A STRATEGIC PERSPECTIVE

ON COMPENSATION MANAGEMENT[1]

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INTRODUCTION

The notion that compensation policies are strategic, thereby affecting the missions of the organization, has considerable currency. This is part of the current popularity of all things strategic. While some may write it off as another fad, a less cynical view is that a strategic perspective on compensation is part of a growing recognition that macro-organizational issues are an important part of the study of human resource management (Dyer, 1985).

The importance of a strategic perspective on compensation rests on three fundamental tenets. The first is that compensation policies and practices differ widely across organizations and across employee groups within organizations. To some students of organizations this may be self evident. But to others,such as economists using human capital models to examine compensation differentials, differences in organizations' compensation policies and practices are treated as random noise with little relevance. Anecdotal evidence and sporadic surveys of specific policies or practices report that differences do exist. (The Conference Board, 1984; American Productivity Center, 1987). For example, some organizations claim to position their base pay to meet the market, while others follow it; some design incentive schemes to emphasize long-term performance, others short term. Some firms employ individual based incentives while others emphasize group or team based gainsharing schemes. Some decentralize the administration of compensation, others do not. Some disclose very specific information about pay to employees, such as ranges and merit guide charts, while others communicate only the broad policies, such as fairness and competitiveness. Surprisingly little systematic evidence exists on the effects of these differences. So the proposition that policy and practice differences have meaningful effects requires more systematic study.

The second tenet is that the decisions managers and employees make help shape these differences; that discretion exists to choose among options and the processes used to implement them. This does not discount the importance of environmental effects such as competitive pressures, changes in tax laws and accounting conventions or workforce demographics. Indeed, a strategic perspective implies the anticipation of such environmental pressures and assesses whether these pressures require changes in pay systems. But tracing all changes and variations in compensation systems to inevitable exogenous imperatives, leaving only a minor role for discretionary decision making, does not seem an accurate representation.

Perhaps most fundamental of all the tenets on which a strategic perspective on compensation is based is the belief that fitting compensation systems to environmental and organizational conditions makes a difference; that systematic variation in compensation systems is more than random noise; that making compensation policies and practices contingent on organizational and environmental conditions has some desired effects on employee behaviors and the performance of organizations. Considering that state of research and theory in compensation, this is probably the greatest leap of faith (Ehrenberg & Milkovich, 1987). In light of these beliefs, the present review focuses on two basic issues: (1) what does it mean to be strategic about compensation? and (2) what factors affect or are affected by compensation strategies?

WHAT DOES IT MEAN TO BE STRATEGIC?

The term strategy is often used to refer to everything considered important. The danger is that if it refers to everything, it may mean nothing. Generally, strategy refers to the overarching, long-term directions of an organization that are critical to its survival and success. Strategies take advantage of the opportunities and manage the threats in the external environment by marshalling internal resources in some coherent, consistent direction (Dyer, 1985). A strategy may be intended and formally articulated in some plan or document, or it may emerge through the patterns of decisions shown by the organization's behaviors. Thus, strategies are both plans for the future and patterns from the past (Mintzberg, 1987).

Strategy applied to compensation management is particularly ill-defined. Analogous to the more general definition just discussed, the term connotes compensation decisions responsive to environmental opportunities and threats, and linked to or supportive of the overall long-term directions and purposes of the organization. Thus, all compensation decisions are not strategic. Most probably are not. Deciding which job evaluation plan to adopt and which merit increase grid to use are unlikely candidates. Choosing whether to link pay increases to individual or team performance and deciding the competitive position in the market are more likely to have strategic consequences. Culling those decisions that are not from those that are critical to the performance of the organization is a major task in defining compensation strategies. Being strategic about compensation implies support of the business strategy and sensitivity to anticipated environmental pressures.

But such a general characterization does not provide much leverage for research or theory building. Nor does it offer much guidance for managing compensation. And the folly of undertaking research based on poorly defined constructs is well recognized (Schwab, 1980). Similarly, basing managerial decisions on poorly thought out purposes is equally ill-advised. Without defining what is meant by strategic compensation decisions, it will be difficult to examine the usefulness of such a perspective.

As a place to start, I offer the following definition: a strategic perspective on compensation focuses on the patterns of compensation decisions that are critical to the performance of the organization. Such decisions, in all likelihood, vary by employee groups within organizations. The matrix shown as Figure 1 captures this definition. One dimension involves the critical policy choices which taken together form a pattern of decisions. The critical employee groups to which these patterns of decisions apply is the other dimension.

Insert Figure 1 About Here

Given this definition, the major research tasks are to (1) identify the compensation decisions and employee groups that are strategic, (2) develop measures or descriptions of these decisions, (3) extract any basic combination or patterns of decisions that may be related to a variety of organizations and environmental conditions, and finally (4) determine if compensation strategies affect workforce behaviors which, in turn, affect the implementation of an organization strategy.

Strategic Employee Groups

The notion of compensation strategy originally surfaced in the literature on executive compensation (Cooke, 1976, Ellig, 1981, Salter, 1973). From a strategic perspective, compensation for executives was defined in terms of several basic elements: base pay, short- and long-term incentives, benefits, and perquisites. The major strategic decisions focused on the deployment of total compensation among the basic elements to best achieve the missions of the organization. Long term incentives as a percent of total compensation is an example. Attention was directed at choices among various short-term versus long-term incentive schemes, the relative emphasis on corporate versus subunit performance, and the riskiness of the total compensation package.

More recently, a strategic perspective has been extended beyond executives to middle managers (Kerr, 1985; Broderick, 1986), scientists and engineers (Balkin & Gomez-Mejia, 1984) and finally to all employees (Lawler, 1981; Carroll, 1987). An argument can be made that only executives make strategic business decisions, hence only their compensation has strategic implications. However, different employee groups may be critical to the performance of different organizations. For example, one business strategy may depend heavily on research and development, another on more efficient production employees, and still another on the sales force. If certain employee groups may be more (or less) critical to the success of the organization than others, it follows that their reward systems become an important part of implementing the organization's business strategy.

