

Chapter Three

Defining Internal Alignment

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For the kingdom of heaven is like a householder who went out early in the morning to hire laborers for his vineyard. And having agreed with the laborers for a denarius a day, he sent them into his vineyard. And about the third hour, he went out and saw others standing . . . idle; and he said to them, "Go you also into the vineyard, and I will give you whatever is just." And again he went out about the ninth hour, and did as before . . . But about the eleventh hour he went out and found others . . . and he said to them, "Go you also into the vineyard." When evening came, the owner said to his steward, "Call the laborers, and pay them their wages, beginning from the last even to the first." When the first in their turn came . . . they also received each his denarius. . . . They began to murmur against the householder, saying, "These last have worked a single hour, and thou hast put them on a level with us, who have

borne the burden of the day's heat." But answering them, he said, "Friend, I do thee no injustice; take what is thine and go."¹

Matthew's parable raises age-old questions about internal alignment and pay structures within a single organization.² The laborers felt that those "who have borne the burden of the day's heat" should be paid more. But perhaps the householder was using a different criterion: an individual's needs without regard to time worked or tasks performed.³ Matthew doesn't tell us how the work in the vineyard was organized. Perhaps laborers worked in teams, with some trimming and others tying the vines. Does trimming require more judgment than tying?

Today's pay structures are typically designed by assessing the content of the work, the skills and knowledge required to perform it, and its relative value for achieving the organization's objectives. The procedures to do this must be acceptable to the parties involved. If not, today's managers and employees murmur, too. That murmuring translates into turnover, unwillingness to try new technologies, and even an indifference to the quality of the grapes or the customer's satisfaction with them. This chapter examines internal alignment and its consequences.

COMPENSATION STRATEGY: INTERNAL ALIGNMENT

Setting objectives was our first issue in a strategic approach. Our second, internal alignment, addresses relationships *inside* the organization. How do the responsibilities and pay of a trimmer versus tyer relate to each other? How do they relate to the responsibilities and pay of the householder's cook or the steward? Internal alignment addresses the logic underlying these relationships.

Internal alignment, often called *internal equity*, refers to the pay relationships among different jobs/skills/competencies within a single organization.⁴ The relationships form a pay structure that should *support the organization strategy, support the work flow, be fair to employees, and motivate behavior* toward organization objectives.

Exhibit 3.1 shows a structure for the engineering work at a division of Lockheed Martin, the world's largest defense contractor. Lockheed also builds rockets, shuttles, and rovers for NASA. The six levels in Lockheed's structure range from entry to consultant. You can see the relationships in the descriptions of each level of work. Decisions on how much to pay the six levels create a pay structure.

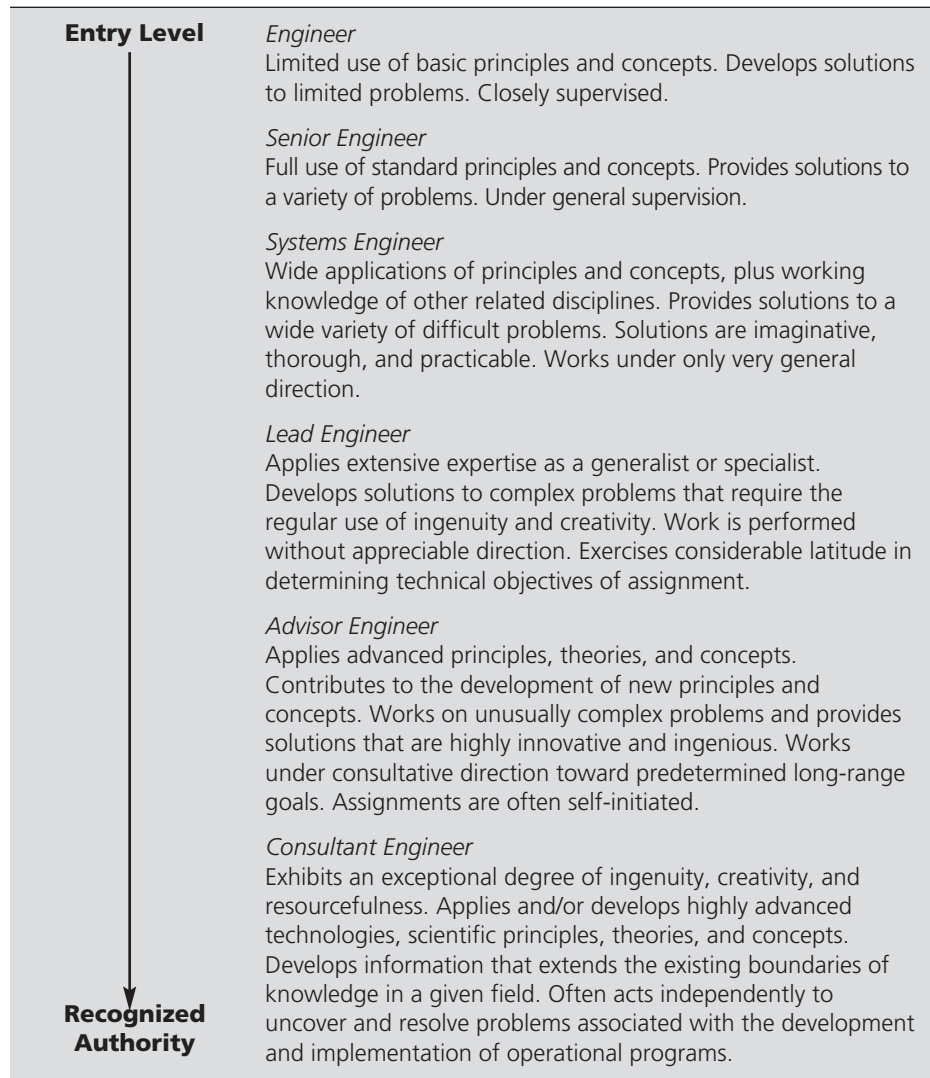
¹Matthew 20: 1–16.

²For a history of the different standards for pay, see Thomas Mahoney, *Compensation and Reward Perspectives* (Burr Ridge, IL: Irwin, 1979); G. Milkovich and J. Stevens, "From Pay to Rewards: 100 Years of Change," *ACA Journal* 9(1) (2000), pp. 6–18; D. F. Schloss, *Methods in Industrial Remuneration* (New York: Putnam's, 1892).

³Several Japanese firms still base a small portion of a worker's pay on the number of dependents. In the early 1900s, workers who were "family men" received a pay supplement in some U.S. firms as well. The "iron rice bowl," which until recently prevailed in China's state enterprises, provided entire families with cradle-to-grave welfare.

⁴"Equity" could refer to stock, to some perceived balance of effort and rewards, and/or pay discrimination (gender equity). We believe "internal alignment" better reflects the meaning and importance underlying pay structures.

EXHIBIT 3.1
Engineering
Structure at
Lockheed
Martin



Pay structure refers to the array of pay rates for different work or skills within a single organization. The *number of levels*, the *differentials* in pay between the levels, and the *criteria* used to determine those differences describe the structure.

Supports Organization Strategy

Fundamentally, organizations exist for a purpose (profits, not-for-profits, government agencies, and so on). The organization’s strategy tells us how it plans to achieve its purpose. Internal structures that are aligned with a strategy help achieve it. Lockheed decided that six levels of engineering work would support the research, design, and development of advanced technology systems to achieve the company’s objectives. The householder’s

internal pay structure may have been aligned with his business strategy, but the employee dissatisfaction raises concerns about its fairness to employees.

Supports Work Flow

Work flow refers to the process by which goods and services are delivered to the customer. The pay structure ought to support the efficient flow of that work and the design of the organization.⁵ For example, drug companies traditionally base the size of their sales forces on the number of physicians to be called on per day and the number of working days per year. The U.S. drug manufacturer Merck decided to take a nontraditional approach to organizing sales and marketing. Merck created teams of account executives, client representatives, and medical information scientists to serve a broader clientele of health maintenance organizations, insurance companies, and physicians. A cross-functional team responsible for a distinct geographic area (rather than a list of physician-clients) provides a relationship-building approach to selling products. Rather than hawking a specific drug and giving out free samples, the Merck teams are a source of knowledge for the physicians and the health organizations. The teams keep clients apprised of regulations and cover drugs for a wider range of medical conditions. One team even translated brochures that explain a course of treatment into Chinese, Russian, and Spanish for a physician whose patients included non-English-speaking immigrants. Such a response would have been beyond the resources of a single sales representative under Merck's old approach. (Of course, the brochure recommended treatment with Merck products.)

To support these work teams, Merck designed a new compensation structure. The pay differences between account executives, customer representatives, and medical information scientists who served on the same teams were a major issue—just as they are for Lockheed engineers and just as they likely are for the cast of *Everwood*.

Think globally. Ford Motor does. Ford acquired Volvo (Sweden), Jaguar and Land Rover (Britain), and most of Mazda (Japan). To leverage its new engineering and manufacturing knowledge, Ford is creating global teams. This changes the work flow and organization design at Ford. Ford also needs to rethink pay structures to be sure they support the new global teams. Global pay structures create special challenges due to different wages and benefits paid for the same jobs in different parts of the world. Later chapters will discuss various ways companies manage this challenge.

Supports Fairness

An internally aligned pay structure is more likely to be judged fair if it is based on the work and the skills required to perform the work and if people have an opportunity to be involved in some way in determining the pay structure.⁶

⁵J. S. Shaw, N. Gupta, and J. E. Delery, "Pay Dispersion and Workforce Performance: Moderating Effects of Incentives and Interdependence," *Strategic Management* 23 (2002), pp. 491–512; R. A. Guzzo and M. W. Dickson, "Teams in Organizations: Recent Research in Performance and Effectiveness," *Annual Review of Psychology* 47 (1996), pp. 307–338.

