Pay System Management Dilemmas: Approaching the New Millennium

Edwin W. Arnold

Compensation is clearly one of the most important human resource management functions. In many firms, labor costs account for more than 50 percent of total costs (Milkovich & Newman, 1996). Pay levels determine the quality of employees acquired and retained, which has a direct impact upon productivity and quality. The design and implementation of pay systems affect the ability to manage other human resource functions, e.g., employee selection.

In a survey of human resource executives, compensation was the human resource management function ranked most frequently among the top five issues of concern to senior management (Mondy & Noe, 1993). Additionally, the design and administration of the pay system have a major impact upon the ability of managers to implement the best management practices cited in research studies in the 1990s (Pfeffer, 1998). As the role of the human resource function has evolved into the 1990s and new responsibilities have been added, compensation management has continued to receive the most emphasis (*SHRM Learning System...*, 1998).

Edwin W. Arnold, Ph.D., SPHR, is a professor of management, Department of Management, School of Business, Auburn University Montgomery, Montgomery, AL.

Although organizational change efforts have become a fact of life in the 1990s, managers continue to encounter a number of pay system dilemmas when they attempt to improve organizations to achieve a more competitive advantage. The number and complexity of dilemmas have been increasing as environmental changes accelerate geometrically. Pressures for higher returns in the short run make it difficult for top management to implement organizational change and install new pay systems that require a long-run timeframe.

Pay system dilemmas occur when managers attempt to implement organizational change, install new work systems, implement merit pay and performance evaluations, or adopt the best practices or contingency perspectives on human resource management. Managers need to consider these dilemmas as they change organizations to adapt more effectively to dynamic environments as we enter the new millennium. This article will focus upon important pay system problems confronting management.

Organizational Change Dilemmas

As organizations implement changes from individual to team-based work systems and adapt to dynamic, highly competitive environments, should management implement new pay systems concurrently or subsequently? Similarly, should firms attempt to change culture and then focus on the pay structure, or should each be changed concurrently? Can organizations expect employees to perform effectively without rewarding evidence of the new values and beliefs expected in a new culture, e.g., one of empowerment? When employees are expected to be more involved in the business, they may be motivated intrinsically in the short run. Eventually, however, they are likely to expect higher financial compensation. Also, how would managers know when to change the reward system to support the new culture?

Do the concerns expressed in the management literature about establishing and implementing rewards in team-based organizations (Novak, 1997; Belcher, 1994) inhibit more rapid, widespread organizational change efforts to move to team-oriented work systems? If these concerns are valid, how can successful team-oriented work systems sustain higher levels of organizational performance in the long run? Will pay system problems render team-oriented work systems less effective in the long run and relegate them to a management fad?

Can human resource management systems, especially pay systems that are a high percentage of operating costs, be effective in improving organizational performance without strong commitment and support from top management? No one is more aware of the need for top management commitment to new pay systems than managers in the field charged with implementing changes. For example, Plant Manager Larry Romans of the Evart Products Company in Evart, Michigan, implemented a gain-sharing plan in the late 1980s to improve quality. The plan worked and quality improved significantly over a four-year period. Mr. Romans acknowledged, "If you don't have the commitment of members of top management in the beginning, forget it—don't go any further" (Ross & Hatcher, 1992, p. 86).

Top management commitment and support may require data to prove a new pay system will be effective, but acquiring the data may require initial top management approval. Even implementing a new pay system on an experimental basis may require top management commitment and advocacy to improve the probability of success. The top management team may be unable to absorb the additional short-run costs required to achieve long-term gains in performance from organizational change efforts to reform the pay system.

A long-term focus is important in implementing new pay systems, as acknowledged by Jim Walker, employee involvement coordinator at Evart Products Company, when he stated, "There has to be an attitude that you're in this for the long term, that it's going to work" (Ross & Hatcher, 1992, p. 82). How can top management teams be expected to change their focus when rewards and job security depend so heavily upon short-run results?

Can management teams implement pay system changes effectively when the changes impact other human resource management functions? Changes in the pay system may have significant impact upon the best practices including selective hiring and extensive training, which have been identified with improved organizational performance.

