—(cf. Miller, 1986; Tichy, 1983; Prescott, 1986). This body of research suggests that coherent or matching strategy types are more effective (e.g. Woo and Cooper, 1981; Hambrick, 1983a, 1984).

The concept of fit is based on the notion that strategies are decomposable (Simon, 1981), consisting of elements (e.g. technology) that are interesting for their individual importance as well as their role in overall strategic plans (Venkatraman and Camillus, 1984). If the various elements are not integrated or congruent with the overall strategy, the organization has an unclear, or missing, strategic direction leading to suboptimal or even dysfunctional outcomes (Lawless, 1987). In other words, because strategy 'elements' should be mutually determined by a firm, this interrelationship implies that an important normative test for a firm's strategy is internal consistency (Porter, 1980; Galbraith and

Schendel, 1983). The congruency question has been operationalized by examining the relationship between vectors of variables that typically fall within the realm of management responsibility; that is, controllable variables such as pricing, promotion, and research and development (e.g. Woo and Cooper, 1981). Because they are collections of controllable factors themselves, it is possible to consider these in terms of functional or subfunctional area strategy, such as marketing strategy, financial strategy, compensation strategy, etc. (Galbraith and Schendel, 1983).

Following the stream of research noted above, a growing number of writers are advocating a strategic approach to the reward system based on such notions as 'congruency', 'fit', and 'linkages' which call for a close articulation between compensation, overall corporate strategies, and business unit missions (e.g. Carroll, 1987; Lawler, 1981; Balkin and Gomez-Mejia, 1987a; Henderson and Risher, 1987). In a futuristic 'environmental scanning' of major compensation trends, Hay Management Consultants (1986) concluded that linking pay systems to

overarching organizational strategies will be the major challenge in compensation as we move into the twenty-first century. The underlying assumption is that, when properly designed, the reward system of an organization can be a key contributor to the accomplishment of its strategic objectives (Schuler and MacMillan, 1984). However, for this to occur, careful analysis needs to be made of the role that reward systems can and should play in the strategic plan of the firm. The normative implication flowing from these arguments is that unless pay strategies reinforce the organization's overall strategy, the return on compensation dollars (which average about 60 percent of total costs in the United States) will be less than optimal, and even negative in some cases if pay policies induce behaviors that run counter to the firm's strategic objectives (Lawler, 1981).

Perhaps the oldest and most voluminous literature that specifically addresses strategic concerns in compensation can be found in the executive compensation area (e.g. Roberts, 1959; Kerr and Bettis, 1987; Salter, 1973; Gomez-Mejia, Tosi and Hinkin, 1987; Tosi and Gomez-Mejia, 1989). The major thrust of this research has been focused on the relationship between pay level, the design of the pay package, and organization performance. Closely related to the work on executive compensation are some studies that have examined the relationship between corporate strategy and rewards for middle managers. Based on expectancy theory, Guth and MacMillan (1986) provide evidence that middle managers are not motivated to implement corporate strategies that conflict with their own self-interest. Kerr's (1985) data, based on 20 large organizations, suggest that the process by which a firm's diversification strategy had been achieved exerts a major influence on the design of the managerial reward system. Napier and Smith (1987) report that highly diversified firms offer larger bonuses to their middle managers when compared to less diversified companies. Some additional research has examined compensation strategy in terms of specific industries and employee groups. For example, Balkin and Gomez-Mejia (1987b) found that the effectiveness of pay incentives for scientists and engineers in the high-technology industry was related to the growth stage of the product life cycle and inversely related to company size.

All things considered, however, surprisingly little empirical investigation has been conducted that could serve as a guide in designing reward systems that are aligned with corporate and business unit (SBU) strategies. Much work remains to be done if we are to move from a prescriptive to a research-based body of knowledge in this area. First, there is a need to study these issues at a macro level of analysis using a broad conceptualization of compensation strategy that includes pay package design, market positioning, and pay policy choices. Second, there is a lack of multivariate research that examines the unique and additive impact of both corporate and business unit strategies on SBU pay strategies, after partialling out the effect of other correlates (e.g. firm size). Third, the contingency notion of effectiveness should be explored so that it is possible to determine the conditions under which reliance on particular pay strategies is more likely to produce desired results. This paper addresses all three of these concerns. The research questions driving this study may be summarized as follows:

1. Are there consistent and recurrent patterns of SBU compensation strategies (in terms of pay package design, market positioning, and pay policy choices) that are associated with particular organizational strategies?
2. Do corporate and business unit strategies exercise an independent as well as a combined influence on various SBU pay strategies? If so, are there any discernible patterns?
3. What is the pay effectiveness configuration for various combinations of pay, corporate, and SBU strategies?

METHOD

Sample

A total of 600 business units from different manufacturing companies was selected for this study. SBUs were chosen within manufacturing to assure some comparability of technology, capital intensity and other characteristics among them (Hambrick, 1983b). The top human resource (HRM) executive within the business unit was selected as an informant because this individual is intimately involved in the formulation of organizational pay policies. Also, the HRM executive is likely to be the most knowledgeable person about the SBU compensation strategies.

The annual membership directory of the American Compensation Association (ACA) was used to identify the respondents. Many human resource executives belong to this association to keep current with trends in the compensation environment. Of the 600 HRM executives selected for this study, 212 (35.3 percent) agreed to participate in exchange for a free copy of a technical report. All participants were promised strict confidentiality of any information provided to the investigators. The organizations that participated in the study had an average sales volume for 1985 (the latest year available) of \$840 million in sales.

The instrument used in the study was developed after an exhaustive literature review and on-site interviews with human resource executives. The survey instrument was pretested with a sample of 10 executives to ensure it was complete, easy to follow, and that the items were not ambiguous. The survey, conducted through the mail during summer 1986, included questions pertaining to corporate and SBU characteristics, corporate and SBU strategy, and pay strategies. The operational measures are described in greater detail below.

