

Rewarding Excellence

Pay Strategies for the New Economy

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Introduction

I believe that a major revolution is occurring in the way organizations are managed. The revolution is being driven by new technologies and by the major social and political changes that have led to the globalization of business and to the increasing numbers of democratic, capitalist countries. Billions of people have recently entered, or are about to enter, the capitalist world. A smaller but very significant number have entered the world of electronic connectedness as a result of the growing popularity of the Internet, satellite TV, cellular phones, and videoconferencing.

The combined effects of technological and political change on organizations are enormous and multifaceted. Increasingly, organizations are finding that in order to be competitive in the new global economy they have to reinvent themselves in important ways. This is true of their basic organizational structure, their global reach, and their use of information technology. It is also true of their reward systems.¹

Performance Demands

The shift toward capitalism and global capital markets, and along with it the lowering of trade barriers, is perhaps the most important new source of pressure on organizations to raise their performance levels. These changes have created many opportunities for growth but have also created many new competitors and more demanding investors. The growing power of institutional shareholders has enabled them to put more pressure on management to produce exceptional returns to shareholders. Retirement funds and mutual funds now hold large ownership shares in many corporations and have become active critics of their performance. This has led to the resignation of some CEOs and the restructuring of many corporate boards.

The 1990s saw a number of major companies-AT&T, Sears, IBM, General Motors, and Compaq Computers-oust their CEOs because of poor corporate financial performance. In the compensation arena, the pressure on boards and senior management to produce high returns for shareholders has had a number of effects, including the growing tendency for board members and senior executives to be required to own stock in their companies. It has also contributed to the proliferation of stock option plans. The reality is that in today's global economy, companies are competing for financial capital, not just with other companies in their country and continent but with companies all over the world. Today, financial capital can and does move quickly to wherever it can earn the best return.

The performance pressure on corporations is heightened by the increased power of buyers. A recent survey of CEOs identified rising customer expectation as the most important challenge they face.² Virtually every product and service in the world is in surplus. There is an oversupply of cars, television sets, and restaurants. The result is a subtle but important shift of power from sellers to buyers-a shift that has been accelerated by the tremendous amount of information buyers now have that helps them

make more intelligent purchases. The Internet, television, and a host of other communication devices allow consumers to compare products and services and to make increasingly well-informed buying decisions. The Internet has also created a new distribution channel that is changing the way many products are bought. It is forcing both retailers and business-to-business suppliers to redesign their business models. Never before have organizations been subject to as much performance and change pressure as they are today, and there is every reason to believe that the pressure will continue to increase.

Knowledge Growth

It is an understatement to say that the last half of the twentieth century was marked by a knowledge explosion. The technological advances of that era were truly incredible. New knowledge led to the creation of new industries and to our ability to send people to the moon, as well as to communicate with each other on earth in new and much cheaper and more effective ways. The future promises the continued development of technology and scientific knowledge. Corporations' spending on research and development continues to grow, as does the number of scientific discoveries.

The rapid and continuing growth of knowledge and information technology has had two important effects on organizations. First, it has made the traditional bureaucratic form obsolete—a form based on an information-distribution model that assumes a scarcity of information and a high cost of transmitting it. With the growth of computers and information technology, these assumptions are no longer valid. Because information can be easily and cheaply transmitted, important new organizational forms have developed that are based on a new logic of organizing, which I will discuss in Chapter One. It is almost certain that most organizations will use these forms as they adapt to the new technical and competitive realities.

Second, the rapid growth of technology has made knowledge management and development increasingly critical issues in organizations.³ It has changed the very structure of jobs and what individuals are expected to know and do. More and more jobs have become knowledge work. This is true for individuals writing software programs for Microsoft, as well as for many production workers. The production worker of the past typically was responsible for performing a simple, repetitive task. In many cases today, production workers may be, for example, running a programmable machine tool, doing statistical process control, or working on scheduling and dealing with suppliers. In short, much of the old work is gone, having been replaced by new work that requires employees to be knowledgeable decision makers and capable of understanding their organization's business strategy, work, and customers.