A recent study by Sibson and Company reported that workers prefer individualized permanent pay increases based on merit while management prefers to make pay a variable cost. Not surprisingly, employees who reported the strongest preference for individualized merit pay were also the highest performers. The study also reported that the pay system, not the pay level, was the most important factor determining employee commitment or intention to leave (LeBlanc & Mulvey, 1998). What is the significance of these findings for employers who are implementing team-oriented work systems? It may become increasingly difficult for employers to minimize fixed costs, tie pay systems to work systems, and continue to motivate top performers. Managers might want to focus on paying people equitably rather than using pay as a motivator.

Work System Dilemmas

Can managers reward employees working in teams to foster achievement of a common goal while at the same time create sufficient individual incentives to continue motivating stars? Will team performance be sustained at high levels in the long run if individual achievement and recognition are swept away in favor of collective evaluations and rewards?

How should managers reward employees who are members of work teams on a relatively permanent basis? If employees are rewarded as individuals, consistent with American culture and employee expectations of individual opportunity, it could encourage individual self-enhancement behavior that is counterproductive for the work team. On the other hand, group and organizational alternative pay systems have had serious problems, e.g., managers have had difficulties adapting gain-sharing plans to the same dynamic environments that were a compelling reason for the installation in the first place. Additionally, profit sharing may cause instrumentality problems as variables beyond employee control, e.g., changes in accounting rules for calculating depreciation may impact negatively on profit levels and sharing amounts.

When managers implement gain sharing, employees participate in deciding how bonuses should be distributed. Unfortunately, groups usually decide on equal distributions that result in an overtime pay problem. *The Fair Labor Standards Act* states that bonuses must be included in a nonexempt employee's compensation when calculating the 50 percent premium (Belcher, 1994), thereby increasing compensation costs for the firm. Bonuses paid as a percentage of the employee's gross income are an exception to the overtime calculation rule, but this type of distribution may create employee perceptions of inequity and impact negatively on motivation. Team members may resent higher bonus allocations to employees who are already earning more and may not have contributed as significantly to team success.

Other dilemmas occur when managers try to link team and organizational goals. The goals of the team and the organization should not be synonymous. Team goals must be realistic and attainable to foster member motivation and commitment. If team and organizational goals are synonymous, and team members believe the goals are attainable, an incentive pay system will not provide motivation for goal achievement and may create disgruntled employees. An example was the E. I. du Pont de Nemours Fibers Division incentive system, introduced in 1988, that failed within two years because lower paid employees complained that they had little ability to influence bonuses (Geber, 1995). The employees could not see a clear relationship between performance and the possibility of a bonus being paid.

How can managers link team and organizational goals and still enable employees to control the achievement of team goals so bonuses have reasonable instrumentality? If a team meets its goals, it may be rewarded appropriately; but has the organization received the behavior and group performance needed for organizational success?

As managers implement pay-for-knowledge systems to reward work-team members, how are motivation and employee development maintained once an employee reaches the top of the ladder? Bonuses could be used, but would employees continue to be motivated in the long run solely by financial compensation without further opportunities for development? Employees may be motivated to take their expensive training with them to greener pastures. Also, how do managers defend paying too many employees for higher, more costly skill levels than are required by the firm? A firm may reach a point at which continuous training adversely affects the bottom-line. A point could be reached at which the cost/benefit of having a large number of employees cross-trained to perform most functions exceeds organizational requirements, and labor costs exceed the advantages of operating with fewer employees in the work-team system. In their efforts to increase pay by acquiring new skills, some team members may focus more on personal goals than organizational requirements.

A 1996 team-based pay survey conducted by the Hay Group found that, "Management continues to be more positive about the use of teams (87 percent) than about how they pay teams (41 percent)" (Novak, 1997, p. 73). Satisfaction levels for team pay were lower for 1996 than 1994. Will basing pay on teams harm pay systems in the long run?