⁶Marcia P. Miceli and Paul Mulvey, "Satisfaction with Pay Systems: Antecedents and Consequences," *Industrial Relations* (January 2000), 39(1); G. Hundley and J. Kim, "National Culture and the Factors Affecting Perception of Pay Fairness in Korea and the U.S.," *International Journal of Organization Analysis* 5, pp. 325–341; M. A. Konovsky, "Understanding Procedural Justice and Its Impact on Business Organizations," *Journal of Management* 26(3) (2000), pp. 489–511; Foard F. Jones, Vida Scarpello, and Thomas Bergmann, "Pay Procedures—What Makes Them Fair?" *Journal of Occupational and Organizational Psychology* 72 (1999), pp. 129–145.

Two sources of fairness are important: the *procedures* for determining the pay structure, called *procedural justice*; and the *results* of those procedures—the pay structure itself—called *distributive justice*.

Suppose you are given a ticket for speeding. Procedural justice refers to the process by which a decision is reached: the right to an attorney, the right to an impartial judge, and the right to receive a copy of the arresting officer's statement. Distributive justice refers to the fairness of the decision: guilty. Researchers report that employees' perceptions of procedural fairness significantly influence their acceptance of the results; employees and managers are more willing to accept low pay if they believe that the way this result was obtained was fair. This research also suggests that pay procedures are more likely to be perceived as fair (1) if they are consistently applied to all employees, (2) if employees participated in the process, (3) if appeals procedures are included, and (4) if the data used are accurate. Nevertheless, a newer study raises a question about the usefulness of employee participation.⁷ In a low-wage company, there was no connection between employee participation and pay fairness. It may be that employees were paid so low that no amount of participation could overcome their dissatisfaction. So rather than tossing aside the idea of participation, it may be that in extreme cases (very low wages), a pay raise may trump participation.

Applied to internal structures, procedural justice addresses how design and administration decisions are made and whether procedures are applied in a consistent manner. Distributive justice addresses whether the actual internal pay differences among employees are reasonable.⁸

Motivates Behavior

Internal pay structures are part of the network of rewards discussed in Chapter 1: pay increases for promotions, bigger titles, more challenging work. The challenge is to design the structures so that they engage people to help achieve organization objectives. Merck marketing teams work together to share unique knowledge with each other and with their clients. Lockheed engineers do, too. And so do the writers, actors, and crew on *Everwood*. The structure ought to make clear the relationship between each job and the organization's objectives.⁹ This is an example of "line-of-sight." The more employees can "see" or understand links between their work, the work of others, and the organization's objectives, the more likely they will be to achieve those objectives.

⁷Frederick P. Morgeson, Michael A. Campion, Carl P. Maertz, "Understanding Pay Satisfaction: The Limits of a Compensation System Implementation," *Journal of Business & Psychology* Fall 16(1) (2001), pp. 133–163.

⁸Edilberto F. Montemayor, "Decisional and Interactional Fairness: Supervisor Influence on Merit Pay Satisfaction," *Management Research: The Journal of the Iberoamerican Academy of Management* 1(2) (Spring 2003), pp. 145–160; Foard F. Jones, Vida Scarpello, and Thomas Bergmann, "Pay Procedures—What Makes Them Fair?" *Journal of Occupational and Organizational Psychology* 72 (1999), pp. 129–145.

⁹R. H. Thaler, "From Homo Economicus to Homo Sapiens," *Journal of Economic Perspectives* 14(1) (Winter 2000), pp. 133–141; Rosemary Batt, Alexander J. S. Colvin, and Jeffrey Keefe, "Employee Voice, Human Resource Practices, and Quit Rates: Evidence from the Telecommunications Industry," *Industrial and Labor Relations Review* 55(4) (July 2002), pp. 573–594; Casey Ichniowski, Kathryn Shaw, and Jon Grant, "Working Smarter by Working Together: Connective Capital in the Workplace," working paper, Columbia University, New York, 2002.

STRUCTURES VARY AMONG ORGANIZATIONS

An internal pay structure can be defined by (1) number of *levels* of work, (2) the pay *differentials* between the levels, and (3) the *criteria* used to determine those levels and differentials.

Levels

One feature of any pay structure is its hierarchical nature: the number of levels and reporting relationships. Some are more hierarchical, with multiple levels; others are compressed, with few levels.¹⁰ GE Plastics engineers thermoplastic resin “solutions.” (With so many companies offering “solutions,” are we running short of problems?) In comparison to Lockheed’s six levels for engineering alone (Exhibit 3.1), GE Plastics uses five broad levels, described in Exhibit 3.2, to cover engineering as well as all professional and executive work. GE Plastics would probably fit the Lockheed Martin structure into two or three levels.

Differentials

The pay differences among levels are referred to as *differentials*. If we assume that an organization has a compensation budget of a set amount to distribute among its employees, there are a number of ways it can do so. It can divide the budget by the number of employees to give everyone the same amount. The Moosewood Restaurant in Ithaca, New York, adopts this approach. But few organizations in the world are that egalitarian. In most, pay varies among employees.¹¹ Work that requires more knowledge or skills, is performed under unpleasant working conditions, and/or adds more value is usually paid

EXHIBIT 3.2 Managerial/ Professional Levels at General Electric Plastics (GEP)

Level	Description
Executive	Provides vision, leadership, and innovation to major business segments or functions of GEP
Director	Directs a significant functional area or smaller business segment
Leadership	Individual contributors leading projects or programs with broad scope and impact, or managers leading functional components with broad scope and impact
Technical/managerial	Individual contributors managing projects or programs with defined scope and responsibility, or first-tier management of a specialty area
Professional	Supervisors and individual contributors working on tasks, activities, and/or less complex, shorter-duration projects

¹⁰ Michael Gibbs, “Incentive Compensation in a Corporate Hierarchy,” *Journal of Accounting and Economics* 19 (1995), pp. 247–277.

¹¹ Researchers use a statistic called the *gini coefficient* to describe the distribution of pay. A gini of zero means everyone is paid the identical wage. The higher the gini coefficient (maximum = 1), the greater the pay differentials among the levels.

more.¹² Exhibit 3.3 shows the differentials attached to Lockheed Martin’s engineering structure. The intention of these differentials is to motivate people to strive for promotion to a higher-paying level.

Criteria

Content and Value

Content refers to the work performed in a job and how it gets done (tasks, behaviors, knowledge required, etc.) *Value* refers to the worth of the work: its relative contribution to the organization objectives. A structure based on content typically ranks jobs based on skills required, complexity of tasks, and/or responsibility. In contrast, a structure based on the value of the work focuses on the relative contribution of the skills, tasks, and responsibilities of a job to the organization’s goals. While the resulting structures may be the same, there are some important differences. In addition to including relative contribution, value may also include external market pressures (i.e., what competitors pay for this level of contribution). Or it may include rates that have been agreed upon through collective bargaining, or even legislated rates (minimum wage). Job values across all organizations in Cuba are set by a government agency. Following the now-discarded approaches of the former Soviet Union and China, Cuba’s government dictates a universal structure: 8 levels for industrial workers, 16 levels for technical and engineering work, and 26 levels for government employees.

Use Value and Exchange Value *Use value* reflects the value of goods or services an employee produces in a job. *Exchange value* is whatever wage the employer and employee agree on for a job. Think about IBM software engineers living in Bangalore, Kiev, and Purchase, New York. Now think about them working together on the same project—same company, same job content, same internal job value. Same use value. Yet they are in very different geographies and external markets. Wage rates in Bangalore and Kiev are a lot less than in Purchase. The exchange value varies.¹³ For promotions, IBM treats these jobs as being at the same level in the structure. But the competitive practices and markets in India, the Ukraine, and the United States yield very different pay rates.¹⁴