Little empirical work exists on identifying employee groups that are strategically relevant. Lacking that, perhaps the best starting point is to simply use the basic occupations for which separate compensation systems are designed. These typically include executives, managerial and professional, scientists and engineers, sales, clerical and production.

Strategic Compensation Decisions

Turning next to the other dimension of compensation strategy, the patterns of critical decisions, Table 1 contains lists of decisions deemed to be strategic in the literature. Both structure and process decisions are included. The list proposed by Lawler (1981), while not the longest,is perhaps the most inclusive. It includes the market position (level of pay relative to competitors), internal versus external orientation, hierarchy (the steepness of the pay structure and the basis--job versus skills--for the pay structure reward mix, and the basis of rewards (performance versus seniority, groups versus individual, criteria used, etc.). Several issues listed by Carroll (1987) (performance measures, size of bonus, timing, etc.) seem consistent with Lawler's more broadly defined issues (e.g. basis for increases). The original issues proposed for executive compensation have also become more broadly defined and applied to all employees. For example, both issues proposed by Ellig, (1981) the relative emphasis to be placed on the various elements of compensation, and the short- versus long-term, are treated as part of the "mix" decision.

Insert Table 1 About Here

Salter (1973) and Lawler (1981) also considered a series of process decisions to be strategic. These included congruency (consistency with other organization systems), standardization of pay systems across subunits, communications (the type of data to disclose, the channels to use, etc.), participation in decision making (levels of employees involved and nature of involvement), and organization change strategy (the role of compensation in organization change).

Kerr (1985), focusing on the compensation of general managers, offered a somewhat different list (35 items in all), including the subjectivity versus objectivity of performance criteria, the time orientation (short- versus long-term), the values orientation (performance versus membership), clarity of the performance-reward relationship, and the proportion of total compensation devoted to incentives.

The expanding list of decisions claimed to be strategically relevant raises doubts about the efficacy of a strategic perspective. It brings to mind the multiple facets of job satisfaction and pay satisfaction that made the constructs more complex than originally conceived (Heneman, 1985). What is required is some research to separate those decisions that are strategic from those that are not. At this point, adopting a generic list of fundamental policy choices offers a framework for the present discussion and perhaps a guide for future research. To this end, Table 2 contains a list of six policies which I propose are strategically relevant. Each policy involves several underlying decisions and options. These policies were extracted from the compensation management literature and the work discussed above.

Insert Table 2 About Here

Competitiveness

The first policy, the degree of competitiveness, can vary among organizations and among occupations within organizations. From a strategic perspective, competitiveness refers to positioning a firm's compensation relative to its competitors (Belcher, 1987; Milkovich & Newman, 1987; Carroll, 1987). Leading, meeting or following are the conventional options. However, experience suggests that competitiveness is more complex (Milkovich & Newman, 1987). The mix of pay forms, the risk-return tradeoffs in the pay forms, and the average pay level relative to competitors are all relevant aspects of a firm's policy regarding the competitiveness of its compensation. The risk-return tradeoff can be illustrated by considering two managerial pay schemes. One has a $50,000 base salary with merit, the other a potential return of $70,000; that is, $40,000 base with a $30,000 bonus potential. Whether these two competitive positions are equivalent depends on the risk-return tradeoffs of prospect employees. A risk-return tradeoff incorporates both the proportion of bonus to total compensation and the likelihood of receiving the bonus (Rabin, 1987). Clearly the two employers have adopted different competitive positions in the market. The effects of these different positions on organization performance and employee behavior are unknown. Such schemes are a common feature of sales force pay systems (some are straight salary, others are highly leveraged with incentives) and recent surveys suggest that it is becoming more common in managerial pay (American Productivity Center, 1987).

Internal Structure

The nature of the internal pay structure is another fundamental policy that is proposed to be strategically relevant. Typically it refers to the distribution of rates, or internal pay differentials (Simon, 1957; Mahoney, 1979; Ehrenberg & Milkovich, 1987). However, several choices are involved. These include the number of levels in the pay hierarchy, factors on which to base the hierarchy, the number of different systems used to devise the structure, and its congruency with other organization characteristics. Pay structures differ widely across organizations applying different technologies. The premise underlying a strategic perspective is that considerable discretion exists to design different pay hierarchies, even in organizations with similar technologies. Some organizations have few job classifications and wide ranges, obscuring differences in task details and/or specific skill requirements. This allows flexibility to deploy the workforce without requiring pay changes. Other firms with similar technologies adopt more job classifications with more detailed specifications of work rules and skill requirements to provide a greater sense of promotional opportunities (e.g., more title changes). In both these cases the slope of the pay hierarchy is the same, but the number of job classes and the differentials between classes differ.

The slopes of the hierarchies may also differ. Variations in organizational design result from many factors and the internal pay structure tends to mirror these arrangements. Further, the criteria on which hierarchies are based may vary. Pay structures in some occupations are consistent with employee attributes such as knowledge/skills and experience (e.g., maturity curves for engineers and scientists or knowledge based pay for factory workers), and on job attributes for other occupations (e.g., job evaluations for managerial, professional, and clerical work).

Finally, the issue of pay equity (i.e., comparable worth) is also embedded in the internal pay structure. The decision to apply one or more job evaluation plans across all occupations has implications for comparable worth (Remick, 1984; Treiman & Hartman, 1981).

Forms of Pay

A third policy in the proposed strategic perspective pertains to the forms of the mix of various elements of total compensation (Heneman & Schwab, 1984; Heneman, 1986; Lawler, 1981; Salter, 1973). Total compensation may include base pay, a variety of incentive schemes, cost of living adjustments, various forms of stock options and an array of benefits. Decisions include the number of forms to offer, the degree to which each is contingent on employees' maintaining their membership in the organization (e.g., entitlements) or performance (e.g., incentives), the relative importance of each form (e.g., benefits as a percent of total compensation) and the proportion of the workforce eligible for each form For example, in some organizations all employees receive stock options or deferred compensation, in others only a handful of executives are covered.