Operational measures

The organizational strategy at both the corporate and business unit level was operationalized from existing strategy typologies. The HRM executives were asked to identify their firm's strategy from written descriptions in a manner similar to the approach used by Snow and Hrebiniak (1980). Advantages of this method are (1) it is possible to obtain standardized and consistent strategy measures across different organizations; and (2) it is possible to study a larger sample of firms (Snow and Hrebiniak, 1980).

Corporate strategy

The corporate strategy measure used in this study is the widely known taxonomy developed by Rumelt (1974), who operationalized it as the degree of diversification exhibited by the firm (see the Appendix for description of scale).

Business unit (SBU) strategy

In the present study, a modified version of the typology developed by Gerstein and Reissman

(1983) was used to measure SBU strategy (see the Appendix for a description of scale). This typology was selected for three main reasons. First, it is a hybrid of most existing typologies and has wide applicability across a broad cross-section of firms. It provides a simple yet eclectic description of each strategy type. Second, it is relatively free of academic jargon, so that it is intuitively meaningful and more appealing to practicing managers. Obviously, this is a crucial consideration given the sample used in this study. Finally, a policy capturing study of manufacturing firms in the PIMS data base by Galbraith and Schendel (1983) produced a SBU typology that greatly overlaps with the Gerstein and Reissman (1983) strategy types, providing empirical confirmation of its validity in a manufacturing environment.

Only the 'dynamic growth' and 'rationalization/maintenance' SBU strategy choices generated enough cases from the respondents to be entered into the analysis. The lack of dispersion of the respondents' SBU strategy choices probably reflects the homogeneity of the ACA membership, which is more representative of larger organizations with full-fledged human resource management departments that provide resources that support professional association memberships and travel to meetings. Business units characterized by entrepreneurial, turnaround or divestiture strategies are more likely to rely on external management consultants instead of hiring their own internal, specialized human resource staff.

The domain of corporate and SBU strategy choices covered in this study is summarized by the matrix in Table 1.

Business unit compensation strategies

Compensation strategies were operationalized in terms of pay package design, market positioning, and pay policy choices (Milkovich, 1988; Balkin and Gomez-Mejia, 1987a; Lawler, 1981; Gomez-Mejia and Welbourne, 1988). The first dimension refers to the relative importance of salary, benefits, and incentives in the pay mix. Market positioning refers to the extent to which the organization targets its pay level below or above its competitors. The last dimension, pay policy choices, consists of the organization's administrative framework, criteria, and procedural approaches used to remunerate its employees.

Table 1. Matrix of corporate and SBU strategies ($n = 192$)

Corporate strategies	SBU strategies		
	Growth ($n = 68$)	Maintenance ($n = 124$)	Decline
Single product ($n = 24$)	$n = 11$ Average = 52 ^a (8, 121) ^b	$n = 13$ Average = 75 (21, 163)	N/A
Dominant product ($n = 32$)	$n = 13$ Average = 422 (85, 657)	$n = 19$ Average = 643 (171, 865)	N/A
Related product ($n = 136$)	$n = 44$ Average = 825 (361, 1124)	$n = 92$ Average = 1042 (549, 1833)	N/A
Unrelated product	N/A	N/A	N/A

^aAverage firm size in sales revenues (\$ millions).

^bRange of firm size in sales revenues (\$ millions).

Thirteen composite scales were created to measure these dimensions (see the Appendix for a description of scales and how they were measured).

SBU pay effectiveness

Pay effectiveness was operationalized in terms of the extent to which the pay system contributes to the achievement of organizational goals. The HRM executives were asked to make this assessment based on five separate pay effectiveness items, which were later averaged into an overall composite (see the Appendix for a description of this measure).

Control variables

A number of control variables were included in the study for both the corporation and the business unit, because they may have an effect on the SBU pay strategy measures, in particular those related to the design of the pay package and market positioning. These control variables include (see the Appendix): sales volume (Lewellen and Huntsman, 1970); profitability (Agarwal, 1981); and the ratio of labor costs to total costs of production (Hicks, 1963; Kochan, 1980).

Analysis

Descriptive statistics (means and standard deviations) were computed for each pay scale, broken

down by organizational strategy. The multivariate linkages between organizational and pay strategies were then measured via multiple regression and discriminant analysis. These multivariate procedures are described below.

A stepwise multiple regression model was utilized to test for the significance of corporate and business unit strategy (as predictors) on each of the SBU pay strategy measures (as dependent variable). The first step consisted of the corporate control variables. The second step tested for the sign and significance of the corporate strategy variable. The third step included the business unit control variables. The fourth step tested for the sign and significance of the business unit strategy measure (as described in the Appendix: 0 = growth; 1 = maintenance).

The corporate strategy typology was operationalized into the regression model by the use of reciprocal averages (Dawis and Weiss, 1968; Weiss, 1963). This method, designed for categorical variables, obtains similar results to that of dummy coding (Gomez-Mejia, 1984). This procedure scales each interval of each predictor according to the magnitude of the mean score on the criterion for those respondents whose predictor scores fall in that interval of each predictor (Dawis and Weiss, 1968; Hoyt and Collier, 1953; Mitzel and Hoyt, 1954).

Discriminant analysis was used to classify each organization by corporate and SBU strategy category, utilizing the pay strategy measures as

discriminating variables. This procedure allows one to obtain a combined estimate of the simultaneous effect of all pay strategies in differentiating across organizational strategies. A separate discriminant analysis procedure using the direct method (Statistical Package for the Social Sciences, 1987) was conducted for the corporate and SBU strategy typology. The classification accuracy of this method is assessed by the 'hit rates' or the percentage correspondence between actual and estimated group membership for each categorical (organizational strategy) variable. Because firms are classified into an estimated group membership for each categorical (organizational strategy) variable, there was no need to develop a numerical scale for each of these variables. Therefore, in addition to the classification information offered by discriminant analysis, this method provided a built-in double check on the reliability of the regression procedure.