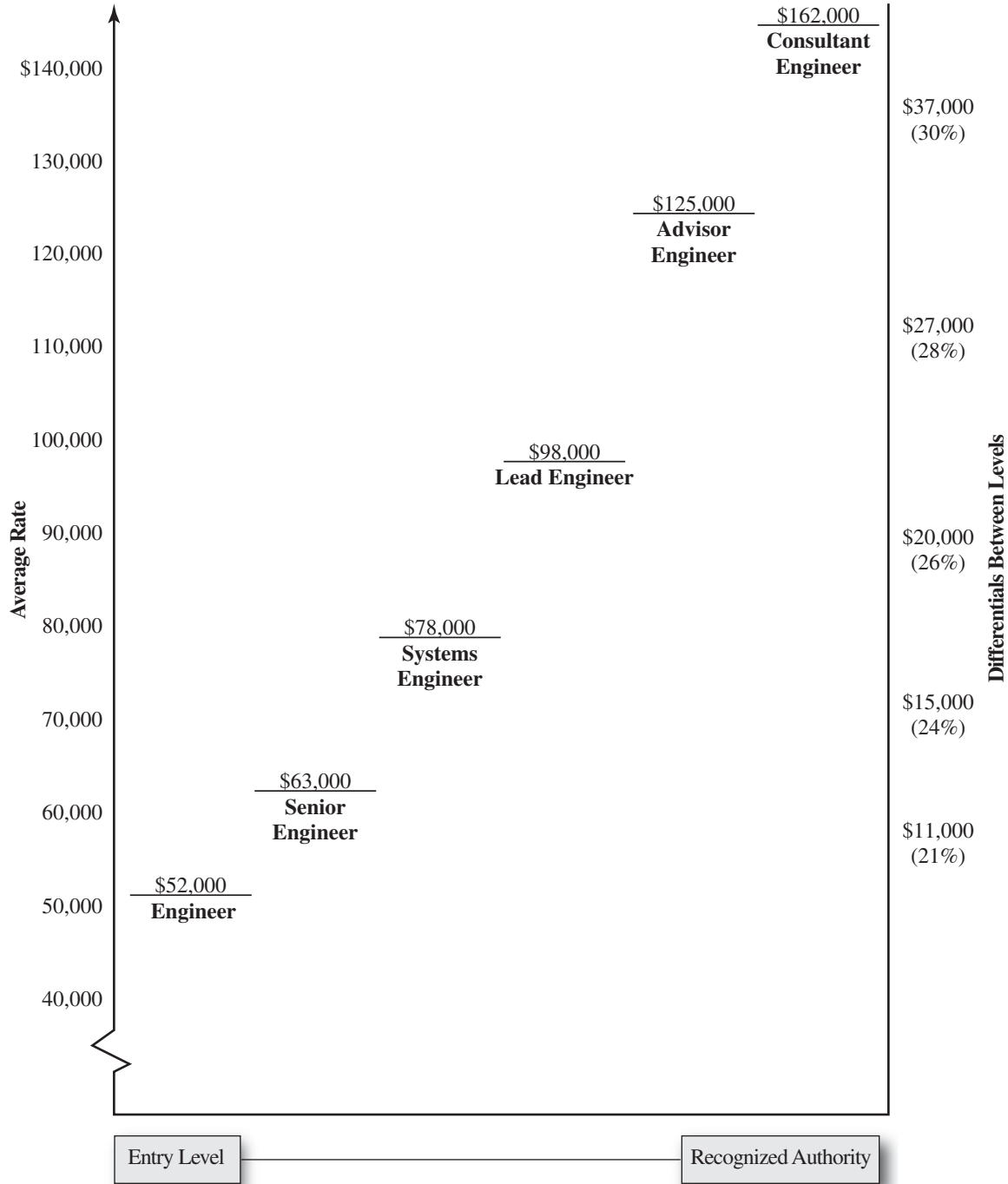
The difference between exchange value and use value also surfaces when one firm acquires another. IBM’s acquisition of PricewaterhouseCoopers (PWC), where consultants were the lifeblood of the company, is a case in point. PricewaterhouseCoopers consultants added more knowledge to IBM’s marketing teams. But the use value of their knowledge within IBM

¹² Barry Gerhart and Sara Rynes, *Compensation: Theory, Evidence, and Strategic Implications* (Thousand Oaks, CA: Sage, 2003); Robert Gibbons and Michael Waldman, “A Theory of Wage and Promotion Dynamics inside Firms,” *Quarterly Journal of Economics*, November 1999, pp. 1321–1358; George Baker, Michael Gibbs, and Bengt Holmstrom, “The Internal Economics of the Firm: Evidence from Personnel Data,” *Quarterly Journal of Economics*, November 1994, pp. 881–919; M. Bloom and G. Milkovich, “Money, Managers, and Metamorphosis,” in *Trends in Organizational Behavior*, 3d ed., eds. D. Rousseau and C. Cooper (New York: Wiley, 1996).

¹³David Kirkpatrick, “The Net Makes It All Easier—Including Exporting U.S. Jobs,” *Fortune*, May 26, 2003, p. 146; Laurie Bienstock and Sandra McLellan, “Job Leveling in a Changing Environment: Does Your Organization Measure Up?” *WorldatWork Journal* 11(4) (Fourth Quarter 2002), www.worldatwork.org.

¹⁴Towers Perrin and other consulting firms offer extensive global surveys: www.towers.com/towers/tpdata/.

EXHIBIT 3.3 Engineering Pay Structure at Lockheed Martin



differs from that within PWC. So basically similar job content in two different companies may be valued differently based on how it contributes to organization objectives. Alternatively, the same work content in the same company (IBM's software engineers) may have different exchange values based on the different geographies.

Job- and Person-Based Structures

A *job-based structure* relies on the work content—tasks, behaviors, responsibilities. A *person-based structure* shifts the focus to the employee: the *skills, knowledge, or competencies* the employee possesses, whether or not they are used in the employee's particular job.¹⁵ The engineering structure at Lockheed Martin (Exhibit 3.1) uses the work performed as the criterion. GE Plastics (Exhibit 3.2) uses the individual employees' competencies required at each level of work.

In the real world, it is often hard to describe a job without reference to the jobholder's knowledge and skills. Conversely, it is hard to define a person's job-related knowledge or competencies without referring to work content. So rather than a job- or person-based structure, reality includes both job *and* person.

WHAT SHAPES INTERNAL STRUCTURES?

The major factors that shape internal structures are shown in Exhibit 3.4. We categorize them as *external* and *organization* factors, even though they are connected and interacting. Exactly how they interact is not well understood. As we discuss the factors, we will also look at various theories.

Economic Pressures

Adam Smith was an early advocate of letting economic market forces influence pay structures. He was the first to ascribe both an exchange value and a use value to human resources. Smith faulted the new technologies associated with the Industrial Revolution for increasing the use value of labor without a corresponding increase in exchange value (i.e., higher wages for workers).

Karl Marx took this criticism even further.¹⁶ He said that employers unfairly pocketed the surplus value created by the difference between use value and exchange value. He urged workers to overthrow capitalistic systems to become owners themselves and reap the full use value of their labor.

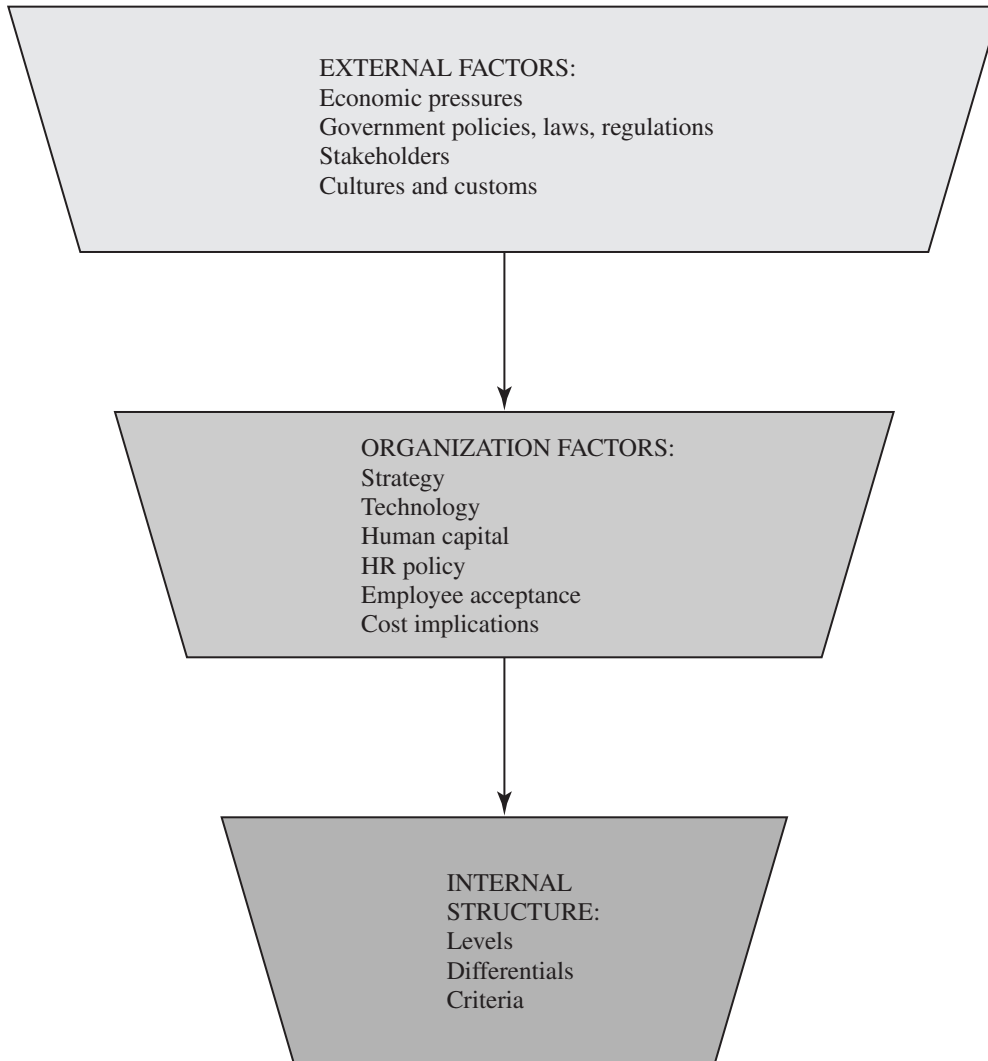
A countering theory put forth in the last half of the 19th century, *marginal productivity*, says that employers do in fact pay use value.¹⁷ Unless an employee can produce a value equal to the value received in wages, it will not be worthwhile to hire that worker. Pay differences among the job levels reflect differences in use value associated with different

¹⁵ E. E. Lawler III, "From Job-Based to Competency-Based Organizations," *Journal of Organization Behavior* 15 (1994), pp. 3–15.

¹⁶C. Tucker, ed., *The Marx-Engels Reader* (New York: Norton, 1978).

¹⁷Allan M. Cartter, *Theory of Wages and Employment* (Burr Ridge, IL: Irwin, 1959).