Basis for Increases

The policies for granting pay increases are also proposed to be strategic. Many facets to these policies are involved; they range from an emphasis on short- versus long-term incentives (Carroll, 1987; Ellig, 1976; Salter, 1973; Wallace, 1987), the degree of pay differentiation in performance differences (Carroll, 1987), the size of the payments (Carroll, 1987; Krzystofiak, Newman & Krefting, 1982; Lawler, 1981), the relative emphasis on individual versus subunit versus corporate performance (Carroll, 1987; Kerr, 1986; Lawler, 1981; Salter, 1973), and the emphasis on guaranteed compensation (Carroll, 1987; Rabin, 1986).

Role in HR Strategy

Descriptions of firms' human resource strategies suggest that compensation plays a variety of roles (Dyer, 1985). In some, compensation plays a dominant role. High risk-high return incentive plans at financial investment firms, and performance-based incentives at some manufacturing firms are examples. In others, compensation appears to be in a coordinate or even subordinate role to other human resource systems (Herzberg, 1959). Instead, they may emphasize their employee relations policies (e.g. IBM's employment security as a shared responsibility and the Hewlett Packard-"HPWay"). In a similar vein, Lawler (1981) suggests that a compensation system can be out on the point to signal changes in an organization business strategy, or it can play a less prominent role during organization changes. So the fifth policy proposed in a strategic perspective is the role of compensation in the overall human resource strategy.

Administrative Style

Finally, the process used to administer compensation also is regarded to have strategic properties (Broderick, 1985; Kerr, 1986; Lawler, 1981; Salter, 1973). Administrative processes involve several choices. Among these are the nature of information to disclose to employees (i.e., broad policies vs. specific details) the nature of employee participation in pay design and administration, and the degree of centralization of pay administration, the nature of dispute resolution procedures.

In summary, these six policies--competitive position, internal structure, mix among forms, basis for increases, role in human resource strategy and administrative style--represent a proposed definition of a strategic perspective on compensation. The need to describe and measure is a recurring theme in personnel research (Wallace, 1983). In the case of compensation strategy, this means construct validation of patterns of strategic decisions involved in the design and administration of pay. Much work is required here, because the idea of being strategic about compensation is new. Many employers are only beginning to consider what it means and what issues are involved. However, research on an emerging concept may afford an opportunity to offer some guidance in making relevant compensation decisions, rather than studying past and often outdated issues.

One place to begin is to select employee groups most likely to be critical to the implementation of an organization's business strategy; more specifically, employees responsible for the organization's distinctive competence (e.g., technology) and competitive advantage (e.g., marketing strategy). General managers in highly decentralized firms and scientists, engineers and marketing personnel in high technology firms are probably examples. Once these strategically critical employee groups are identified, then the patterns in the six compensation policies applied to them can be assessed.

Assessing Compensation Strategies

Strategy as applied to human resource management is bereft of research. Most of the literature is prescriptive--case studies describing formal procedures in specific employers. However, a few empirical studies are beginning to emerge (deBejar & Milkovich, 1986; Dyer, 1985). Studies of strategies specifically related to compensation are even rarer. This section examines them.

Only one reported study directly posed the question, "Can a set of critical organizational-level pay decision (i.e., strategic decisions) be identified and measured?" In this study, (Broderick, 1985), five basic strategic decisions (competitiveness, hierarchy, mix, increase basis and administrative style) were extracted from the literature. Two hundred and eight corporate compensation directors answered a 70-item questionnaire based on the five basic decisions. Compensation for middle managers was the focus of the study. Seven factors, shown in Table 3, emerged from the factor analysis and confirmed most of the strategic decisions speculated about in the literature. Three structural factors emerged: (1), external competitiveness (expressed as leads, meets or follows competitors' average pay level); (2), mix (expressed as the proportion of total compensation contingent on membership or performance); and (3), basis for pay increases (expressed as increases based on efficiency/costs improvement or revenue growth). And four aspects of administrative style also emerged: (1), employee participation (2), level of managers approving pay decisions (3) similarity of plans across business units and (4), formalization. Items related to the internal pay hierarchies were not found to be significant, and items about the role of compensation in the overall human resource strategy were not included.

Insert Table 3 About Here

It is not clear why the hierarchical factor was not confirmed. It may very well be that decisions about the nature of internal pay structures are infrequently made; that only major environmental jolts, such as threats of unionization, lawsuits, economic survival or major technological innovations, act as triggers to cause employers to reconsider the factors on which the internal structure is based. It may also be that managers do not consider policies regarding internal structure to be strategic. It would be interesting to see if replicating this study on another employee group--engineers, for example--would yield similar results.

All of the remaining research surveyed in this paper adopted a particular set of pay decisions assumed by the researchers to be strategic. Little concern over the correctness of their assumption is reported. Nevertheless, the decisions deemed to be strategic in the literature found some empirical support in Broderick's (1985) study, at least for managerial compensation.

FACTORS AFFECTING STRATEGIC CHOICES IN COMPENSATION

The basic issue here is to determine what factors shape the patterns of policy choices in compensation. Preliminary research in overall human resource strategy and compensation suggests the following three major sets of factors are involved: organization business strategies, and factors in the internal and external environment.

Insert Figure 2 About Here

Using the schematic in Figure 2 as a guide, studies of the determinants of compensation strategy can be grouped into these three sets. Those that focused primarily on the relationship of organization strategies (i.e., corporate, business unit, and functional human resource strategies) to compensation policies and systems is the first. Most of the reported research falls here, since in the literature, compensation strategy is opined to be primarily a function of the organization's overall strategy. The second group consists of a few studies which consider factors making up the organization's internal environment. These variables include its structural arrangements, its administrative style, and its technological characteristics. Finally, the schematic in Figure 2 suggest the possibility of a third set of studies; those that treat factors in the external environment as important determinants of compensation policies.

Organization Strategy and Compensation Strategy

The nature of an organization's strategy has been postulated to be the primary determinant of its compensation strategy (Balkin & Gomez-Mejia, 1984; Lawler, 1981; Salter 1973). A convention in the organization literature is to distinguish among three levels of strategies: corporate, business unit, functional. These are seen as interrelated but distinct concepts (Hofer & Schendel, 1978; Galbraith & Schendel, 1983; Leontiades, 1982). These three levels have been carried into the strategic human resource management literature (Dyer, 1985). Since such a variety of definitions, typologies, and measures of strategies exists at each level, only those used in research directly related to compensation are discussed here.