The last set of analyses was designed to answer the question: which pay strategies appear to be most effective under each corporate and SBU strategy type? A cross-tabulation table was developed, with each of the pay strategies on the vertical axis and the corporate and SBU strategies along the horizontal axis. Each of the pay strategies was dichotomized into 'high' (firm is above the median) and 'low' (firm is below the median) groups. A matrix was then created that showed the mean effectiveness score for each cell. So, for example, all firms below the median in 'internal equity' that are also pursuing a 'growth' strategy would have an average pay effectiveness score calculated in that subsample. Statistical tests of significance were then computed for mean differences. This procedure provides an overall picture of the effectiveness configuration associated with various organization/pay strategy combinations.

RESULTS

Table 2 presents descriptive statistics (means and standard deviations) for each of the pay strategies broken down by corporate and SBU strategy type. As shown in the table, the overall relationship between corporate strategy and each of the 13 SBU pay strategies was statistically significant. The related product strategy (i.e. most diversified firms) is associated with a higher pay level as

and greater emphasis on salary and benefits vis-à-vis incentives. It is also associated with the most bureaucratic pay policies. There is a higher degree of pay secrecy, internal consistency, pay centralization and job-based pay policies and a lower degree of pay-for-performance, egalitarianism, participation in pay decisions and long-term pay policies. The single-product strategy, on the other hand, is associated with lower pay levels relative to the market and a stronger emphasis on incentives in the compensation mix. It is also associated with more flexible pay policies: an emphasis on pay for performance, pay participation, decentralized compensation decisions, egalitarianism, long-term orientation and skill-based pay and lower levels of pay secrecy and internal consistency. The dominant-product category tends to be associated with pay strategies that fell between the mean responses of the single-product strategy and the related-product strategy.

Table 2 also shows a comparison of pay strategy means for the SBU strategy types. The relationship between SBU strategy, the design of the pay package, and market positioning reached statistical levels of significance. The maintenance strategy is associated with a higher pay level relative to the market and more emphasis on salary and benefits vis-à-vis incentives in the compensation mix. The growth strategy, on the other hand, exhibits a lower market position and a greater reliance on pay incentives. Risk-sharing is also more pronounced under the growth strategy, with a portion of an employee's earnings tied to individual, group or organizational goals. Only three out of eight pay policies are significantly related to SBU strategy. Under the maintenance category, pay policies are less egalitarian, less involving employee participation and more job-based (implying a lower tendency toward skill-based pay). Under the growth strategy there were higher levels of egalitarianism, participation in pay decisions and skill-based pay.

Table 3 summarizes the stepwise regression findings. The overall regression model explained between 25 percent (long-term pay) and 44 percent (market positioning) of the variance (R^2) of the SBU pay strategies. (Note: the direction of the corporate strategy variable in the regression table with respect to the reciprocal averages coding procedure can be discerned by inspecting the corresponding means for each strategy type

Table 2. Means and standard deviations for pay strategy measures broken down by corporate and SBU strategy types

Compensation strategies		Corporate strategy			Business unit strategy	
		Single product (n=24) \bar{x}	Dominant product (n=32) \bar{x}	Related product (n=136) \bar{x}	Growth (n=68) \bar{x}	Maintenance (n=124) \bar{x}
<i>Pay Mix</i>						
1.	Salary	2.52 (1.00)	3.43 (1.11)	3.70** (1.03)	3.03 (1.14)	3.95** (0.53)
2.	Benefits	2.43 (1.00)	3.15 (1.03)	3.52** (0.95)	2.87 (1.19)	3.61** (0.58)
3.	Incentives	4.16 (1.11)	3.34 (0.96)	3.04** (1.07)	3.58 (1.13)	2.82* (0.71)
<i>Marketing positioning</i>						
4.	Pay relative to competitors	1.66 (1.02)	3.01 (0.91)	3.42** (0.92)	2.87 (1.03)	3.80** (0.66)
<i>Pay policies</i>						
5.	Risk sharing	4.32 (0.86)	3.15 (0.92)	2.97** (0.98)	3.46 (0.99)	2.79** (0.68)
6.	Internal consistency	2.78 (0.79)	3.37 (0.71)	3.36** (0.87)	3.13 (0.92)	3.41 (0.65)
7.	Pay secrecy	2.22 (0.88)	2.53 (0.83)	3.10** (1.05)	2.59 (1.17)	3.19 (0.61)
8.	Pay for performance	4.66 (0.48)	3.76 (0.87)	3.67** (0.93)	3.85 (1.06)	3.49 (0.67)
9.	Pay decentralization	3.98 (1.21)	2.97 (1.08)	3.04** (1.08)	3.42 (1.05)	3.03 (0.74)
10.	Egalitarian pay	4.45 (0.59)	3.41 (1.07)	3.03** (0.98)	3.57 (0.93)	2.73** (0.77)
11.	Pay participation	3.95 (1.21)	3.16 (1.05)	2.73** (1.00)	3.31 (1.05)	2.62* (0.56)
12.	Job-based pay	2.33 (1.17)	3.01 (0.82)	3.18** (0.92)	2.79 (1.07)	3.44* (0.80)
13.	Long-term pay	4.36 (0.90)	3.34 (0.88)	3.40** (0.98)	3.85 (0.85)	3.58 (0.86)

Standard deviations in parentheses.

* $p \leq 0.05$; ** $p \leq 0.01$ (*F* test, one-way ANOVA).

in Table 2). After partialling out the effect of the control variables (step 1), corporate strategy (step 2) was significant for incentives (scale 3), market positioning (scale 4), and for all nine pay policies (scales 5–13). Corporate strategy accounted for an average increase of 2.4 percent in explained variance across the 13 pay scales.