EXHIBIT 3.4 What Shapes Internal Structures?



jobs. One job is paid more or less than another because of differences in relative productivity of the job and/or differences in how much a consumer values the output. Hence, differences in productivity provide a rationale for the internal pay structure.

In addition to supply and demand for labor, supply and demand for products and services also affect internal structures. Rapid, often turbulent changes, either in competitors' products/services (as in the rise of the Internet for making purchases) or in customers' tastes (as in the popularity of sport-utility or low-emission vehicles), force organizations to redesign work flow and force employees to continuously learn new skills. Turbulent,

unpredictable external conditions require pay structures that support agile organizations and flexible people.¹⁸

Government Policies, Laws, and Regulations

In the United States, equal employment legislation forbids pay systems that discriminate on the basis of gender, race, religion, or national origin. The Equal Pay Act and the Civil Rights Act require “equal pay for equal work,” with work considered equal if it requires equal skill, equal effort, and equal responsibility and if it is performed under equal working conditions. An internal structure may contain any number of levels, with differentials of any size, as long as the criteria for setting them are not gender, race, religion, or national origin.

Much pay-related legislation attempts to regulate economic forces to achieve social welfare objectives. The most obvious place to affect an internal structure is at the minimums (minimum-wage legislation) and maximums (special reporting requirements for executive pay). But legislation also aims at the differentials. A contemporary U.S. example is the “living wage.”¹⁹ A number of U.S. cities require minimum hourly wage rates well above what federal law requires. The anticipated outcome of such legislation is a flatter, more compressed structure of wage rates in society.

We have already described the mandated pay structures in Cuba. Cuba wasn’t alone. Until recently, an entire government agency in the Slovak Republic in central Europe was devoted to maintaining a 15-level pay structure that was required in all Slovak companies (but not foreign ones). The detailed procedures manuals and job descriptions filled a number of shelves. People dissatisfied with the pay rate for their jobs could appeal to this agency. Not surprisingly, few did. Recent reforms offer greater freedom to companies and unions to negotiate pay structures.²⁰

External Stakeholders

Unions, stockholders, and even political groups have a stake in how internal pay structures are determined. Unions are the most obvious case. Most unions seek smaller pay differences among jobs and seniority-based promotions as a way to promote solidarity among members. At the minimum, unions want the interests of their members represented. In the United States, the AFL-CIO uses information on the pay differences between top executives and employees to rally support for union membership (see www.aflcio.org).

¹⁸G. Milkovich and M. Bloom, “Rethinking International Compensation: From Expats and National Cultures to Strategic Flexibility,” *Compensation & Benefits Review*, Issue 1, 1998; S. Brown and K. Eisenhardt, *Competing on the Edge: Strategy and Structured Chaos* (Boston: Harvard Business Press, 1998); George Baker, Michael Gibbs, and Bengt Holmstrom, “The Internal Economics of the Firm: Evidence from Personnel Data,” *Quarterly Journal of Economics*, November 1994, pp. 881–919; Michael Gibbs, “Incentive Compensation in a Corporate Hierarchy,” *Journal of Accounting and Economics* 19 (1995), pp. 247–277.

¹⁹Scott Adams and David Neumark, “Living Wage Effects: New and Improved Evidence,” NBER working paper 9702, 2003.

²⁰M. Bloom, G. Milkovich, and A. Mitra, “International Compensation: Learning from How Managers Respond to Variations in Local Host Contexts,” *International Human Resource Management* (in press); M. Mendenhall and G. Oddou, *Readings and Cases in International HRM* (Cincinnati: Southwestern, 2000).

Stockholders pay attention to the gap between executive and employee pay. The \$6 million cash compensation (plus stock options worth \$197 million) for Disney CEO Michael Eisner stands in sharp contrast to that earned by Disney employees who perform as Mickey or Minnie Mouse. Mickey, Minnie, Pluto, Goofy, and even Snow White earn union rates of between \$18 and \$25 an hour. (Yes, Mickey and Minnie are Teamsters.) Shareholders of several companies ranging from General Electric to Glaxo Smith Kline are beginning to pressure companies to control or at least better justify executive pay. Research is beginning to determine the effects of these pay differentials on employees' behaviors and performance and, consequently, organization performance.²¹

Cultures and Customs

Garrison Keillor defines culture by what songs we know in common—camp songs, religious hymns, the big hits of the year we were 15. A more academic definition of culture is the mental programming for processing information that people share in common.²² Shared mind-sets may judge what size pay differential is fair. In ancient Greece, Plato declared that societies are strongest when the richest earned a maximum of four times the lowest pay. Aristotle favored a five-times limit. In 1942 President Franklin Roosevelt proposed a maximum wage: a 100 percent tax on all income above 10 times the minimum wage.

Historians tell us that in 14th-century western Europe, the church endorsed a “just wage” doctrine, a structure of wages that supported the existing class structure. The doctrine was an effort to end the economic and social chaos resulting from the death of one-third of the population from plague. The shortage of workers that resulted gave common people power to demand higher wages, much to the dismay of church and state. Market forces such as skills shortages (higher exchange value) were explicitly denied as appropriate determinants of pay structures. Today, advocates of the living wage are trying to change societal judgments about what wage is just.

Even today cultural factors continue to shape pay structures. Many traditional Japanese employers place heavy emphasis on seniority in their internal pay structures. But pressures from global competitors plus an aging work force have made age-based pay

²¹Michael L. Bognanno, “Corporate Tournaments,” *Journal of Labor Economics*, 19(2) (2001), pp. 290–315; Mason A. Carpenter and James B. Wade, “Microlevel Opportunity Structures as Determinants of Non-CEO Executive Pay,” *Academy of Management Journal* 6 (2002), pp. 1085–1103.

²²G. Hofstede, *Culture's Consequences: International Differences in Work Relationships and Values* (Thousand Oaks, CA: Sage, 1980); R. Donkin, “The Pecking Order's Instinctive Appeal,” *Financial Times*, August 23, 2002; A. Mitra, M. Bloom, and G. Milkovich, “Crossing a Raging River: Seeking Far-Reaching Solutions to Global Pay Challenges,” *WorldatWork Journal*, 11(2) (Second Quarter 2002); F. Trompenaars, *Riding the Waves of Culture: Understanding Diversity in Global Business* (Burr Ridge, IL: Irwin, 1995); J. Brockner, Y. Chen, K. Leung, and D. Skarlick, “Culture and Procedural Fairness: When the Effects of What You Do Depend on How You Do It,” *Administrative Science Quarterly* 45 (2000), pp. 138–159; Thomas Li-Ping Tang, Vivienne Wai-Mei Luk, and Randy K. Chiu, “Pay Differentials in the People's Republic of China: An Examination of Internal Equity and External Competitiveness,” *Compensation and Benefits Review* 32(3) (May/June 2000), pp. 43–49; Jing-Lih Farh, Chen-Bo Zhong, and Dennis W. Organ, “Organizational Citizenship Behavior in the People's Republic of China,” in *Organization Science*, special issue: *Corporate Transformations in China* (in press).

structures very expensive. Consequently, some Japanese employers are emphasizing performance and downplaying seniority.²³ This change is particularly irksome; as we have grown older, the wisdom of basing pay on age has become more obvious to us.

Organization Strategy

You have already read how organization strategies influence internal pay structures. The basic belief of a strategic perspective is that pay structures that are not aligned with the organization strategy may become obstacles to the organization's success.

Organization's Human Capital

Human capital—the education, experience, knowledge, abilities, and skills that people possess—is a major influence on internal structures.²⁴ The stronger the link between the skills and experience a person possesses and an organization's objectives, the more pay those skills will command. Lockheed's structure pays consultant engineers more than lead or senior engineers because the human capital of consultant engineers brings a greater return to Lockheed. It is more crucial to Lockheed's success.

Organization Work Design

Technology used in producing goods and services influences the *organizational design*, the *work* to be performed, and the *skills/knowledge* required to perform the work.²⁵ The technology required to produce precision military hardware differs from that used to manufacture plastics. Defense contract work is more labor-intensive (more than 50 percent of operating expenses are labor costs) than is plastics (less than 20 percent); hence, different structures emerge. Apparently the engineering labor costs for Mars rovers and military weapons exceed those for engineering the coatings for such products as DVDs, automobile parts, building materials, and bullets. Lockheed uses six levels for engineering alone, whereas GE Plastics uses five levels for all managerial/professional/technical employees.

The design of organizations is undergoing profound changes. According to Drucker, “A staggering number of people who work in organizations are no longer traditional employees of these organizations.”²⁶ These “nonemployees” are employed by someone—either a supplier of information technology services (e.g., IBM or Hewlett-Packard) or perhaps a

²³Yoshio Yanadori and George Milkovich, “Minimizing Wage Competition? Entry-Level Compensation in Japanese Firms,” working paper, Center for Advanced HR Studies, Ithaca, NY, 2003.

²⁴D. Levine, D. Belman, G. Charness, E. Groshen, and K. C. O’Shaughnessy, *The New Employment Contract: How Little Wage Structures at U.S. Employers Have Changed* (Kalamazoo, MI: Upjohn, 2001).

²⁵Rosemary Batt, Alexander J. S. Colvin, and Jeffrey Keefe, “Employee Voice, Human Resource Practices, and Quit Rates: Evidence from the Telecommunications Industry,” *Industrial and Labor Relations Review* 55(4) (July 2002), pp. 573–594; P. Milgrom and J. Roberts, *Economics, Organization, and Management* (Englewood Cliffs, NJ: Prentice-Hall, 1992); J. S. Shaw, N. Gupta, and J. E. Delery, “Pay Dispersion and Workforce Performance: Moderating Effects of Incentives and Interdependence,” *Strategic Management* 23 (2002), pp. 491–512.