Corporate Strategies

The two proxies for corporate strategy employed in the research on compensation strategy are diversification and life cycles. Neither of these proxies are direct measures of organization strategy. Diversification seems to be an outcome of a corporate strategy which involves operating in multiple product markets. Life cycles, arguably, could be a determination of an organization's business strategy. The lack of clarity in the meaning of these proxies is but one of the limitation inherent in this research. Diversification is the most widely used. With it, organizations are classified as to whether they exhibit a single, dominant, related, or unrelated product diversification strategy (Rumelt, 1974). According to organization theory, greater diversification gives rise to the need for mechanisms to integrate and control the corporation's separate business units consistent with corporate objectives (Lawrence & Lorsch, 1967). The compensation system serves as a key integration and control mechanism available to management.

Several studies of corporate diversification also examined compensation issues (Kerr, 1985). Three issues were of principal interest: (1) to what degree were division general managers' incentives based on business unit versus some combination of business unit and corporate performance; (2) to what degree were their performance measures subjective versus quantitative and based on end results; and (3) to what degree were general managers' bonuses discretionary versus formula-based.

One study of five conglomerates (i.e., unrelated product firms that grew rapidly by acquisition) and five diversified firms (i.e., related products that grew more slowly by internal expansion) reported that the basis for pay increases (performance measurement) and incentives (pay mix) for division managers varied. This difference was attributed to different corporate/division relationships in the conglomerates (Berg, 1969, 1973). The conglomerate's goals were to retain the division managers of acquired firms and to motivate them to operate as autonomous entrepreneurs accountable for the performance of their divisions. Accordingly, compensation increases were based on division performance, using quantitative end results or financial measures, with considerable discretion in establishing amounts of bonus awards. Management was by incentives rather than by controls.

Lorsch and Allen (1973) studied two conglomerates and one vertically integrated firm. The conglomerates used more formalized procedures with predetermined indices based on division results; managers' pay increases were tied to objective formulas and the conglomerates used financial end results criteria. The integrated firm used a less formal system based on corporate results, incorporating some intermediate measures as well as end results measures, which were not linked to pay increases by a formula. Pitts (1974, 1976) studied the evaluation of division managers in six "internal growth diversified firms" (IGDs), similar to Berg's conglomerates, and five "acquisitive growth diversified firms" (AGDs), similar to Berg's diversified majors. He found that four of the AGDs had pay increases based on division results only; the IGDs used some combination of division, group, and corporate results. Four AGDs computed bonus awards using a formula-based process on quantitative, financial type performance measures that allowed no discretion in determining bonuses. The rest of the firms allowed for varying degree of discretion in bonus determination.

These studies, though consistent in findings, only examined a limited range of the compensation policies proposed earlier in this paper, and focused only on business unit level managers. Due to sample size limitations, factors such as size, ratio of labor costs to total costs, profitability, and so on, were not controlled. Considering these limitations, Kerr (1985) designed a study of 20 firms, controlling the sample for size (revenues). Compensation policies included in this study were pay increase criteria, performance measurement, mix (i.e., salary, bonus, stock awards, perquisites, and promotions) and administrative processes. Corporate strategy was measured on two dimensions: degree of diversification (single-product, dominant-product, related-product or unrelated product); and process of diversification (growth through internal evolution versus expansion through mergers, acquisitions, and joint ventures). Kerr categorized firms according to similarity of compensation patterns, analogous to the definition of compensation strategy proposed above. Two compensation strategies were identified. In one, labelled hierarchy-based, the bonuses for general managers were subjectively determined and constituted a small portion of total compensation. In the other, labelled a formal performance based strategy, precise definitions of performance were tightly linked to pay increases. The process was formal and objective, the general managers' bonuses were large and formula-based, allowing little discretion. Internal diversifiers followed the hierarchical based pay strategy and the evolutionary firms, followed the formal performance-based strategy. Kerr concluded that compensation strategy was influenced more by the process of diversification than by the extent of diversification and that the corporate strategy influenced pay strategy through generating a need for control over the business units.

Based on these studies, the following propositions emerge as corporations become increasingly diversified: (1) quantitative measures are used to evaluate managerial performance, (2) pay increases are determined by objective formulas, (3) performance is more likely to be defined through subunit performance rather than corporate results, and (4) compensation strategies are affected by the process of diversification (internal vs. acquisition).

However, a recent study examining the relationship among corporate diversification, pay increase criteria, and corporate manager compensation did not support these earlier findings (Napier & Smith, 1985). Less diversified firms were reported to use more objective pay increase criteria and bonuses were a significantly greater proportion of total compensation in more diversified corporations. The differences in results may be due to the small sample sizes and the differences in employee groups studied. The earlier studies all focused on business unit general managers, whereas Napier and Smith examined pay strategies for a more heterogeneous group, "corporate level managers." Once again, these differences point to the need for rigorous definitions of employee groups as well as organization characteristics since strategic compensation decisions are conceived to be related to both.

Life Cycles

Perhaps the most detailed prescriptions of how compensation strategy should vary with organization strategy have used the concept of life cycle. The application of life cycles in compensation management originated in executive compensation, but has since been extended to cover all employees' pay (Cook, 1973; Ellig, 1982; Milkovich, 1986).

Prescriptions vary depending on the author, but generally the recommended strategy for an organization in the startup phase includes an external market emphasis, low base/high incentive mix (though disagreement exists on the relative emphasis to place on long- versus short-term incentives), low benefits, and an administrative style that emphasizes decentralization and informality. The recommended strategy for mature/stable firms typically has the following pattern: internal equity emphasis, competitiveness that meets/leads competition, a high base and benefits/low incentives mix, and administrative processes consistent with control.

Life cycles have received widespread attention as heuristic devices in the professional compensation literature, yet, the concept has been widely criticized. These criticisms include: more than one set of compensation policies may be appropriate for a given cycle (Wils & Dyer, 1984; Milkovich, 1986; Milkovich & Newman, 1987), it is deterministic (e.g., managers' objectives may be to avoid or prevent declining cycles) (Kerr, 1985); and organizations typically have multiple products at different stages in a life cycle, making classification difficult. Confusion also exists over types of cycles. Some use product life cycle (Ellig, 1981), whereas others use the market or industry life cycle and the company life cycle (Cooke, 1973). Cooke even alludes to the life cycle or aging of compensation techniques, paralleling the life cycle of the firm. Life cycles may more accurately reflect business unit rather than corporate characteristics, but the criticisms still apply.