The business unit strategy (last step in the regression model) was significant for two out of three pay package design variables (salary and incentives), and for market positioning. Only two out of nine pay policies (internal equity and pay for performance) reached statistical levels of

significance. The SBU strategy increased R^2 an average of 0.8 percent across all pay scales, and 2.0 percent for salary, incentives, market positioning, and pay for performance.

The following control variables reached statistical levels of significance in the regression model: corporate sales volume (in 12 out of 13 regressions), corporate labor cost/total cost (in 12 out of 13 regressions), business unit sales volume (in 6 out of 13 regressions), and corporate profitability (in 1 out of 13 regressions).

Table 4 summarizes the multiple discriminant analysis results in terms of hit rates and the

Table 3. Regression analysis of the relationship between corporate and business unit strategy and SBU pay strategies ($n = 192$)

Independent and control variables	SBU pay strategies												
	1	2	3	4	5	6	7	8	9	10	11	12	13
<i>Step 1</i>													
Corporate sales volume	0.280** (0.077)	0.244** (0.074)	-0.212** (0.084)	0.339** (0.084)	-0.274** (0.079)	0.217** (0.063)	0.150* (0.072)	-0.145* (0.073)	0.190* (0.080)	-0.317** (0.078)	-0.193** (0.077)	0.171* (0.075)	-0.113 (0.076)
Corporate profitability	-0.093 (0.070)	-0.019 (0.067)	0.003 (0.076)	0.040 (0.076)	-0.018 (0.072)	-0.093 (0.057)	-0.029 (0.075)	-0.034 (0.067)	0.067 (0.073)	0.005 (0.071)	-0.006 (0.070)	-0.057 (0.068)	0.184** (0.069)
Corporate labor cost/total cost	-0.304** (0.075)	-0.306** (0.072)	0.231** (0.082)	-0.314** (0.082)	0.232** (0.077)	-0.140* (0.061)	-0.126 (0.080)	0.170* (0.071)	0.335* (0.078)	0.217** (0.076)	0.362** (0.075)	-0.258** (0.073)	0.400** (0.074)
R^2	0.30	0.31	0.26	0.31	0.26	0.26	0.24	0.23	0.28	0.29	0.29	0.30	0.19
<i>Step 2</i>													
Corporate strategy	0.466 (0.271)	0.307 (0.282)	-0.605* (0.313)	0.615** (0.193)	-0.773** (0.232)	0.684* (0.309)	0.775* (0.322)	-0.703** (0.279)	0.623* (0.314)	-0.756** (0.218)	-0.434* (0.209)	0.628* (0.307)	-0.740** (0.236)
R^2	0.31	0.32	0.27	0.34	0.30	0.28	0.26	0.26	0.30	0.33	0.31	0.32	0.23
<i>Step 3</i>													
Business unit sales volume	0.224* (0.093)	0.156 (0.092)	-0.237* (0.104)	0.119* (0.053)	-0.156 (0.097)	0.119 (0.080)	0.247** (0.100)	-0.152* (0.074)	0.167 (0.101)	-0.103 (0.096)	-0.127 (0.096)	0.191* (0.093)	-0.116 (0.095)
Business unit profitability	-0.085 (0.101)	-0.041 (0.099)	-0.027 (0.112)	0.143 (0.107)	-0.008 (0.105)	0.007 (0.086)	0.036 (0.108)	-0.092 (0.098)	-0.071 (0.109)	-0.027 (0.103)	0.088 (0.104)	0.117 (0.100)	0.022 (0.206)
Business unit labor cost/total cost	-0.136 (0.086)	-0.149 (0.085)	0.025 (0.096)	-0.076 (0.092)	0.102 (0.090)	-0.090 (0.074)	0.096 (0.092)	0.039 (0.085)	0.071 (0.094)	-0.043 (0.089)	0.075 (0.089)	0.049 (0.086)	0.112 (0.088)
R^2	0.39	0.36	0.32	0.42	0.34	0.29	0.33	0.29	0.32	0.36	0.34	0.37	0.25
<i>Step 4</i>													
Business unit strategy	0.201* (0.083)	0.339 (0.362)	-0.270* (0.114)	0.293* (0.132)	0.393 (0.425)	0.223* (0.146)	0.653 (0.320)	-0.778* (0.375)	0.886 (0.947)	0.380 (0.421)	-0.409 (0.552)	0.043 (0.500)	-0.422 (0.669)
R^2	0.41	0.36	0.34	0.44	0.35	0.29	0.34	0.31	0.32	0.36	0.34	0.37	0.25

Code for pay strategies: 1 = salary importance; 2 = benefits importance; 3 = incentives importance; 4 = pay compared to market; 5 = risk-sharing; 6 = internal consistency; 7 = pay secrecy; 8 = pay for performance; 9 = decentralized pay decisions; 10 = egalitarian pay; 11 = pay participation; 12 = job-based pay; 13 = long-term pay.

Standard errors in parentheses.

* $p < 0.05$; ** $p < 0.01$.