²⁶Peter F. Drucker, “They’re Not Employees, They’re People,” *Harvard Business Review*, February 2002, pp. 70–77.

contractor or temporary work supplier (e.g., Accountemps, Manpower Services). The security guards, software engineers, accountants, and even entire company functions such as information technology services may be supplied by outsourcing specialists. Pay for these employees is based on the internal structure of their home employer (e.g., IBM or Accountemps) rather than of the workplace at which they are currently located.

Another major work design change is *delayering*. Entire levels of work are disappearing. Delayering can cut unnecessary, noncontributing work. It can also add work to other jobs, enlarging them. This changes the job's value and subsequently the job structure. Delayering is occurring at the top of the structure, where the number of firms with chief operating officers has decreased by 20 percent in the past decade.²⁷ Delayering is also occurring in operations. Through the use of self-managed work teams, entire levels of supervisory jobs are removed and the work is delegated to the teams.²⁸ All these changes influence the type of internal pay structures required to support them.

Overall HR Policies

The organization's other *human resource policies* also influence internal pay structures. Most organizations tie money to promotions to induce employees to apply for higher-level positions.²⁹ However, some organizations believe that offering a grander job title is a sufficient inducement and little or no pay differential is required.³⁰ Nevertheless, a theory to explain why people might want a bigger title without additional pay to go with it has yet to be worked out.

Internal Labor Markets: Combining External and Organization Factors

Internal labor markets combine both external and organizational factors. *Internal labor markets* refer to the rules and procedures that (1) determine the pay for the different jobs within a single organization and (2) allocate employees among those different jobs.³¹ As

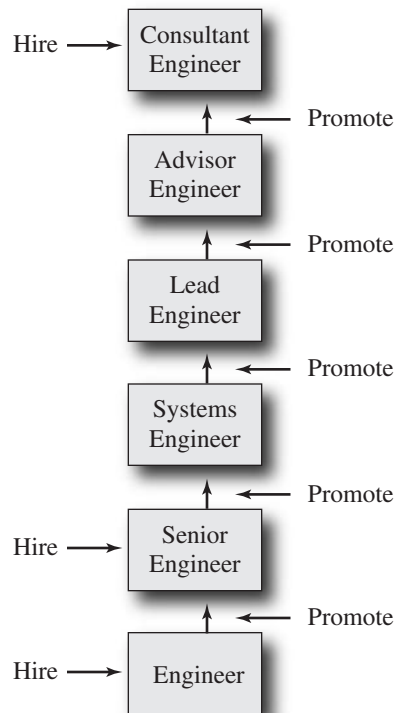
²⁷Raghuram G. Rajan and Julie Wulf, "The Flattening Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies," working paper, Wharton, November 2002.

²⁸Rosemary Batt, Alexander J. S. Colvin, and Jeffrey Keefe, "Employee Voice, Human Resource Practices, and Quit Rates: Evidence from the Telecommunications Industry," *Industrial and Labor Relations Review* 55(4) (July 2002), pp. 573–594; Casey Ichniowski, Kathryn Shaw, and Jon Grant, "Working Smarter by Working Together: Connective Capital in the Workplace," working paper, Columbia University, New York, 2002.

²⁹Paul Schumann, Dennis Ahlburg, and Christine B. Mahoney, "The Effects of Human Capital and Job Characteristics on Pay," *Journal of Human Resources* 29(2), pp. 481–503.

³⁰A. Kohn, *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise and Other Bribes* (Boston: Houghton Mifflin, 1993); Jerald Greenberg and Suzy N. Ornstein, "High Status Job Titles as Compensation for Underpayment: A Test of Equity Theory," *Journal of Applied Psychology* 68(2) (1983), pp. 285–297.

³¹Thomas A. Mahoney, "Organizational Hierarchy and Position Worth," *Academy of Management Journal*, December 1979, pp. 726–737; Barry Gerhart and Sara Rynes, *Compensation: Theory, Evidence, and Strategic Implications* (Thousand Oaks, CA: Sage, 2003).

EXHIBIT 3.5
Illustration of
an Internal
Labor
Market

depicted in Exhibit 3.5, in many organizations individuals are recruited only for specific entry-level jobs (an engineer would be hired right out of college; a senior engineer would have a few years' experience) and are later promoted or transferred to other jobs. Because the employer competes in the external market for people to fill these entry jobs, their pay must be high enough to attract a pool of qualified applicants. In contrast, pay for jobs filled via transfer and promotions is buffered from external forces. External factors are dominant influences on pay for entry jobs, but the differences for nonentry jobs tend to reflect the organization's internal factors.³²

³²John Sutherland, "Wages In and Voluntary Quits from an Establishment Internal Labour Market," *Applied Economics* 34 (2002), pp. 395–400.; Philip Moss, "Earnings Inequality and the Quality of Jobs," in *Corporate Governance and Sustainable Prosperity*, eds. W. Laznick and M. O'Sullivan (New York: Macmillan, 2001); Erica L. Groshen and David I. Levine, "The Rise and Decline (?) of U.S. Internal Labor Markets," Research Paper No. 9819, (New York Federal Reserve Bank, 1998); S. Bacharach and E. Lawler, "Political Alignments in Organizations" chap. 4 in *Research in the Sociology of Organizations*, Vol. IV, eds. Sam Bacharach and Stephen Mitchell (Greenwich, CT: JAI Press, 1998).

Employee Acceptance: A Key Factor

Employees judge the fairness of their pay through comparisons with the compensation paid others for work related in some fashion to their own.³³ Accordingly, an important factor influencing the internal pay structure is its *acceptability to the employees involved*.³⁴

Pay structures change in response to changing external pressures such as skill shortages. Over time, the distorted pay differences became accepted as equitable and customary; efforts to change them are resisted. Thus, pay structures established for organizational and economic reasons at an earlier time may be maintained for cultural or other political reasons. It may take another economic jolt to overcome the cultural resistance. Then new norms for employee acceptance are formed around the new structure. This “change-and-congeal” process does not yet support the continuous changes occurring in today’s economy. New norms for employee acceptance will probably need to include recognition that people must get used to constant change, even in internal pay relationships.

The pay for airport security screeners relative to other airport jobs illustrates the change and congeal process. Prior to 9/11, airport screeners were paid about \$5.50 an hour with no benefits. Recent immigrants, some undocumented, and relatively unskilled people were hired to screen travelers and their luggage. After the 9/11 attacks, the Transportation Security Administration (TSA) took over airport security and screening. Wages are now comparable to police and fire protection jobs. Entry-level pay starts at around \$20 an hour plus U.S. federal employee benefits. Employees in other jobs need to accept the changes in the security jobs—or they will be at the door asking for more pay.³⁵

STRATEGIC CHOICES IN DESIGNING INTERNAL STRUCTURES

The basic premise underlying the strategic approach is that “fit” matters. Aligned pay structures support the way the work gets done, fit the organization’s business strategy, and are fair to employees. Greater internal alignment—fit—is more likely to lead to success. Misaligned structures become obstacles. They may still motivate employee behavior, but it may be undesirable behavior. Jeff Goldblum’s mathematician character may never have stolen the dinosaur egg in *Jurassic Park* if he had been given the pay raise he felt he deserved.

³³E. Robert Livernash, “The Internal Wage Structure,” in *New Concepts in Wage Determination*, eds. G. W. Taylor and F. C. Pierson (New York: McGraw-Hill, 1957), pp. 143–172.

³⁴Charlie O. Trevor and David L. Wazeter, “Reactions to Interdependence among Pay Dispersion, Pay Relative to Internal and External Referents, and Procedural Fairness: Toward a General Compensatory Effect,” working paper, University of Wisconsin–Madison, May 2003; T. Judge and H. G. Heneman III, “Pay Satisfaction,” in *Compensation in Organizations: Current Research and Practice*, eds. S. Rynes and G. Gerhart (San Francisco: Jossey-Bass, 2000); Robert Folger and Mary Konovsky, “Effects of Procedural and Distributive Justice on Reactions to Pay Raise Decisions,” *Academy of Management Journal*, March 1989, pp. 115–130; Kimberly D. Elsbach and Greg Eloffson, “How the Packaging of Decision Explanations Affects Perceptions of Trustworthiness,” *Academy of Management Journal* 43(1) (2000), pp. 80–89; Suzanne S. Masterson, Kyle Lewis, Barry M. Goldman, and M. Susan Taylor, “Integrating Justice and Social Exchange: The Differing Effects of Fair Procedures and Treatment on Work Relationships,” *Academy of Management Journal* 43(4) (2000), pp. 738–748; Stefanie E. Naumann and Nathan Bennett, “A Case for Procedural Justice Climate: Development and Test of a Multilevel Model,” *Academy of Management Journal* 43(5) (2000), pp. 881–889.

³⁵“Federal Uniformed Police: Selected Data on Pay, Recruitment, and Retention at 13 Police Forces in the Washington, D.C. Metropolitan Area,” GAO-03-658, June 13, 2003.

But what does it mean to fit or tailor the pay structure to be internally aligned? Two strategic choices are involved: (1) how tailored to organization design and work flow to make the structure, and (2) how to distribute pay throughout the levels in the structure.

Tailored versus Loosely Coupled

A low-cost, customer-focused business strategy such as that followed by McDonald’s or Wal-Mart may be supported by a closely tailored structure. Jobs are well defined with detailed tasks or steps to follow. You can go into a McDonald’s in Cleveland, Prague, or Shanghai and find they all are very similar. Their pay structures are, too. The customer representative and the food preparation jobs are very well defined in order to eliminate variance in how they are performed. The amount of ketchup that goes on the burger is premeasured; even the keys on the cash register are labeled with menu items rather than numbers. It is hard to make a mistake in these jobs. It is also hard to be the very best french fryer in the whole company. Differences in pay among jobs are relatively small.