For all its attention as a heuristic device, research on life cycles and compensation systems is rare. As part of their study of 33 high tech and 72 non-high tech firms' compensation strategies, Balkin and Gomez-Mejia (1984) reported the effects of two stages in the life cycle; growth (defined as annual sales growth of 10% or greater) and mature (defined in terms of product familiarity). Firms were classified as high tech if the ratio of their R&D costs to total revenues exceeded 5%. The hypothesis was that higher tech firms in the growth stage are more likely to follow an incentive-based strategy than companies at the mature stage. The authors concluded that mature firms are more likely to adopt incentives and select a lower competitive position than firms in the growth stage, which is just the reverse of what was expected. For some reason the product life cycle was not significantly related to compensation strategies in firms that placed less emphasis on R&D. Caution needs to be exercised here. For example, product familiarity may be more of an indicator of market penetration and saturation than are measure of a mature stage.

In another study, in which 2000 manufacturing firms were classified into growth, mature, or declining stages, Anderson and Zeithaml (1984) reported that the firms' competitiveness (pay level relative to competitors) was greater in each progressive stage. They also reported that the higher relative pay in mature firms adversely affected their return on investment. However, growth firms with higher pay levels relative to competitors' reported increased market share.

Business Unit Strategies

In perhaps the most ambitious study of compensation strategy, Gomez-Mejia (1987) examined the relationship of both corporate and business unit strategies to pay strategies. The study was based on survey responses from compensation professionals in 192 business units in manufacturing firms. Corporate strategy was defined as the extent of product market diversification, using Rumelt's classification scheme. Business unit strategies were grouped into two types: growth and maintenance. Compensation strategies had several dimensions: competitiveness (i.e., market positioning of pay level), pay mix (i.e., relative importance of salary, benefits and incentives), and 13 administrative policy choices, which included the basis for pay increases and procedures. The employee groups to which these compensation strategies applied were not specified. A number of control variables were also included specifically sales volume, profitability, and ratio of labor costs to total costs.

The preliminary findings show that the most diversified corporations (related product markets in this study) are associated with higher pay levels (competitiveness), greater emphasis on salaries and benefits than incentives (mix), greater formalization, centralization, and a higher degree of secrecy. The least diversified firms were associated with lower competitiveness and greater emphasis on incentives in their pay mix, more open communication, and decentralized decision making. Using discriminant analysis, the patterns of compensation policies were able to correctly classify business units into their appropriate strategy considerably beyond chance. The results are interpreted as supporting the proposition that management adjusts its pay strategies to fit the organization's strategies (Gomez-Mejia, 1987). In a given business unit, compensation policies and techniques are affected by both the degree of decentralization at the corporate level and whether the business unit faces growth or maintenance in its product markets. And the identifiable patterns of compensation policies can be identified for different types of business unit strategies.

Harking back to the schematic in Figure 2, the research suggests that a corporate business strategy has both direct effects on a business unit's approach to compensation and an indirect effect through the various business unit strategies. More specifically, the extent that a corporation diversifies its products, and the process it uses to achieve this diversification, directly affect its degree of competitiveness, emphasis on incentives, basis used to determine pay increases, and administrative style. Conflicting evidence exists on the nature of the relationship. The strategy of each business unit, defined in terms of its market niche, also plays a direct role in shaping compensation strategies.

Caution regarding the robustness of these findings needs to be exercised. Every article emphasizes its preliminary nature; the employee groups to which the pay policies apply tend to be managerial or professional or are not well specified; the findings are based on survey or interview data; and the data tend to be the perceptions of personnel/compensation managers.

Human Resource Strategy

Two studies report findings that suggest that an organization's human resource strategy also affects its compensation policies. The first examined the relationship between twenty-two business units' strategies and dimensions of their human resource strategies (Wils & Dyer, 1984). The business unit strategies were classified as growth, profit, or stabilization. Human resource strategies were found to vary among these three business strategies. Managers of growth units listed compensation, recruitment of new managers, and organization development as the most important personnel activities. Compensation was not seen as among the most important activities in either profit or stabilized units. This study is unique in that it surveyed line managers perceptions rather than personnel specialists. The authors concluded that compensation in the context of the total human resource strategy varied with the business strategies an organization pursues.

The second study analyzed the business and human resource strategies of business units (129) from a variety of industries to derive an empirical definition of human resource strategy (deBejar & Milkovich, 1986). After factor analyzing items describing major personnel activities, the nature of incentive compensation emerged as a critical dimension. Other dimensions of compensation strategy failed to emerge as critical aspects of a human resource strategy.

These two studies suggest that an organization's approach to compensation is also related to its overall human resource strategy. The results are very preliminary. Compensation was important in growth firms' human resource strategy but not in other types of business strategy, and incentives may be more closely related to the human resource strategy than other forms of compensation. Here again, managerial compensation was the focus of these studies.

Internal Environment and Compensation Strategy

Obviously, other organization characteristics besides strategies affect differences in compensation systems. These are treated as part of the nature of the internal organization environment in Figure 3. The variables listed are those used in studies reviewed here. Many of them were treated as control variables (e.g. size, profitability, labor costs/total costs).

Miles and Snow (1978) proposed an approach to typing the characteristics of organizations which incorporated elements of strategy, but went beyond it to include structure, administrative style and the like. The three organization prototypes, Defenders, Prospectors and Analyzers, have been related to compensation strategies (Broderick, 1985; Carroll, 1987). Defenders and Prospectors have very different, almost opposite characteristics, whereas Analyzers are a composite of the other two. A Defender operates in narrowly defined, stable markets. Its structural design is functional, it emphasizes cost/efficiency-based approaches, and its administrative style tends to be centralized, formal, and standardized. Prospectors, by contrast, emphasize innovative approaches to dynamic, changing markets. Its structure tends to be divisional or product-based, and its administrative style tends to be decentralized, informal, and flexible. Analyzers are in multiple markets and tend to be a mixture of the characteristics of the other two.