New Deal

The performance demands that organizations face, combined with the rapid growth in technology and changes in the nature of work, have led to an important change in the relationship between employers and employees. One part of this change is the much-discussed shift from a relatively permanent employment relationship to one that is much more transitory.⁴ Another part—the most significant part—is the transfer of power from employers to employees. Yes, corporations are engaging in and will continue to engage in large and frequent layoffs. Yes, workers have less job security. Yes, individuals have to worry much more about their careers and skills. But the fact is that an increasing number of employees have the upper hand when it comes to their relationships with corporations. Of course not every employee has the upper hand. Who has it and who doesn't depends on who has the skills and knowledge organizations need and on how

scarce and important those skills and that knowledge are.

Organizations are increasingly desperate for employees who can provide knowledge and skills that give them a competitive advantage in today's business environment. Human capital is increasingly critical to organizational effectiveness. Thus, obtaining, developing, and managing human capital can be an important source of competitive advantage if it is managed and organized in a way that leads to high performance.

Historically, employers were in charge of the work relationship. People applied for jobs, were granted an interview, and were selected by the organization. But this relationship is changing in sports, entertainment, information technology, consulting, finance, education, and a host of other industries. Increasingly, organizations must recruit and compete for talent. They have to focus on capturing the right human capital, that is, being able to hire the most talented people. Sometimes by hiring the right people they can capture not just key human capital but some of the competencies and capabilities of their major competitors.

The power of human capital is most visible in the rewards that are received by CEOs, entertainers, sports figures, and technology experts. The best people in these professions can command incredibly high pay. Those in the greatest demand can negotiate for personalized reward packages that often include a variety of perks such as first-class airfare, luxury hotel suites when travel is required, home loans, and limousine or helicopter transportation between home and office.

In sports and entertainment there is a long tradition of agents negotiating contracts and helping manage careers. Agents have begun to represent senior executives and technology experts as well. Agents help with public relations, as well as with their clients' career development and contract negotiations. A good guess is that as human capital continues to become more valuable and job security becomes less available, an increasing number of employees will recognize that they are now in a market position that makes it worth using agents to get a maximum return on their human capital. It is also likely that more and more employees will seek job security terms in their employment contracts.

In sports the best baseball, football, and basketball players make forty or fifty times more than the less-well-paid performers. This provides an interesting contrast with traditional salary ranges, which rarely allow the best performer to earn even 30 percent more than the least effective performer. The key difference is that in traditional jobs the best performer may not be adding much more value than the least effective performer. In sports and other kinds of highly skilled work, the best performers often add a tremendous amount more value. In sports the stars draw more viewers to TV and bring more fans into the stands. CEOs can potentially make billions of dollars of difference in the total return to shareholders by increasing earnings and their company's stock price.

Professional sports provide many dramatic examples of the difference between the salaries of outstanding performers and those of other team members. In 1998, for example, the top-paid players at virtually every position in the National Football League made more than \$3 million. In the case of the highest-paid position-quarterback-Dan Marino of the Miami Dolphins made \$7.5 million. On every team there were also many players making the league minimum of \$131,000 a year-quite a pay range for individuals on the same team and playing the same position.

The range for American football is probably somewhat narrower than it would be if not for the salary cap that the owners put in place to keep themselves from paying "too

much" for human capital. It strictly limits the total amount that any team can spend on employing players. Judging from what has happened in major league baseball in the United States, which does not have a salary cap, most likely the salary cap in football has limited the pay of very top players and served to restrict the range of salaries. In baseball, the top players now make over \$15 million a season, whereas the lower-paid players' salaries are similar to those in professional football. In basketball, which has a "soft" cap, Michael Jordan made over \$30 million in 1998. An analysis by Fortune magazine suggests that the money was well spent: it estimates that he has produced nearly \$1 billion in revenue for the NBA during his career.⁵ Human Capital and Organizational Performance In baseball and other professional sports the highest-paying teams by and large win the most games. In 1997 the Florida Marlins had one of the highest payrolls, and they won the World Series. In 1998 they decided they could not afford to be a high-paying team and traded a number of their higher-paid players; as a result, they dramatically reduced both their payroll and their performance. The New York Yankees, however, increased their payroll to the second highest in baseball and replaced the Marlins as the World Series winners. In 1998 the highest-paying team in baseball—the Baltimore Orioles—had a losing season, demonstrating that it is not just how much you spend that matters. How you spend also matters.