Merit Pay and Performance Evaluation Dilemmas

How can managers implement a pay system with merit increases large enough to be perceived as "merit" rather than cost-of-living adjustments that have been given just to maintain a certain standard of living? Budget constraints, product market competition, pressure for short-term profits, tight labor markets for recruiting employees, and the need to predict the cost of merit increases before the next performance period combine to complicate the administration and motivational impact of merit pay.

How do firms allocate rewards equitably in individual or team-based work systems and deal with the problems in performance evaluation systems? Problems in performance appraisal such as political motivation of supervisors and peers, lack of effective appraisal interviews, lack of discussion about employee development, interviewer biases, etc., are numerous. The implementation and administration of performance evaluation systems are difficult problems for managers, especially when the evaluation is linked to merit pay. In a recent William Mercer study, 47 percent of employers reported their performance management plans provided little value to employees, and 51 percent of employees said the performance management system provided little value to the organization (Pfeffer, 1998). Additionally, many employees have expressed dissatisfaction with evaluation systems (Schellhardt, 1996), making the situation even more difficult, yet providing a significant opportunity for managers to improve motivation and performance in their organizations if the evaluation system and its administration can be improved.

Problems with merit pay and performance evaluation have been partially responsible for the movement to alternative reward systems in organizations. Managers will need to know how to work with employee resistance if they implement alternative reward systems that do not contain individually based merit opportunities preferred by many of the best performing employees.

Best Practices and Contingency Dilemmas

Human resource management research in the 1990s has considered whether firms should manage from a strategic fit perspective by aligning human resource systems with operating and strategic objectives or a best practices approach for managing employees that has universal, positive effects on organizational performance (Becker & Gerhart, 1996). These two approaches have been termed contingency and universal perspectives, respectively (Youndt et al., 1996).

In his book entitled *The Human Equation*, Jeffrey Pfeffer (1998), presented seven best practices of successful organizations. These included employment security, selective hiring of new personnel, self-managed teams, and decentralization of decision making as the basic principles of organizational design. Also included were comparatively high compensation contingent on organizational performance, extensive training, and reduced status distinctions and barriers, including dress, language, office arrangements, and wage differences across levels. Finally, extensive sharing of financial and performance information throughout the organization was included.

Each of the practices identified by Pfeffer depends significantly on pay policies and practices for successful implementation. Providing employment security may require a firm to keep employees on the payroll and accept higher costs during short-run aberrations in demand. In order to hire selectively, a firm may be required to pay above market rates, especially in tight labor markets. The complexities involved in designing and implementing pay systems when an organization moves to self-managed teams for organizational design have already been discussed. It can be difficult to reward the team while maintaining high levels of individual motivation to perform. When compensation levels are high and contingent on organizational performance, greater pressure is placed on compensation professionals to design programs that survive intense scrutiny. Contingent compensation programs, such as gain sharing, are also vulnerable to changes in the external environment. If an organization offers extensive training, this offer may enable it to acquire employees for lower entry rates, but the costs of conducting training may be quite significant. Reduced status distinctions may help reduce costs in terms of fewer private offices and special restrooms, etc., but what if the egalitarian climate reduces the motivation to advance because of the fewer privileges in the higher positions? Employees may have less incentive to work for promotions. Extensive sharing of financial and performance information may help lower compensation costs if it elicits suggestions for improving the organization, but firms will have to ensure that proprietary data do not leave the organization.

A related question is whether pay systems should be considered by combining the best practices and contingency perspectives. Should the pay system be in place to facilitate strategy implementation under the contingency approach and rendered at a significant level to be consistent with the universal approach, i.e., should best practices be determined for different strategies? Or should the firm focus on high compensation based upon organizational results and reduced status distinctions in wage differentials across levels as included in best practices identified by Pfeffer (1998)? Managers will need to monitor research findings regarding these perspectives and determine the best course of action for their organizations.

Conclusion

Managers are encountering important dilemmas in managing pay systems as changes are implemented to develop a more sustainable competitive advantage. These dilemmas are likely to increase in complexity in the new millennium as managers and researchers continue to develop new approaches for implementing and administering pay more effectively. How well managers recognize these dilemmas prior to the implementation of changes will play an important role in the future success of their organizations.

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