Carroll (1987) has suggested that organizations with such different characteristics are likely to adopt different compensation strategies. Broderick (1985) found that they do. The results of her study are summarized in Table 3. Controlling for organization size (i.e., net sales and number of employees) and industry, she reported that the patterns among seven policies (see the third column in Table 3) for middle manager pay systems differed significantly between Defender and Prospector organizations. When considered individually, three of the seven policies--basis for pay increases (efficiency versus growth), participation, and formalization--varied significantly across organization types. The other individual dimensions varied in the expected directions, but were not significant. Using discriminant analysis, the patterns among the seven dimensions were able to correctly classify the organizations as the correct type significantly beyond chance, thus offering additional evidence supporting the proposition that patterns of compensation decisions vary among different types of organizations.

Internal labor markets is another approach to classify organization environments (Osterman, 1984; Doeringer & Piore, 1971). Defined in terms of the rules that regulate the allocation and compensation of human resources, internal labor markets have been variously classified as open (hiring at all levels) versus closed (hiring only at lower skill levels), craft-professional (technically skilled with little intra-organizational mobility except within the craft or profession), and salaried-managerial (general skills with high cross-functional mobility). Different types of internal markets are described as possessing different compensation policies. A few case descriptions of internal markets have been published, but they remain to be content analyzed for differences in compensation policies and practices (Osterman, 1984). The nature of the rules used to determine pay are so intertwined with the definition of internal markets that an independent measure of each type of market may prove difficult.

External Environment and Compensation Strategy

The model in Figure 2 contains a third vector of variables: legislation, union, and labor markets. This is the external environment which directly affects compensation strategies. None of the research studies cited above considered the effects of environmental differences. Some attempted to control for these effects through sample selection (Balkin & Gomez-Mejia, 1984; Broderick, 1985; Gomez-Mejia, 1987; Kerr, 1985), but most simply do not refer to the possibility of environmental effects.

The effect of unions on various aspects of compensation strategy (level, mix, hierarchy, basis for increases, administrative procedures) has a substantial research base (Medoff & Freeman, 1984). This body of knowledge is beginning to be integrated into the strategic human resource management models (Kochan, Katz & McKersie, 1986; Osterman, 1988).

The responsiveness of compensation decisions to legislative change is widely discussed, but not systematically researched. For example, the 1986 Tax Reform Act is said to be having a significant effect on executive and middle management compensation (Cooke, 1987). Other examples of significant legislation are pension reform and Minnesota's comparable worth law. Legislative change may trigger different responses in compensation policies for certain employee groups. For example, include changes in minimum wage affects lower paid employees, tax reform affects executive pay, and pension reform affects all covered employees.

Whether legislative changes allow managers sufficient discretion to adopt different policies based on their business strategy is open to conjecture. Increases in the legally required minimum wage need to be paid. There is nothing too strategic about that decision. However, the decision to increase investment in automation in anticipation of increased labor costs has strategic properties since it is critical to the implementation of the organization strategy. Non-legislative external jolts such as a strike do permit a variety of adaptations by organizations with different business strategies and different internal environments.

In summary, external factors have a major effect on the strategic choices made in compensation. The effects of unions and broad industry characteristics are well documented in the industrial relations and labor economics literature. What is missing is systematic data on whether organizations faced with similar industry and other external pressures adopt different patterns of compensation policies and practices.

DO COMPENSATION STRATEGIES MATTER

Here we face the "so what" question: to what extent do compensation strategies matter? Most of those seeking an answer to this question rely upon contingency theory and the related concept of "fit." Contingency theory seems a situational art form, ... "there is no one best way--but all ways...are not equally effective. The choice is dependent or contingent on something" (Galbraith & Nathanson, 1979). Contingency theory applied to compensation strategy is depicted in Figure 3. The basic premise is that compensation strategies and organization strategies should "fit" each other; the better the fit, the better the organization's performance.

Insert Figure 3 About Here

Conceptually, several contingencies between organization and compensation strategies are implied in this model. The most obvious one is that compensation strategies are more likely to be effective if they are contingent on the overall strategy followed by an organization, other things being equal (e.g., the internal and external environment). Conversely and less apparently an organization's business strategy is more likely to be effective if it is contingent on it's compensation strategy. This contingency rests on the premise that successful implementation of business strategies depends on human resources. Formulating an organization's strategy involves assessing internal resources. Compensation decisions directly affect these resources through their impact on expenses and on their ability to attract, retain, and motivate critical human resources.

To the extent that the current pay systems are inflexible, they act as a constraint on the organization's ability to shift its strategy. At the minimum, implementing a new compensation strategy which better fits the organization's strategy may be hindered by the existence of the original pay system, existing union contracts, and the internal norms and expectations. In such cases, contingency theory predicts that performance suffers.

The degree of fit between compensation strategy and organization strategy contributes to organization performance by signaling and rewarding the behaviors that are consistent with the organization's objectives.

Further, better fit more accurately signals to applicants the types of behaviors expected and accommodates compensation demands on the organization's cash flow (Ellig, 1983). So the degree of fit is the cornerstone of contingency theory and underlies the presumed effect that compensation strategy has an organization performance.

Yet doubts remain; one gets a queasy sense of constructing on shifting sands. All three constructs on which performance depends--organization strategy, compensation strategy and fit--are elusive, especially fit. This applies to its use in the policy/strategy literature as well as in compensation management (Van de Ven & Drazin, 1985; Venkatraman & Gran, 1986). Broderick (1985) defined fit empirically as the variance between compensation policies and business strategies. Two measures were employed. One was the relationship of each dimension of compensation strategy with differences in corporate strategy. The other was the relationships between different patterns of compensation policies and differences in organizational strategies.

Contingency models applied to compensation treat fit as static. The reality may be that matching compensation and organization strategies is like shooting at a moving target. This suggests that both timing and degree of fit affect performance. A firm that fits its pay system to support its business strategy, and does it quickly, may have a competitive advantage. For example, the move to a greater emphasis on performance, to define performance as team or unit (gainsharing), rather than individual, and to knowledge-based pay hierarchies is believed to create a competitive advantage (Lawler, 1981).