The lesson from all this is clear. If organizations want to attract high performers and be high performers, they have to be willing to reward excellent performers highly. This requires abandoning traditional pay structures and practices in which the best performers are only paid a little more than average and below-average performers. This may be acceptable in a traditional bureaucratic organization but not in an organization in which individuals make the difference between winning and losing or between being a highly profitable company and just an average, run-of-the mill company. In today's new economy companies have to invest money in human capital in order to make money.

The importance of human capital is clearly reflected in the stock price of many knowledge-work companies. For example, Microsoft has little in the way of plant and equipment but a high stock value because of its intellectual capital. In 1999 its market value was the highest of any U.S. corporation, higher than the value of General Electric, General Motors, DuPont, and a host of other firms with many more employees and a great deal more in physical assets.

The idea that employees are a critical part of an organization's worth is not new. In the 1960s and 1970s there was an effort to put the human assets of corporations on their balance sheets.⁶ This effort failed to gain significant momentum, in part because it mistakenly argued that people should be thought of as assets. But assets can be bought and sold because they are owned. People cannot be bought and sold because they are not owned. People are better thought of as human capital investors.⁷ Capital is owned by investors, not by an organization, and can be invested or not, depending on the return that is offered for it and how it is treated.

Employees invest time, energy, intelligence, and skills; organizations must pay them for that investment. Organization members, in essence, forgo the opportunity to put their human capital into other organizations in order to work for just one. Individuals continuously choose where they will invest their human capital. They also make active choices about improving and developing their capital. Those who do not improve their skills and knowledge often find that they are worth less, whereas those who make wise investments find that they are worth more.

Companies must deal with individuals who have significant and continuously changing market values. Many of these individuals can move easily to other corporations that want

their skills and knowledge and are willing to pay a fair market price for them. In today's highly competitive world, every employee is a free agent, just as every company is free to downsize, de-layer, and change its strategy. Thus, the market value of human capital must be accurately reflected in the compensation amounts received by human capital investors; otherwise, they will not remain members of the organization. The bonds of loyalty have been broken as a result of layoffs, downsizing, and the loss of job security. New bonds that are based on rewards need to be created.

Perhaps the most intense war for talent is taking place at the senior executive level. A study by the McKinsey consulting firm found that companies are seeing a shortage of executive talent and feel they have to focus a great deal of their attention on the recruitment, development, and retention of senior executives.⁸ Three-quarters of corporate officers surveyed by McKinsey said that their companies had insufficient talent to fill their senior management ranks. Not surprisingly, given this result, the study argues that attracting talent is critical to the long-term effectiveness of every major corporation. Because of the changing nature both of corporations and the business environment, executives are an increasingly important key to the success of major corporations. Simply stated, being a successful executive requires more talent and motivation than it used to. Today it is not good enough to simply be a good manager. A successful executive has to be an exceptional leader and manager, as well as something of a visionary.

As their ability to offer stock ownership and other financial incentives has increased, mid-sized and small companies are becoming increasingly competitive when it comes to attracting top management talent. They can frequently offer reward packages that include an upside potential that cannot be matched by most large corporations. Thus, large companies that used to be able to dominate the competition for talent are finding themselves increasingly in tough battles with companies that previously were not in their league. Clearly, attracting and retaining talent is more difficult than it used to be and is increasingly centered on financial rewards. As the idea of lifetime careers, secure jobs, and loyalty to a single company has disappeared, highly talented individuals increasingly are looking for the best financial deals.

In today's environment, attracting human capital means not only competing with other corporations but in many cases with self-employment. Many talented people don't have to work for a corporation; they can be self-employed. Thus, corporations must provide a job in which individuals can do what they want to do better than they can do it on their own.

In the case of organizations that make products requiring extensive financial capital, the argument for creating large corporations is obvious. However, in many knowledge-work activities such as consulting, architecture, and film production, corporations have a much harder time proving to individuals that it is worth their time and effort to sign on with them. Being part of a virtual organization may be much more attractive.