In contrast to McDonald’s, 3M’s business strategy requires constant product innovation and short product-design-to-market cycle times. The 3M competitive environment is turbulent and unpredictable. 3M engineers may work on several teams developing several products at the same time. 3M’s pay system needs to accommodate this flexibility. Hence, its pay structures are more loosely linked to the organization in order to facilitate constant change.

Egalitarian versus Hierarchical

Pay structures can range from egalitarian at one extreme to hierarchical at the other. Exhibit 3.6 clarifies the differences. Egalitarian structures have fewer levels and smaller differentials between adjacent levels and between the highest- and lowest-paid workers.

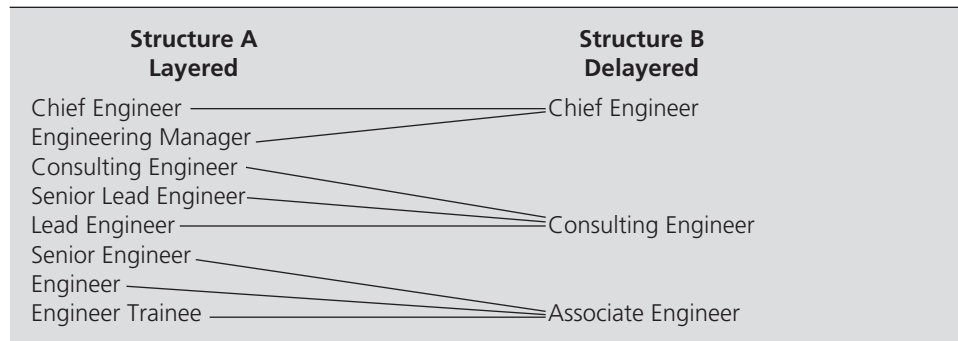
In Exhibit 3.7, Structure A has eight different levels, with relatively small differentials in comparison to structure B, which has only three levels. Structure A is hierarchical compared to the egalitarian structure of B; the multiple levels typically include detailed descriptions of work done at each level and delineate who is responsible for what. Hierarchical structures provide a lot more opportunities for promotion. Hierarchies send the message that the organization values the differences in work content, individual skills, and contributions to the organization.³⁶

EXHIBIT 3.6
Strategic
Choice:
Hierarchical
versus
Egalitarian

	Hierarchical ←	→ Egalitarian
Levels	Many	Fewer
Differentials	Large	Small
Criteria	Person or job	Person or job
Supports:	Close fit	Loose fit
Work Organization	Individual performers	Teams
Fairness	Performance	Equal treatment
Behaviors	Opportunities for promotion	Cooperation

³⁶Elliot Jaques, "In Praise of Hierarchies," *Harvard Business Review*, January–February 1990, pp. 32–40; Matthew C. Bloom, "The Performance Effects of Pay Structures on Individuals and Organizations," *Academy of Management Journal* 42(1) 1999, pp. 25–40.

EXHIBIT 3.7
Which
Structure Has
the Greatest
Impact on
Performance?
on Fairness?



Structure B can also be characterized as delayed or compressed. Several levels of work are removed so that all employees at all levels become responsible for a broader range of tasks but also have greater freedom to determine how best to accomplish what is expected of them. An egalitarian structure sends the message that all employees are valued equally. It implies that more equal treatment will improve employee satisfaction, support cooperation, and therefore affect workers' performance.³⁷

Yet more egalitarian structures are not problem-free, either. For example, Ben and Jerry's Homemade, a purveyor of premium ice cream, tried to maintain a ratio of only 7 to 1 between its highest-paid and lowest-paid employees. (When the company started, the spread was 5 to 1.) The relatively narrow differential reflected the company's philosophy that the prosperity of its production workers and its management should be closely linked. The compressed structure also generated a great deal of favorable publicity. However, it eventually became a barrier to recruiting. Ben and Jerry's was forced to abandon this policy to hire an accounting manager and a new CEO. And only when the company was acquired by Unilever, a Dutch multinational, did the press publicize the fact that the value of Ben and Jerry's stock increased the total compensation for founders Ben Cohen and Jerry Greenfield to much more than the 7-to-1 ratio.

Still, it is hard to be against anything called "egalitarian." If we instead use the word "averagism," as Chinese workers do when describing the pay system under socialism's state-owned enterprises, where maximum differentials of 3 to 1 were mandated, some of the possible drawbacks of this approach become clear.³⁸ Equal treatment can mean that the more knowl-

³⁷R. D. Bretz and S. L. Thomas, "Perceived Equity, Motivation, and Final-Offer Arbitration in Major League Baseball," *Journal of Applied Psychology* 77 (1992), pp. 280–287; M. Bloom and J. Michel, "The Relationships among Organizational Context, Pay Dispersion and Managerial Turnover," *Academy of Management Journal* (1) (2002), pp. 33–42.

³⁸Daniel Z. Ding, Keith Goodall, and Malcolm Warner, "The End of the 'Iron Rice-Bowl': Whither Chinese Human Resource Management?" *International Journal of Human Resource Management* 11(2) (April 2000), pp. 217–236; Thomas Li-Ping Tang, Vivenne Wai-Mei Luk, and Randy K. Chiu, "Pay Differentials in the People's Republic of China: An Examination of Internal Equity and External Competitiveness," *Compensation and Benefits Review* 32(3) (May/June 2000), pp. 43–49; Li Hua Wang, "Pay Policies and Determination in China," working paper, Northwestern University, 2003; Chao Chen, Jaepil Dhoi, and Shu-Cheng Chi, "Making Justice Sense of Local-Expatriate Compensation Disparity: Mitigation by Local Referents, Ideological Explanations, and Interpersonal Sensitivity in China-Foreign Joint Ventures," *Academy of Management Journal* 43(4) (2002), pp. 807–817.

edgeable employees—the stars—feel underpaid. They may quit or simply tune out and refuse to do anything that is not specifically required of them. Their change in behavior will lower overall performance. So a case can be made for both egalitarian and hierarchical structures.

Keep in mind, though, that the choice is rarely either/or. Rather, the differences are a matter of degree: Levels can range from many to few, differentials can be large or small, and the criteria can be based on the job, the person, or some combination of the two.

Career Path Differentials

Reexamine the differentials for engineers shown in Exhibit 3.3. They range from \$11,000 (21 percent differential between senior engineer and engineer) to \$37,000 (30 percent differential between consulting engineer and advisor engineer). These represent pay differences available for promotion from one level in the structure to the next. Recall from Chapter 1 that promotion increases add into base pay, so their expected value compounds over the employee's entire career.

WHAT THE RESEARCH TELLS US

Before managers recommend a pay structure for their organizations, we hope they will not only look at organization strategy, work flow, fairness, and employee motivation but also look at the research. Both economists and psychologists have something to tell us about the effects of various structures.

Equity Theory

Employees judge the equity of their pay by comparing the work, qualifications, and pay for jobs similar to theirs.³⁹ However, very little research addresses the question of what specific factors influence employees' perceptions of the equity or fairness of the *pay structure*, as opposed to the equity or fairness of the *amount of pay*.⁴⁰ Consequently, equity theory could support both egalitarian and hierarchical structures.⁴¹

Tournament Theory

Economists have focused more directly on the motivational effects of structures. Their starting point is a golf tournament where the prizes total, say, \$100,000. How that \$100,000 is distributed affects the performance of all players in the tournament. Compare a 3-prize schedule of \$60,000, \$30,000 and \$10,000 with a ten-prize schedule of \$19,000,

³⁹E. E. Lawler, *Pay and Organizational Effectiveness: A Psychological View* (New York: McGraw-Hill, 1971); E. E. Lawler, *Rewarding Excellence: Pay Strategies for the New Economy* (San Francisco: Jossey-Bass, 2000); T. A. Mahoney, *Compensation and Reward Perspectives* (Homewood, IL: Irwin, 1979).

⁴⁰T. Judge and H. G. Heneman III, "Pay Satisfaction," in *Compensation in Organizations: Current Research and Practice*, eds. S. Rynes and G. Gerhart (San Francisco: Jossey-Bass, 2000); Foard F. Jones, Vida Scarpello, and Thomas Bergmann, "Pay Procedures—What Makes Them Fair?" *Journal of Occupational and Organizational Psychology* 72 (1999), pp. 129–145; Charlie O. Trevor and David L. Wazeter, "Reactions to Interdependence among Pay Dispersion, Pay Relative to Internal and External Referents, and Procedural Fairness: Toward a General Compensatory Effect," working paper, University of Wisconsin–Madison, May 2003.

⁴¹J. S. Shaw, N. Gupta, and J. E. Delery, "Pay Dispersion and Workforce Performance: Moderating Effects of Incentives and Interdependence," *Strategic Management* 23 (2002), pp. 491–512.

\$17,000, \$15,000, \$13,000, and so on. According to tournament theory, *all* players will play better in the first tournament where the prize differentials are sizable.⁴² Raising the total prize money by \$100,000 in the Professional Golf Association tournament lowered each player's score, on average, by 1.1 strokes over 72 holes.⁴³ And the closer the players got to the top prize, the more their scores were lowered. (Note to nongolfers: A lower score is an improvement.)