Just how does one determine the appropriate degree of fit. On the one hand, the more congruent the compensation system with the organization and its environment, the better the performance. On the other hand, tailoring compensation strategies to fit too tightly, may straightjacket the flexibility required to take advantage of future opportunities (Mahoney, 1987).

Research on compensation strategy is so recent that little work has been reported on its effects on organization performance or employee behaviors. Some of the work on executive compensation and firm performance is related (Ehrenberg & Milkovich, 1987). Two studies included attempts to directly examine the relationship among organization strategy, compensation strategy and performance (Balkin & Gomez-Mejia 1987, Gomez-Mejia, 1987). Performance was assessed by asking compensation directors the extent to which the pay system contributed to the achievement of organizational goals. The limitations of this measure were recognized by the researchers but justified using the logic that acceptability is a key criterion of compensation system performance. Even if this logic is accepted, managers and employees are arguably more appropriate constituents to judge pay system acceptability (Tsui & Milkovich, 1987). So the effects of compensation strategy and the degree of its fit with organization strategy on performance remain unplowed turf. Considering the elusiveness of the notion of the degree of fit, it seems like risky research.

CONCLUDING OBSERVATIONS

Research on compensation strategy began in the context of executive compensation and in studies of the relationships between business strategy, structure, and process. Compensation was conceived as a control mechanism, executives were the focal group and the nature of pay incentive schemes was the principal dimension of compensation included. Little recognition was given to the need to define compensation more systematically. Typically, the level of analysis was the corporation, and strategies studied involved diversification.

In subsequent studies, the definition of compensation, the variables included and the methodologies evolved in several ways. The definition of compensation needs to be broadened to recognize its multidimensionality. Research has begun to study variations in the total pattern of compensation policies in addition to variations in specific policies. The focal group has been extended beyond executives, to all employees and to employee groups that are critical to the organization's success. The determinants that may affect compensation strategy have extended beyond corporate strategies to include business unit strategies, internal organization factors, and external factors. Thus, control variables such as industry, labor costs/total costs, profitability, sales, workforce size, and the like need to be included in research designs.

More attention needs to be devoted to the effect of environmental jolts on compensation strategies. It may be, as Mintzberg (1987) suggests, that strategic reorientations occur in brief quantum leaps. Accordingly, major jolts are required before organizations realign their business strategies to set their direction or lay out new courses of action. In between such reorientations, stability prevails. If this is so, then studies of organizations experiencing such jolts and reorientations may shed light on which compensation decisions have strategic properties, and what their effects are likely to be. Finally, studies of the relationship between compensation strategy and organization performance are beginning, but more are required.

At the root of the interest in a strategic perspective of compensation is the basic tenet referred to at the beginning of this paper: that human resource policies in general, and compensation policies in particular, affect workforce and organization performance. The belief is largely untested, yet the entire field of human resource management rests upon it. The research agenda that emerges from a desire to examine this tenet is extremely complex (Dyer, 1980). It is part of the organizational perspective on human resource management alluded to at the beginning of this paper. Its conceptual links are as much to policy, microeconomics, finance, organization theory and sociology as to micro organization behavior and psychology (Dyer, 1985).

An immediate need exists for research aimed at collecting accurate descriptions of the content of compensation strategy and the process involved in its formulation. What are the critical dimensions of compensation? For which employee groups? How should such questions be answered? Asking and/or observing those who are in strategically relevant roles, such as executives and members of corporate compensation committees, is one approach. Another is to undertake "policy capturing" studies. Both require access and data that simply are not readily available.

Beyond descriptive research, more work is needed to understand both what determines variations in patterns of compensation decisions their effects. A major challenge is to formulate manageable research issues. Issues too narrowly defined suffer from ignoring the multi- dimensionality of compensation and the context in which compensation decisions occur. On the other hand, issues too broadly drawn are too time consuming, too ambiguous, too expensive, and often poorly specified.

Perhaps a place to begin is to identify compensation decisions that have strategic properties. For example, do firms within the same industry establish different competitive positions in labor markets? Conventional wisdom is that they do. How do they accomplish this--by different average levels of base pay, by varying the risk-return tradeoffs or the ratio of incentives to total compensation? Do characteristics of organizations vary with their competitive position? These might include some of the determinants discussed in this paper such as organization strategies, organization characteristics, and external factors. Finally does a firm's competitive position have any discernable effect on the size and quality of the applicant pool, on its ability to hire those people it selects, or its ability to retain high performers?

Similar studies need to be conducted for each aspect of compensation. For example, little is known about the nature of the pay structure or the mix of pay forms and their effects on workforce behaviors. The same can be said about each of the dimensions of compensation.

In closing, it is useful to step back and consider the nature of compensation management. A fairly convincing argument can be made that existing compensation policies and practices have grown over time in a somewhat haphazard manner, as ad hoc administrative responses to various pressure, rather than through some rational, analytical, objective-directed process. If that is so, then much of the foregoing has simply been an attempt to impose structure and rationality on compensation management. But even if this is the case, the need remains to understand the variation in these decisions made by organizations and how these variations affect the behaviors of the workforce and the success of the organization.