A dramatic example of the potential advantage that an individual can have operating alone is provided by the management guru Tom Peters. He started his career working as a consultant for McKinsey but left for a variety of reasons, not the least of which was the opportunity to get a higher return on his human capital by operating as an individual. At McKinsey, the royalties on an author's books go to the corporation rather than the author. By leaving McKinsey, Peters was able to receive the royalties on the multi-million-copy sales of his many books—a clear example of the benefits of operating alone.

The privately owned SAS Institute, a leading software company, has taken a broad-based

approach to obtaining and retaining talent. It is frequently cited as one of the best places to work. The company offers a number of attractive benefits to its employees, including a free health clinic, two day-care centers, private offices for everyone, flexible hours, a pianist in the subsidized cafeteria, year-end bonuses and profit sharing, a 35,000-square-foot recreational facility, and a thirty-five-hour workweek in an industry that is known for its long work hours. SAS also ties individuals into the community of Cary, North Carolina, where it is located. SAS offers 10 percent discounts on land in a subdivision the CEO has developed; employees also get discounts on memberships at the country club he owns. Finally, employees get a tuition break if their children are admitted to a private academy in Cary. One of the effects of this generous, reward-rich environment is extremely low turnover. According to one report it hovers at around 4 percent-much lower than the industry average, which is probably closer to 20 percent.⁹

The low turnover rate may also in part be accounted for by benefits the company does not offer: tuition reimbursement for M.B.A. degrees and stock options. Both are likely to lead to turnover. Giving stock options can lead to the "Microsoft problem"-individuals cashing out their stock options and ending up so rich they no longer need to work. And giving tuition reimbursement for an M.B.A. means that employees can increase their market value through education and as a result be motivated to move on to a higher-paying position elsewhere. In short, SAS has done a creative job of putting together a benefits package that effectively locks its employees in for the long term.

Some consulting firms, including the largest, Andersen Consulting, have been even more direct than SAS in developing programs that train individuals and at the same time retain them. Before they invest in training, they require individuals to sign a contract requiring them to pay the organization back for the cost of training unless they work for a certain period of time after the training is completed. This is an obvious attempt to be sure that training does not make employees more mobile. In some cases it can be an effective approach, but when a person is in high demand, hiring organizations will offer to "buy the employee out" by simply paying the amount that is owed to the organization that provided the training.

There is no guarantee that employees who have significant human capital will use it in ways that improve an organization's performance. The reward system challenge, therefore, is to attract the right kinds of human capital and to motivate it to develop and perform in ways that increase shareholder value. Unless their reward system accomplishes these two objectives, most organizations simply cannot be effective in a highly competitive business environment. It is of course one thing to say that an organization must attract the right human capital; it is another to do this effectively at a reasonable cost. Simply spending large amounts of money is not enough; the money must be spent in ways that attract and develop the right people.

Rewards and Excellence

The old reward practices and systems that worked well in nationally focused, bureaucratic, capital-intensive, hierarchical, steady-state, near-monopoly corporations such as the old General Motors and AT&T simply don't fit the realities of today's business environment. Dramatic change is needed, and it is not difficult to identify what the key theme of today's reward systems should be: a focus on rewarding excellence. Many factors argue for excellence being the number-one focus of any organization's reward system, including the ability to attract and retain the best people and to motivate the kind of performance that an organization needs in order to succeed in the new economy.

Creating reward systems that focus on excellence and treat employees as human capital investors requires a major change in the way most systems operate.¹⁰ Reward systems typically treat employees as job holders who are rewarded according to the size and nature of their jobs and how well they perform their jobs.¹¹ Viewing them as human capital investors suggests a different approach to rewards in two respects. First, it suggests basing rewards on the value of the human capital that people bring to the organization. What their job is at a particular moment is much less important than the value of their knowledge and skills. Second, it suggests rewarding people according to how effectively they use their human capital—their knowledge, skills, and competencies—to help the organization improve its business performance.

Creating reward systems that recognize the value of human capital and reward performance excellence is not easy. It requires a careful articulation among an organization's reward system, business strategy, organization design, information systems, and employees. I will begin our discussion of how it can be done by considering how reward systems impact organizational effectiveness.