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Table 4. Discriminant analysis results in terms of classification accuracy for corporate and SBU strategy categories using control variables and pay strategies as discriminating factors

	Corporate strategy			SBU strategy	
	Single product (n=24)	Dominant product (n=32)	Related product (n=136)	Growth (n=68)	Maintenance (n=124)
<i>Control variables</i>					
Hit rate	52.1	32.0	46.2	48.2	46.2
Percentage improvement over chance	18.8	-1.3	12.9	-1.8	-2.8
<i>Pay mix variables</i>					
Hit rate	78.1	54.8	71.1	66.3	69.3
Percentage improvement over chance	44.8	21.5	37.8	16.3	19.3
<i>Market positioning</i>					
Hit rate	82.2	58.6	79.6	76.9	79.8
Percentage improvement over chance	48.7	25.3	46.3	26.9	29.8
<i>Pay policies</i>					
Hit rate	89.1	67.7	89.4	82.3	84.5
Percentage improvement over chance	55.8	34.4	56.1	32.3	34.5

Note: The percentage increment in hit rates attributable to the pay strategies entered at each step reached statistical levels of significance at $p < 0.05$ in all equations.

percentage improvement over chance in classifying cases by corporate and SBU strategy. By chance alone, 33.3 percent of the cases should be correctly classified by corporate strategy (which has three categories), and 50 percent by SBU strategy (which has two categories). As shown in that table, the control variables have a percentage improvement over chance (PIC) averaging 10.1 percent for corporate strategy and a slightly negative average PIC for SBU strategy (-2.3 percent). Addition of the pay mix variables into the discriminant analysis increases the PIC to an average of 34.7 percent for corporate strategy (a 24.6 percent increase) and 17.8 percent for SBU strategy (a 20.1 percent increase). Including market positioning into the equation increases the cumulative PIC to an average of 40.1 percent for corporate strategy and 28.4 percent for SBU strategy. The last set of variables simultaneously added into the discriminant analysis procedure, the nine pay policies (scales 5-13), increased the cumulative PIC to an average of 48.8 percent for corporate strategy and 33.4 percent for SBU strategy. These results indicate that pay package design, market positioning and pay policies do have substantial discriminating power in distinguishing across various corporate and SBU strategy categories.

Table 5 shows the mean effectiveness scores broken down by each of the pay scales and the organizational strategy categories. Table 6 summarizes these findings by indicating the corporate and SBU strategies under which particular pay strategies are most effective.

The profile shown in Table 6 supports the contention that the effectiveness of the compensation system (based on assessments made by the executives in the survey) varies as a function of the interaction between pay and organizational strategies. An emphasis on incentives vis-à-vis salary and benefits appears to work best for single-product firms and for SBUs following a growth strategy. Paying above the market seems to be most appropriate for related product firms and for more mature SBUs. This pattern suggests that offering of incentive pay by single-product firms and SBUs at the growth stage may be a useful strategy to attract and retain employees, while at the same time underemphasizing expensive fixed-pay components (salary and benefits) relative to more established, mature firms. Such a compensation strategy would tend to free up scarce dollars in the short run so that these may be devoted to finance continued expansion. Although pay level may be below market for these firms, employees may choose to work there

Table 5. Average compensation effectiveness scores broken down by pay and organizational strategies

Pay strategies	Corporate strategy			SBU strategy	
	Single product (n=24)	Dominant product (n=32)	Related product (n=136)	Growth (n=68)	Maintenance (n=124)
1. Salary					
Low	4.82	4.35	4.39*	4.53	3.61**
High	2.05	3.37	3.04**	1.88	3.41**
2. Benefits					
Low	4.82	4.25	4.26**	4.53	3.44**
High	4.05	3.22	3.03*	2.00	3.44**
3. Incentives					
Low	1.87	3.22	2.91**	1.75	3.40**
High	4.77	4.25	4.11**	4.45	3.51**
<i>Market positioning</i>					
4. Pay level vis-à-vis competition					
Low	4.82	4.21	4.18**	4.51	3.24**
High	2.35	3.41	3.04*	2.02	3.49**
<i>Pay policies</i>					
5. Risk-sharing					
Low	2.40	3.20	2.98**	2.14	3.39**
High	4.78	4.17	4.14**	4.45	3.55**
6. Internal equity					
Low	4.82	4.21	4.18**	4.52	3.29**
High	2.84	3.48	3.05*	2.33	3.53**
7. Pay secrecy					
Low	4.73	4.01	4.08**	4.46	3.29**
High	2.45	3.08	3.08*	2.28	3.50**
8. Pay for performance					
Low	2.50	3.73	3.01**	2.17	3.47**
High	4.70	3.85	4.16**	4.52	3.32**
9. Pay decentralization					
Low	2.45	3.46	2.97**	2.15	3.40**
High	4.82	4.24	4.11**	4.45	3.49**
10. Egalitarian pay					
Low	2.24	3.07	2.98*	1.99	3.47**
High	4.71	4.20	4.07**	4.44	3.67**
11. Pay participation					
Low	2.15	3.23	2.94*	2.04	3.45**
High	4.82	4.31	4.27**	4.56	3.38**
12. Job based pay					
Low	4.77	4.17	4.05**	4.36	3.46**
High	2.65	3.41	3.00**	2.25	3.42**
13. Long term pay					
Low	2.46	3.47	2.99**	2.33	3.37**
High	4.83	4.36	4.02**	4.35	3.51**

* $p < 0.05$; ** $p < 0.01$.

Note: A one-way ANOVA was computed for mean differences in pay effectiveness scores across the corresponding organizational strategy categories.

Table 6. A profile of most effective pay strategies by corporate and SBU strategies

	Corporate strategy		SBU strategy	
	Single product (n=24)	Related product (n=136)	Growth (n=60)	Maintenance (n=124)
Pay package design	Incentives	Salary and benefits	Incentives	Salary and benefits
Market positioning	Below market	Above market	Below market	Above market
Pay policies	Risk-sharing	Guaranteed pay	Risk-sharing	Guaranteed pay
	Flexibility	Internal consistency	External orientation	Internal orientation
	Open pay communication	Pay secrecy	Open pay communication	Pay secrecy
	Pay for performance	Seniority	Pay for performance	Seniority
	Pay decentralization	Pay centralization	Pay decentralization	Pay centralization
	Egalitarian pay	Hierarchical pay	Egalitarian pay	Hierarchical pay
	Employee participation	Low employee input	Employee participation	Low employee input
	Skill-based pay	Job-based pay	Skill-based pay	Job-based pay
	Long-term orientation	Short-term orientation	Long-term orientation	Short-term orientation

Note: For the sake of simplicity, only the two ends of the corporate strategy types (single-product and related-product) are shown in the above table.

in exchange for greater potential returns in the future. Balkin and Gomez-Mejia (1987a) found that to be the case among smaller high-tech firms in the New England area, which tend to rely quite heavily on incentive compensation.