Applying these results to organization structures, the greater the differential between your salary and your boss's, the harder you (and everyone else but the boss) will work. If Lockheed pays its advisor engineers \$125,000, and its consultant engineers \$162,000, the tournament model says that everyone (except the consultants) will work harder if the consultants are instead paid \$200,000. Rather than resenting the big bucks paid to the consultants, engineers at all levels in the structure will be motivated by the greater differential to work harder to be a "winner," that is, get promoted to the next level on the way to being a consultant engineer. Within limits, the bigger the prize for getting to the next level of the structure, the greater the motivational impact the structure will have.

Several studies support tournament theory. One reported that giving larger raises with a promotion increases effort and reduces absenteeism.⁴⁴ Others find that performance improves with larger differentials at the top levels of the structure. The "winner-take-all" idea springs from these studies.⁴⁵ However, a study of the National Basketball Association revealed that once teams fail to get into the playoffs, where players would have made a lot more money, team performance drops precipitously. In fact, it can be called a "race for the bottom." Why? The poorest teams have first-draft choice for next year's new players. So, overnight, the reward is for worst record rather than best.⁴⁶

But most work is not a round of golf or a good jump shot. Virtually all the research that supports hierarchical structures and tournament theory is on situations where individual performance matters most (auto racing, bowling, golf tournaments) or, at best, where the demand for cooperation among a small group of individuals is relatively low (professors, stockbrokers). In contrast, team sports provide a setting where both individual players' performance and the cooperative efforts of the entire team make a difference.⁴⁷ Using eight years of data on major league baseball, one study found that teams with equal-

⁴²B. E. Becker and M. A. Huselid, "The Incentive Effects of Tournament Compensation Systems," *Administrative Science Quarterly* 37 (1992), pp. 336–350; E. Lazear and S. Rosen, "Rank-Order Tournaments as Optimum Labor Contracts," *Journal of Political Economy* 89 (1981), pp. 841–864; Matthew C. Bloom, "The Performance Effects of Pay Structures on Individuals and Organizations," *Academy of Management Journal* 42(1) (1999), pp. 25–40; Michael L. Bognanno, "Corporate Tournaments," *Journal of Labor Economics* 19(2) (2001), pp. 290–315.

⁴³R. G. Ehrenberg and M. L. Bognanno, "The Incentive Effects of Tournaments Revisited: Evidence from the European PGA Tour," *Industrial and Labor Relations Review* 43 (1990), pp. 745–885; Tor Eriksson, "Executive Compensation and Tournament Theory: Empirical Tests on Danish Data," *Journal of Labor Economics*, April 1999, pp. 262–280.

⁴⁴E. P. Lazear, *Personnel Economics* (Cambridge, MA: MIT Press, 1995).

⁴⁵Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society: Why the Few at the Top Get So Much More Than the Rest of Us* (New York: Penguin, 1996).

⁴⁶Beck A. Taylor and Justin G. Trogdon, "Losing to Win: Tournament Incentives in the National Basketball Association," *Journal of Labor Economics* 20(1) (2002), pp. 23–41.

⁴⁷Matthew C. Bloom, "The Performance Effects of Pay Structures on Individuals and Organizations," *Academy of Management Journal* 42(1) (1999), pp. 25–40.

itarian structures (practically identical player salaries) did better than those with hierarchical structures (very large differentials among players). In addition to affecting team performance (games won, gate receipts, franchise value, total income), egalitarian structures had a sizable effect on players' individual performance, too (batting averages, errors, runs batted in, etc.). A mediocre player improved more on a team with an egalitarian structure than on a team with a hierarchical structure. Of course, it may also be that the egalitarian pay structure reflects a more flexible, supportive organization culture in which a mediocre player is given the training and support needed to improve. The egalitarian structure would be aligned with an egalitarian corporate culture.

Cybercomp

Salaries for all the players on the major league baseball teams are listed at www.canoec.ca/BaseballMoneyMatters/salaries_players.html. Pick some of your favorite teams and compare the highest- and lowest-paid players on the team. Based on the differentials, which teams do the models and research discussed in this chapter predict will have the better record?

Click on the link for "Standings" and check it out. Suggestion: Don't bet your tuition on the relationship between player salary differentials on a team and the team's performance.

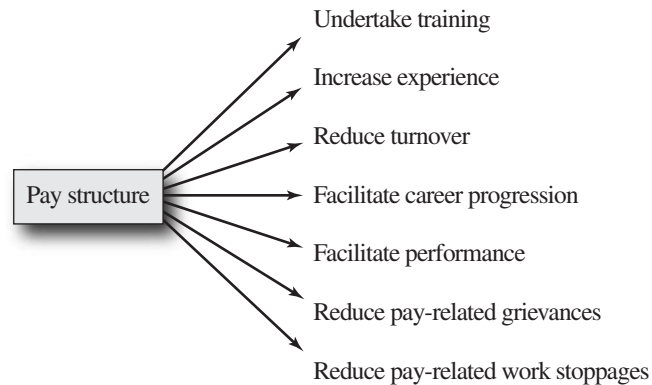
Tournament theory does not directly address turnover. However, a study of executive leadership teams in 460 organizations concluded that executives were twice as likely to leave if the companies had large pay differentials among the leaders.⁴⁸ In this study, hierarchy breeds turnover. For example, Biomet CEO Dane Miller would hardly notice if his pay envelope was switched with someone else's on the leadership team. There is only about a 15 percent pay difference among the top five executives at Biomet. In contrast, at Louisiana Pacific, CEO Mark Suwyn's salary and bonus totaled \$1.37 million, about three times the total of other executives on his team. True to prediction, Louisiana Pacific had 13 changes in its five-person executive team over five years, compared to only 1 change on the Biomet team (a retirement). Conclusion: If executives need to operate like a baseball team, then an egalitarian structure is probably a better fit.

Institutional Model: Copy Others

Some organizations ignore the question of strategy altogether. Instead, they simply copy what others are doing. By extension, internal pay structures are sometimes adopted because they have been called a "best practice."⁴⁹ It is still common for managers to bring back "the answers" discovered at the latest conference. Recent examples of such behaviors include the rush to delayer, to emphasize teams, to deemphasize individual contributions, and to shift to a competency-based pay system, often with little regard to whether

⁴⁸M. Bloom and J. Michel, "The Relationships among Organizational Context, Pay Dispersion and Managerial Turnover," *Academy of Management Journal* (1) (2002), pp. 33–42; W. Jurgens, "Look Out Below," *Wall Street Journal*, April 1, 2000, p. R3.

⁴⁹P. S. Tolbert and L. G. Zucker, "Institutionalization of Institution Theory," in: *Handbook of Organization Studies*, pp. 175–199; eds. G. Glegg, C. Hardy, and W. Nord (London: Sage, 1996), M. Barringer and G. Milkovich, "A Theoretical Exploration of the Adoption and Design of Flexible Benefit Plans: A Case of HR Innovation," *Academy of Management Review* 23(2) (1998), pp. 305–324; Y. Yanadori, "Organization Variations in Stock Option Designs: Insights of Organization Theory," working Paper, CAHRS, Ithaca, NY, 2004.

EXHIBIT 3.8
Some
Consequences
of an
Internally
Aligned
Structure

any of these practices make sense (fit) for the particular organization or its employees.⁵⁰ The institutional model predicts that very few firms are “first movers”; rather, they copy innovative practices after innovators learn whether the practices work. The copiers have little concern for best fit, opting instead for best practice.

Which Structure Fits Best?

Exhibit 3.8 summarizes the effects attributed to internally aligned structures:

- More hierarchical structures are related to greater performance when the work flow depends more on individual contributors (e.g., consulting and law practices, surgical units, stockbrokers, even university researchers).
- More egalitarian structures are related to greater performance when close collaboration and sharing of knowledge are required (e.g., firefighting and rescue squads, manufacturing teams, hotel customer service staffs, global software design teams). The competition fostered in the “winner-take-all” tournament hierarchies appears to have negative effects on performance when the work flow and organization design require teamwork.
- Structures that are not aligned with the work flow appear to be related to greater turnover.

Beyond these points, much remains to be studied. There is practically no research on the optimal size of the promotional increase or its effects on behaviors, satisfaction, or performance. Nor is much known about whether smaller, more frequent promotions are better (or worse) than fewer, larger, less frequent promotions. Perhaps informal expectations get developed at each workplace. (“You can expect to get promoted here after about three years, and a 10 percent hit usually goes with it.”) In universities, promotion from assistant to associate professor tends to occur after six years, although there is no norm on promotion pay increases. In Japanese pay structures, promotion from associate to *kakaricho* occurs after five years in a company. Similar norms exist in the military. Little is known about how these rules of thumb develop and what their original logic was. But they do matter. Promotions sooner (or later) than expected, accompanied by a larger (or smaller) pay increase, send a powerful message.

⁵⁰Harry Levinson, “Why the Behemoths Fell: Psychological Roots of Corporate Failure,” *American Psychologist* 49(5) (1994), pp. 428–436.

So what size should the pay differentials be between the adjacent engineering levels within Lockheed? To answer this question, we would need to understand how differentials within the career path support Lockheed's business strategy and work flow, motivate engineers to contribute to Lockheed's success, and are considered fair by the engineers. The next several chapters discuss how to manage these internal structures.

CONSEQUENCES OF STRUCTURES

Let's turn again to that "so-what" question. Why worry about internal alignment at all? Why not simply pay employees whatever it takes to get them to take a job and to show up for work every day? Why not let external market forces or what competitors are paying determine internal wage differentials?