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Table 1

Evolution of Compensation Decisions Considered Critical to Organization Performance

	Ellig/Cooke (1976)	Salter (1973)	Lawler (1981)	Carroll (1987)
Employee Occupation	Executives	Executives and Managers	All Employees	All Employees
Structure (Design)	Relative Emphasis on each element Short vs. long term incentives	Short vs. long term incentives Unit vs. corporate performance Degree of risk (bonus/base)	Market position Internal vs. external emphasis Degree of hierarchy Reward mix Basis for increases	Pay level in market Internal equity Performance Measures Frequency of Measures Size of Bonus Merit Differentiation Use of Individual Bonus Use of Group Bonus Long vs. Short Term use Deferred Compensation Use of Gainsharing Use of Guaranteed Compensation
Process (Administrative style)		Pay system congruency Standardization across subunits	Pay system congruency Decision making Centralization Communications Change strategy	

Table 2

STRATEGICALLY RELEVANT COMPENSATION POLICIES: AN A PRIORI SET

1) COMPETITIVENESS	- Competitive position relative to competition - Lead, lag, meet - Total compensation, risk-return trade-off
2) INTERNAL STRUCTURE	- Internal pay differentials - Number of levels, criteria for hierarchy, congruency with organization features - Number of different job evaluation systems used
3) MIX AMONG FORMS	- Forms to offer - Relative importance of each - Short vs. long term
4) BASIS FOR INCREASES	- Membership vs. performance - Specific criteria, individual, unit, corporate performance - Size and frequency
5) ROLE IN OVERALL HUMAN RESOURCES STRATEGY	- Dominant vs. coordinate vs. subordinate - Signal vs. support organization change
6) ADMINISTRATIVE STYLE	- Employee participation - Communications - Centralization - Dispute resolution mechanisms

Table 3

Empirically Derived Dimensions of Compensation Strategy

Strategic Issues	Literature Based Dimensions	Empirically Based Dimensions
(1) Competitiveness	(1) External Competition vs. Internal Pressures	(1) External Competitiveness
(2) Internal Hierarchies	(2) Differential Hierarchies vs. Egalitarian Arrangements	
	Job Content vs. Knowledge Requirements	
(3) Mix	(3) Membership vs. Performance	(2) Performance/Membership
(4) Pay Increase Bases	(4) Corporate, subunit vs. Individual	(3) Efficiency (costs) vs. Growth
	Short vs. Long Term	
(5) Administrative Style	(5) Degree of Employee Participation	(4) Level of managers participating
	Degree of Centralization	(5) Level of managers approving decisions
	Degree of Standardization (consistency across subunits)	(6) Standardization, similarity of plans across units
	Degree of Formalization	(7) Formalization written documentation

Based on Broderick (1985).

Figure 1

A STRATEGIC PERSPECTIVE ON COMPENSATION

CRITICAL EMPLOYEES GROUPS

Executives R&D Sales Production . . . . .

CRITICAL

POLICY

CHOICES

Compensation Strategies:

Patterns of Compensation Decisions that are Critical to the Performance of the Organization

Figure 2

DETERMINANTS OF COMPENSATION STRATEGY

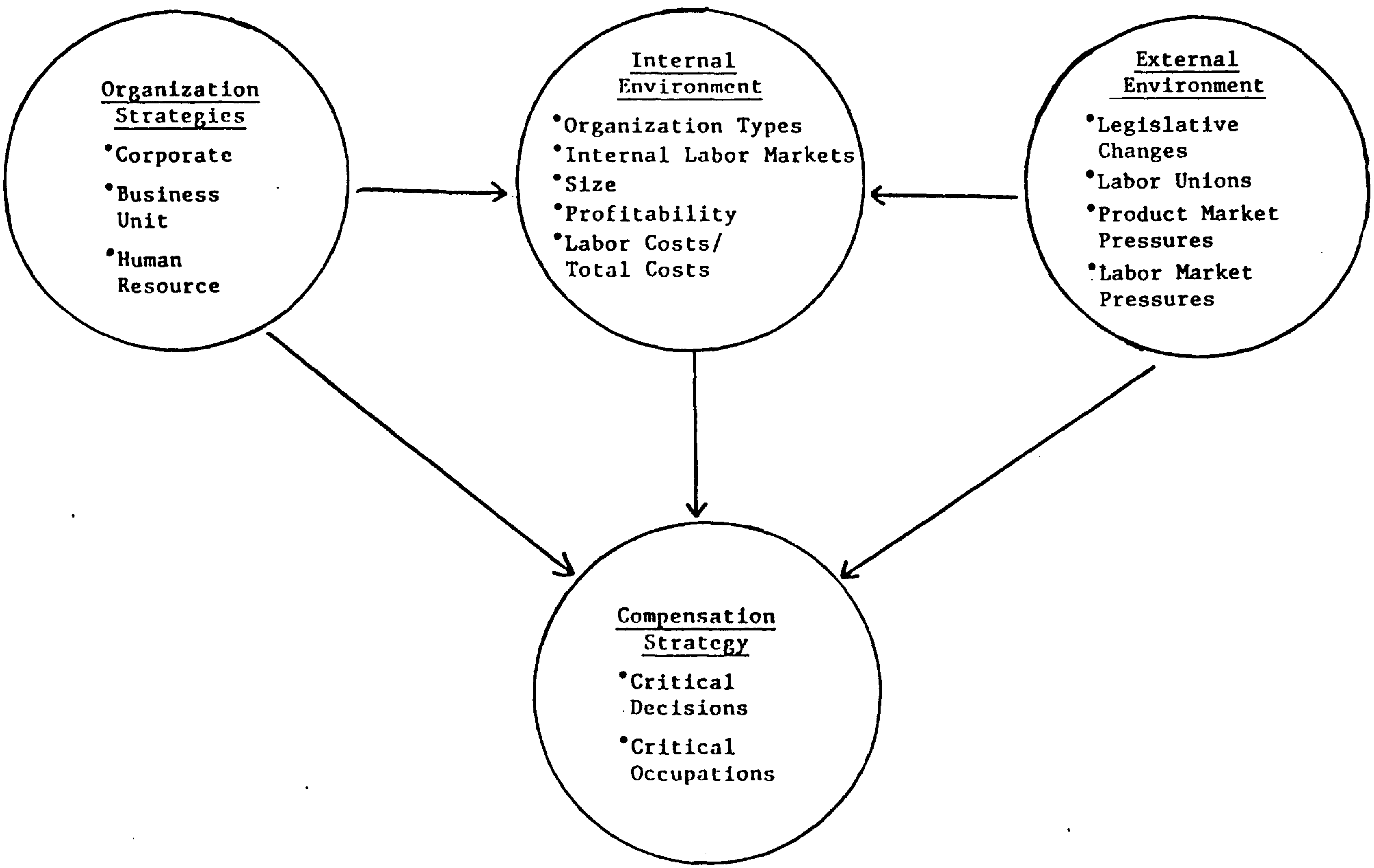

Figure 3

Contingency Model Applied to Compensation Strategy