The profile shown in Table 6 also suggests that more 'freewheeling' pay practices that are responsive to varying conditions, contingencies, and individual situations seem to be most effective for single-product firms and SBUs at the growth stage. Formalized rules and procedures that tend to 'routinize' pay decisions, and that are applied uniformly across the entire organization, appear to work best for related-product firms and SBUs at the maintenance stage. In contrast to single-product firms and SBUs at the growth stage, the following pay policies appear to be most effective for the latter group: (1) guaranteed pay vs. risk sharing; (2) internal consistency vs. flexibility; (3) pay secrecy vs. open pay communication; (4) seniority vs. performance emphasis; (5) hierarchical vs. egalitarian pay; (6) low employee input vs. employee participation; (7) job-based

vs. skill-based pay; and (8) short-term vs. long-term orientation.

DISCUSSION AND CONCLUSIONS

The purpose of this study has been to examine the relationship between organizational and pay strategies and their interactive impact on the effectiveness of the compensation system. The results reported here indicate that two levels of organizational strategy, corporate and business unit, are determinants of several SBU pay strategy dimensions. The corporate-level influences pay strategies across a wide domain, including pay package design, market positioning, and all nine pay policies included in the study. The SBU level, on the other hand, seems to have a more focused effect on pay strategies, primarily those pertaining to pay package design and market positioning.

The data also show that organization size as

measured by sales volume is related to pay package design. Large organizations place a heavier emphasis on fixed pay components (salary and benefits). Smaller organizations tend to rely on variable pay components (pay incentives) to complement the salary and benefits.

The findings may be interpreted to support a contingency approach to compensation. That is, management adjusts its pay strategies to fit with the organizational strategy. The results suggest that in a given business unit in a diversified corporation, the pay policy is influenced by both the corporate and business unit strategy. In business units of diversified corporations in related businesses, corporate strategy influences most of the pay administration policies such as the amount of pay information to reveal to employees or the level of employee participation in the development of pay policies. On the other hand, both the corporate and business unit strategy were found to influence the design of the pay package and pay level relative to competitors. The salary level may reflect the competitive market position of the business unit in the local or regional labor market, reflecting the business unit strategy. The design of the benefits package may reflect the business unit strategy because some benefits such as life insurance or vacation pay are tied to the salary level. It may also reflect corporate strategy because benefits are perceived as organizational membership rewards and need to be internally consistent across related business units to maintain employee perceptions of fairness.

The data indicate that as corporate strategy shifts from a low level of diversification to a higher level of diversification (but still remaining in related businesses) the SBU reward system becomes more bureaucratic and inflexible. As additional business units are added to the corporate structure according to the diversification strategy, pay comparisons across business units are made by corporate management. Pay policies that ensure fair, consistent treatment of employees in different business units are developed at the corporate level. Internal pay equity through job evaluation becomes increasingly important as the level of diversification increases. This means that managing the potential conflict between the quest for 'fairness and equity' vs. 'adaptiveness and differentiation' in the pay system could become a major challenge

in organizations with corporate strategies that lead them to diversify into unrelated businesses, i.e. conglomerates, the reward system policies may not develop according to the above discussion, however. The findings in this study are only extended to corporate diversifications in related businesses where corporate management possesses a core of management expertise that relates to the different businesses in the corporation.

The results also suggest that as the business unit strategy shifts from a growth to a maintenance focus there is a change in pay mix. The pay mix associated with the growth strategy has a strong incentive component (to emphasize unit and individual performance and to share the results of growth) with lower salary and benefits (to conserve cash which can be reinvested in the business). The pay mix associated with a maintenance strategy has a strong emphasis on salary and benefits (because the business unit is more likely to be operating efficiently and profitably) and lower emphasis on pay incentives.

This study provides some data that support the congruency notions of effectiveness. It appears that the use of incentives to complement a lower salary and benefits level, accompanied by flexible and less formalized pay policies and procedures with an emphasis on performance, seems to work best for single-product firms and SBUs at the growth stage. A reliance on fixed compensation and the use of bureaucratically oriented pay policies and procedures seem to be most effective for related product firms and SBUs at the maintenance stage.

The empirical findings suggest that there are two major strategic patterns of compensation decisions. Each pattern is associated with a unique set of corporate and SBU strategies that tend to 'hang together'. This dual typology is discussed below.

The mechanistic pattern is associated with related product firms and SBUs at the maintenance stage. It emphasizes formalized rules and procedures that are uniformly applied across the organization. The mechanistic pattern focuses on paying for the job, not the individual. The pay mix consists mainly of salary and benefits. Pay policies reflect the job's hierarchical position in the firm and tend to be centralized, subject to secrecy and lacking in opportunities for employee participation.

The second strategic pattern of compensation dimensions to emerge is organic in nature. The organic pattern is associated with single-product firms and SBUs at the growth stage. It emphasizes pay practices that are flexible. The organic pattern pays for the individual, not the job, and places a significant part of the pay package 'at risk' in the form of pay incentives to complement the salary and benefits. Pay policies tend to be decentralized with open communication of pay procedures, and there are opportunities available for employees to participate in pay decisions.

The mechanistic and organic patterns of compensation may be viewed as two extreme positions on a continuum. Many firms may find that their patterns of compensation policies fall between these two poles, exhibiting some characteristics of each. It is our belief, however, that a firm's relative positioning on this continuum will depend on its corporate and business unit strategies. The greater the deviance from the 'ideal' compensation pattern associated with a particular corporate and business unit strategy, the less effective the firm's pay policies are likely to be.