There are several very practical reasons for paying attention to internal structures. The first is unique jobs that reflect organization idiosyncrasies. For example, the National Aeronautics and Space Administration (NASA) employs a planet protection specialist whose job is to see that neither Mars nor Earth (nor any other planets) are inadvertently contaminated in the course of planetary exploration. No other employer in this world (or any other) has a planet protection specialist on the payroll. How does NASA determine the appropriate pay for this job? A friend suggested that NASA start with whatever it pays for "plant protection" (guards rather than sprayers of aphids) and add "a wee bit." Instead, NASA chose to compare the skills/knowledge/experience/responsibilities for the planet protection job with requirements for other NASA jobs. Its existing internal pay structure provides a basis for arriving at a rate for unique jobs.⁵¹

The second reason for paying attention to internal alignment is that, as we have already noted, different job structures must be harmonized during acquisitions and mergers. Increasingly, the most vivid illustration is from global companies paying people who are in different external markets. Yet many of these organizations say a common internal structure is required to support their global strategy.

Efficiency: Competitive Advantage

Why manage the internal pay structure? An aligned structure has the potential to lead to better organization performance. If the structure does not motivate employees to help achieve the organization's objectives, then it is a candidate for redesign.

Internal pay structures imply future rewards. The size of the differentials between the entry level in the structure and the highest level may induce employees to remain with the organization, increase their experience and training, cooperate with co-workers, and seek greater responsibility.⁵²

Chapter 2 raised the strategy question, Do you want to be difficult to imitate? We already noted that the number of levels and titles in a career path may be rewarding beyond

⁵¹Previous editions of this textbook used an example of a unique job taken from Cornell University's School of Veterinary Medicine. Former students have expressed great affection for the "Cornell cows." However, in light of a changing environment, we are trying to move from the agrarian to the aquarian.

⁵²Edward Lazear, "Labor Economics and Psychology of Organization," *Journal of Economic Perspectives* 5 (1991), pp. 89–110; David Wazeter, "Determinants and Consequences of Pay Structures," Ph.D. dissertation, Cornell University, 1991.

the pay attached to the titles. Microsoft added a “distinguished engineer” title to its structure. The consulting firm McKinsey and Company added an “associate partner.” Their rationale was that more frequent steps in the career ladder offer employees more opportunities for rewards. These are new titles and levels that are not yet reflected in the external market.

Fairness

The early-20th-century U.S. labor leader George Meany is famous for his reaction to proposed pay innovations: “Tell me how much pay we will get, and I will tell you if I like it.” Hierarchical structures evoke the same response. If I am at the top of the structure, I am probably persuaded that my high pay is an important signal to suppliers and customers that the company is doing well. If I am lower in the structure, I am probably less persuaded that the company ties its pay to employee contributions—at least, not *my* (undervalued) contributions.⁵³

Several writers argue that employees’ attitudes about the fairness of the pay structure affect their work behaviors.⁵⁴ Writers have long agreed that departures from an acceptable wage structure will occasion turnover, grievances, and diminished motivation.⁵⁵ But that is where the agreement ends. One group argues that if fair (i.e., sizable) differentials among jobs are not paid, individuals may harbor ill will toward the employer, resist change, change employment if possible, become depressed, and “lack that zest and enthusiasm which makes for high efficiency and personal satisfaction in work.”⁵⁶ Others, including labor unions, argue for only small differentials, in the belief that more egalitarian structures support team cooperation, commitment to the organization, and improved performance.

Compliance

As with any pay decision, the design and management of internal pay structures must comply with the regulations of the countries in which the organization operates.

While the research on internal alignment is very informative, there is still a lot we do not know. What about the appropriate number of levels, the size of the differentials, and the criteria for advancing employees through a structure? We believe the answers lie in understanding the factors discussed in this chapter: the organization’s strategic intent, organization design and work flow, human capital, and the external conditions, regulations, and customs it faces. We also believe that aligning the pay structure to fit the organization and the surrounding conditions is more likely to lead to competitive advantage for the organization and a sense of fair treatment for employees. On the other hand, beliefs, experience, and common sense often mislead. Turns out there are no canals on Mars, and frogs don’t cause warts. So there is general agreement that internal pay structures probably do motivate people. But exactly what behaviors result from this motivation needs to be better understood.⁵⁷

⁵³R. L. Heneman, *Merit Pay: Linking Pay Increases to Performance Ratings* (Reading, MA: Addison-Wesley, 1992); H. H. Meyer, “The Pay-for-Performance Dilemma,” *Organization Science* 33 (1975), pp. 39–50.

⁵⁴Foard F. Jones, Vida Scarpello, and Thomas Bergmann, “Pay Procedures—What Makes Them Fair?” *Journal of Occupational and Organizational Psychology* 72 (1999), pp. 129–145.

⁵⁵E. Robert Livernash, “The Internal Wage Structure,” in *New Concepts in Wage Determination*, eds. G. W. Taylor and F. C. Pierson (New York: McGraw-Hill, 1957), pp. 143–172.

⁵⁶Elliot Jaques, “In Praise of Hierarchies,” *Harvard Business Review*, January–February 1990, pp. 32–46.

⁵⁷Richard Feynman, “Cargo Cult Science: Some Remarks on Science, Pseudoscience, and Learning How to Not Fool Yourself,” in Feynman, *The Pleasure of Finding Things Out* (Cambridge: Perseus, 1999), pp. 205–216; Carl Sagan, *The Demon-Haunted World: Science as a Candle in the Dark* (New York: Ballantine, 1997).

Your Turn So You Want to Lead the Orchestra!

Peter Drucker calls orchestras an example of an organization design that will become increasingly popular in the 21st century, in that they employ skilled and talented people, joined together as a team to create products and services. (Drucker may hear what he wants to hear. In spite of his confidence in orchestral teamwork, jokes like the following are common among orchestra members: *Q. Why do so many people take an instant dislike to the viola? A. It saves time.*)

Job descriptions for orchestras look simple: Play the music. (*Q. How is lightning like a keyboardist's fingers? A. Neither strikes the same place twice.*) Violins play violin parts; trumpets play trumpet parts. Yet one study reported that orchestra players' job satisfaction ranks below prison guards. However, they were more satisfied than operating room nurses and hockey players.

Exhibit 1 shows the pay structure for a regional chamber orchestra. (*Q. How can you make a clarinet sound like a French horn? A. Play all the wrong notes.*) The pay covers six full orchestra concerts, one Caroling by Candlelight event, three Sunday Chamber Series concerts, several Arts in Education elementary school concerts, two engagements for a flute quartet, and one Ring in the Holidays brass event as well as the regularly scheduled rehearsals. (*Q. How can you tell when a trombonist is playing out of tune? A. When the slide is moving.*) The figures do not include the 27-cents-per-mile travel pay provided to out-of-town musicians.

1. Describe the orchestra's pay structure in terms of levels, differentials, and job- or person-based approach.
2. Discuss what factors may explain the structure. Why does violinist I receive more than the oboist and trombonist? Why does the principal trumpet player earn more than the principal cellist and clarinetist but less than the principal viola and flute players? What explains these differences? Does the relative supply versus the demand for violinists compare to the supply versus the demand for trombonists? Is it that violins play more notes?
3. How well do equity and tournament models apply?

EXHIBIT 1 Orchestra Compensation Schedule

Instrument	Fee	Instrument	Fee
Violin, Concertmaster	\$6,970	Violin I	\$2,483
Principal Bass and Conductor	5,070	Violin I	2,483
Principal Viola	5,036	Violin I	2,483
Principal Flute	4,337	Violin II	2,483
Principal Trumpet	4,233	Violin II	2,483
Principal Cello	4,181	Viola	2,483
Principal Clarinet	4,146	Violin II	1,975
Trumpet	3,638	Viola	2,212
Principal Oboe	3,615	Oboe	2,206
Principal Violin II	3,488	Trombone	2,137
Principal Horn	3,390	Viola	2,033
Keyboard I	3,361	Violin II/Viola	1,784
Cello	3,228	Cello	1,634
Principal Percussion	3,049	Clarinet	1,548
Violin I	2,899	Horn	1,548
Cello	2,882	Flute	1,455
Principal Bassoon	2,824	Keyboard II	1,392
Violin I	2,685	Bassoon	1,265
		Violin II	1,178

Summary

This chapter discusses internal alignment and how it affects employees, managers, and employers. Internal alignment refers to the pay relationships among jobs/skills/competencies within a single organization. The potential consequences of internal pay structures are vital to organizations and individuals. Recent research plus experience offers guidance concerning the design and management of internal pay structures.

Pay structures—the array of pay rates for different jobs within an organization—are shaped by societal, economic, organizational, and other factors. Employees judge a structure to be equitable by comparing each job’s pay with the qualifications required, the work performed, and the value of that work. Acceptance by employees of the pay differentials among jobs is a key test of an equitable pay structure. Such structures are part of the network of rewards offered by organizations.

Keep the goals of the entire compensation system in mind when thinking about internal pay structures. There is widespread experience and increasing research to support the belief that differences in internal pay structures, particularly employee career paths, influence people’s attitudes and work behaviors and therefore the success of organizations.

Review Questions

1. Why is internal alignment an important policy in a strategic perspective of compensation?
2. Discuss the factors that influence internal pay structures. Based on your own experience, which ones do you think are the most important? Why?
3. Internal structures are part of the incentives offered in organizations. Look into any organization: your college, workplace, or the grocery store where you shop. Describe the flow of work. How is the job structure aligned with the organization’s business, the work flow, and the organization’s objectives. How do you believe it influences employee behaviors?
4. What is the “just-wage” doctrine? Can you think of any present-day applications?
5. Under what organization designs are more egalitarian versus more hierarchical structures likely to be effective?