The empirical findings suggest some needed research that may build on this study to further examine the relationship between organizational strategy and pay policy. There are several research issues and concerns that arise that could not be adequately handled within the constraints of this study. First, does organizational strategy affect the pay of all job families equally, or are the rewards of some employees more closely linked to organization strategy than others? More specifically, do strategic factors explain the pay policies of executives and sales representatives and nonstrategic factors explain the pay policies that affect pay for production workers and clericals? How does the effectiveness of these strategies vary by employee group? Newman (1988) argues that employees in 'boundary spanning' roles (such as executives and sales) should be given the highest priority when designing compensation strategies. Second, how do pay strategies differ by 'entrepreneurial', 'turnaround', and 'divestiture' strategies? These interesting categories could not be examined in the present study due to low cell sizes.

Another research question that builds on this study is how do conglomerates develop compensation strategies as the shared core of management expertise declines? Are conglomer-

ates more likely to use mechanistic or organic patterns of compensation dimensions? Research on this question should include different industries and focus on different job families to extend the generalizability of the findings.

Finally, research should be undertaken to examine how, within related-product firms, the conflict between the need for consistency and the need for flexibility in the pay system is managed for each SBU. Carroll (1988) appropriately argues that this is one of the most challenging tasks in designing strategic pay systems, yet we know very little about it. For example, suppose an electronics corporation is following a related-product strategy and has one of its units following a growth SBU strategy. The SBU is pursuing a strategy which places a high emphasis on research and development. How can it differentiate its pay system to attract and retain the scientists and engineers it requires, while at the same time being responsive to the need for consistency and equity in pay which is important to other employees in the corporation? To answer questions such as this will require the use of qualitative and quantitative methodologies to unravel the mechanisms used by these firms to buffer, yet at the same time integrate, the pay systems of diverse SBUs.

APPENDIX: OPERATIONAL MEASURES OF VARIABLES

Corporate strategy

The corporate strategy in the present study was reported by HRM executives according to Rumelt's (1974) typology of diversification: (1) the single-product firm which obtains 95 percent of its revenue from a single product (24 cases); (2) the dominant-product firm which obtains between 70 and 94 percent of its revenue from a single-product domain (32 cases); (3) the related-product firm which receives less than 70 percent of its revenues from a single-product domain and the remainder of its revenues from a related-product domain (136 cases); (4) and the unrelated-product firm which receives less than 70 percent of its revenues from a single-product domain and the remainder of its revenues from an unrelated-product domain (eight cases). The diversification strategies were coded on a nominal scale. Because only eight cases were

associated with the last category, this category was deleted from the analysis.

While it may seem surprising that there are few 'unrelated-product' firms, the sample selection procedure of choosing manufacturing firms for purposes of comparability led to the deletion of many conglomerates from the sample. Therefore a subset of the full range of diversification strategies is examined in this study in order to assure some comparability between firms.

Business unit (SBU) strategy

Executives were asked to identify their SBU strategy by choosing one of the following categories (see Gerstein and Reissman, 1983): 'entrepreneurial' (five cases), 'dynamic growth' (68 cases), 'rationalization/maintenance' (124 cases), 'turnaround' (no cases) and 'divestiture' (seven cases). Because of small n sizes, only the second and third categories were included in the analysis. These two categories are briefly described below.

- (a) **Dynamic growth strategy.** Projects with significant financial risks are undertaken frequently. Firm is making high investments in order to expand market share. There is a constant dilemma between doing current work and building support for the future. A need is beginning to be felt for more control and structure for an ever-expanding operation. This category closely corresponds to the 'growth' strategy in the Galbraith and Schendel (1983) study.
- (b) **Rationalization/maintenance strategy.** The firm is interested in minimizing costs while retaining its position in the market. The focus is on maintaining existing profit levels. Modest cost-cutting and employee terminations may be occurring. Control systems are well developed along with an extensive set of policies/procedures. This category closely corresponds to the 'maintenance' strategy in the Galbraith and Schendel (1983) study.

Business unit compensation strategies

The HRM executives were asked to report the pay strategies followed in their business units in

terms of pay mix, their target position vis-à-vis the market, and pay policy choices. To this end, a set of 35 Likert-type items was developed to cover these different aspects. These 35 items were then used to construct 13 separate composite scales. A brief description of each scale is provided below; Table A1 lists the items associated with each of the scales and the coefficient alphas.

Six items were used to operationalize pay mix, broken down into three separate scales that measure the relative importance of salary, benefits and incentives (see Table A1). The response format for each item consisted of a five-point Likert scale ranging from 'strongly disagree' to 'strongly agree'. As shown in Table A1, the coefficient alpha exceeded 0.80 for each of the three scales, indicating high internal reliability.

Two questions in the survey (one for salary and one for benefits) asked the executive to indicate the SBUs preferred pay level vis-à-vis its competitors (see Table A1). The response format consisted of a five-point Likert scale ranging from 'substantially below the market' to 'substantially above the market'. These two items were combined into a single score to measure the SBU's market positioning. The Cronbach alpha for the composite scale was 0.94, indicating a high degree of homogeneity.

The nine pay policy dimensions used in this study were adapted from Lawler (1981). Table A1 shows the items associated with each of the nine pay policy scales and the coefficient alphas. The response format for each item consisted of a five-point Likert scale ranging from 'strongly disagree' to 'strongly agree'. The coefficient alphas were all satisfactory, ranging from a low of 0.83 for 'internal consistency' to a high of 0.92 for 'risk-sharing'.

SBU pay effectiveness

A five-item scale (see Table A1) was developed to measure pay effectiveness. The response format for each item consisted of a 1–5 Likert scale that ranged from (1) 'strongly disagree' to (5) 'strongly agree'. The composite scale was tested for reliability and found to be internally consistent with an alpha of 0.94. The composite effectiveness score was calculated by averaging the responses to the five items.

It would be ideal if objective pay effectiveness indices could be used as a way to cross-validate

Strategy dimension I: Pay package design (pay mix)

1. *Salary* (coefficient alpha: 0.92)
 - (a) The base salary is an important part of the total compensation package.
 - (b) The base salary is high relative to other forms of pay that an employee may receive in this organization.
2. *Benefits* (coefficient alpha: 0.84)
 - (a) The benefits are an important part of the total pay package.
 - (b) The employee benefits package is very generous compared to what it could be.
3. *Incentives* (coefficient alpha: 0.89)
 - (a) Pay incentives such as a bonus or profit sharing are an important part of the compensation strategy in this organization.
 - (b) Pay incentives are designed to provide a significant amount of an employee's total earnings in this organization.

Strategy dimension II: Market positioning

4. *Pay relative to competitors* (coefficient alpha: 0.94)
 - (a) Preferred position of organization's salary levels with respect to competitors.
 - (b) Preferred position of organization's benefits level with respect to competitors.

Strategy dimension III: Pay policy choices

5. *Risk sharing* (coefficient alpha: 0.92)
 - (a) In this organization a portion of an employee's earnings is contingent on group or organization performance goals being achieved.
 - (b) We designed our compensation system so that a portion of our compensation costs is variable.
 - (c) We believe that employees should be risk takers with some of their pay.
6. *Internal consistency in pay relationships* (coefficient alpha: 0.83)
 - (a) Internal pay equity is an important goal of our pay system.
 - (b) We try hard to achieve comparable pay relationship across different parts of the organization.
 - (c) In our organization we give a higher priority to internal pay equity than we do to external market factors.
7. *Pay secrecy* (coefficient alpha: 0.90)
 - (a) We keep pay information secret from the employees.
 - (b) We have formal policies that discourage employees from divulging their pay to coworkers.
 - (c) Our organization does not openly disclose the administrative procedures on how pay levels and pay raises are established.
8. *Pay-for-performance* (coefficient alpha: 0.90)
 - (a) We have a strong commitment to a merit pay system.
 - (b) In this organization pay raises are determined mainly by an employee's job performance. There is a large pay spread between low performers and high performers in a given job.
 - (c) An employee's seniority does *not* enter into pay decisions.
9. *Pay decentralization* (coefficient alpha: 0.89)
 - (a) Pay policy is *not* centralized in this organization.
 - (b) The Personnel staff in each business unit has freedom to develop its own compensation programs.
 - (c) There is a minimum of interference from corporate headquarters with respect to pay decisions made by line managers.
10. *Egalitarian pay* (coefficient alpha: 0.89)
 - (a) Our compensation system reflects a *low* degree of hierarchy. In other words, we try to give a minimum of perks (reserved parking spots, first-class air travel, etc.) to top executives.
 - (b) We offer special pay packages and privileges as status symbols to the higher echelons in the organization.
 - (c) We try to make our pay system as egalitarian as possible. There are very few perks or special rewards available to any 'elite' groups of employees.

11. *Pay participation* (coefficient alpha: 0.88)
 - (a) Employees' feelings and preferences for various pay forms (e.g. bonus vs. profit-sharing) are taken very seriously by top management.
 - (b) Many different kinds of employees (individual contributors, managers, personnel staff, executives) have a say in pay policies.
 - (c) Pay decisions in this organization are made on an autocratic basis. We tend to 'follow the book' very closely. Very few employees have any input to pay decisions.
12. *Job-based pay* (coefficient alpha: 0.88)
 - (a) We have a job-based pay system. That is, factors within the job are key determinants of the amount of pay.
 - (b) We have a skill-based pay system. That is, individuals are rewarded in part on their mastery of job skills.
 - (c) The job is a more important factor than an incumbent's ability or performance in the determination of pay rates in this organization. Heavy emphasis is placed on job evaluation procedures to determine pay levels.
13. *Long-term pay* (coefficient alpha: 0.84)
 - (a) The pay system in this organization has a futuristic orientation. It focuses employees' attention on long-term (2 or more years) goals.
 - (b) The pay system in this organization rewards employees for short-term accomplishments during a fixed time period (e.g. annual or semiannual performance reviews).
 - (c) Our pay policies recognize that long-term results are more important than short-term results.

Compensation system assessment

14. *Pay effectiveness* (coefficient alpha: 0.94)
 - (a) Our pay policies and practices are highly effective.
 - (b) Management is very happy with the way the compensation system contributes to the achievement of overall organizational goals.
 - (c) All things considered, the compensation strategies used in our organization truly give shareholders 'their money's worth'.
 - (d) Our pay policies and practices appear to enjoy widespread acceptability among employees.
 - (e) Our pay policies and practices greatly contribute to retention, attraction, and motivation of employees.

Note: with the exception of the 'pay relative to competitors' scale, all items had a five-point response format ranging from 'strongly disagree' to 'strongly agree'. The 'pay relative to competitors' scale had a five-point response format ranging from 'substantially below the market' to 'substantially above the market'. All items worded negatively were reverse-scored for consistency.

the perceptual assessments. The exclusive reliance on self-report effectiveness measures was dictated, in large part, by the sensitive nature of pay-related information. It was judged that reliable information about the specific characteristics of the compensation system, and about the effectiveness of the pay policies, would not be readily forthcoming if subjects were asked to identify their companies. Also, it was felt that the response rate would drop dramatically if the survey was not anonymous.

Control variables

Sales volume was operationalized as annual sales revenues during 1985. Profitability was measured

as the return on investment (ROI) for 1985. The ratio of labor costs to total costs was measured as a percentage. The participants in the survey reported these figures based on the latest available company information. These measures were reported both at the corporate level and the business unit level.

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