Organizational approaches to design of pay and reward systems

Introduction

In the early human resource management (HRM) model developed by Fombrun et al., (1984) the HR policy consists four key components, which are selection, appraisal, development and rewards. Also, the Harvard model of four HR policy areas offered by Beer et al. (1984) consist human resource flow, reward system, employee influence, work system. Furthermore, reward is identified as a key lever in Storey's model of HRM (Storey, 1992). Therefore, it is vital that organisations should develop pay and reward systems appropriately, that reward workers fairly in terms of their performance.

In order to explore the internal and external factors that influence the design of pay and reward system, firstly, it is necessary to review the definition and types of reward and pay. In pay system, pay level, pay structure, and pay form are key elements. Then, with understanding of some fundamental motivation theories, it is easier to identify the factors affect in pay and reward system design. The external factors are demand and supply and the segmentation of the labour market, the government intervention and the regional price level. The internal factors are employers themselves and the nature of jobs. It is worth noting that besides pay, extrinsic rewards should coincide with financial rewards.

Definitions and Types of Reward

Reward is one of the four HRM policy areas in both HRM models developed by Fombrun et al., (1984) and Beer et al., (1984). Storey (1992) mentions in his model that reward is a key lever in managing human resources. The reward system in managerial context emphasizes a facet of the employment relationship, which constitutes an economic exchange. Simply, the employees take a certain amount of works from employers and make profit for them, in return, receiving payment and reward. John Bratton (2003) defined reward as: 'reward refers to all of the monetary, non-monetary and psychological payments that an organization provides for its employees in exchange for the work they perform'.

These rewards can take various forms. Organisations can provide intrinsic and extrinsic reward for employees. Intrinsic reward is a psychological satisfaction and personal fulfilment derived from undertaking his or her paid work, and satisfying 'higher-level' needs for personal esteem and self-development. (Kessler, 2005; Bratton, 2003) For example, the intrinsic reward could be training and career development opportunities, gaining respect and recognition, job satisfaction, high quality of working life, flexible working time for employees and etc. Extrinsic reward refers to monetary payment that satisfy the basic needs of employees for survival, security and recognition and non-monetary payment in the guise of wages or other benefit (Kessler, 2005). In terms of extrinsic reward, sometimes, called 'compensation' in America, it has the forms of pay, pension or other indirect paid benefit, such as health coverage, life insurance and social welfare programs. Bratton (2003) argued that the reward system constitutes of both intrinsic and extrinsic rewards, in which, the monetary and financial element being called pay system.

Pay

Pay, the financial facet of reward, is an important form in reward system; after all, it is the main reason why people work. In a pay system design, the fundamentally compensation policy issues are pay level, pay structure, and pay form (Guthrie, 2007). Pay level refers to pay position of an organisation compared with other competitors in labour market. In a word, it refers to 'how much' employees are paid. Organisations can lag, lead, or match the market. Pay structure refers to a framework within which an organisation sets different pay levels for jobs or groups of jobs. In some organisations, it presents as pay grades. Pay forms are methods of rewarding people for their efforts to the organisation and influence employee motivation and performance.

There are two types of pay-fixed pay and variable pay. Fixed pay is contractual compensation that regularly paid and does not vary according to performance or results achieved. Variable pay is contingent on performance or results with variable amount and usually discretionary. Fixed amount is to meet employees' need for income stability, while the variable pay is to reward and stimulate great contributions. The fixed pay may be paid in different forms, such as basic salary, compensatory allowance, dearness allowance and house rent allowance. It is worth clarifying that although dearness allowance varies with the price index, it is a part of fixed pay as it is not linked to performance. Also, the variable pay can be paid in the forms of bonus, incentive, overtime, commission, and it can be linked to different performance indicators set by the organisations.

Base pay is fixed pay paid to employees for specific job responsibilities. Normally, employee base pay is determined with a range of forms when hired. For example: time based pay, service or seniority based pay, status position based pay, etc. Notwithstanding, employee's base pay can be changed through his/her career in many ways. For example, changes in job, no matter promotion, demotion or lateral transfer. Because whatever promotion or demotion is accompanied with changes in duty assignment and job responsibilities, changes in job will lead to base pay changes. And, similarly, base pay can also be changed through adjust salaries based on their career ladder system. In order to establish the level of base pay, there are two methods- market pricing and job evaluation. Market pricing is based on the 'going price' for a certain job in the labour market, and job evaluation is a systematic process to establish pay structure. (Armstrong, 1998)

On the contrary, 'variable pay is defined strictly as pay which does not become a permanent part of base pay.' (Armstrong, 1999) In today's business world, variable pay is an increasingly popular method of compensation used by employers for its flexibility. Furthermore, 'variable pay facilitates employee- organisation partnership by linking the fortunes of both parties' (Schuster and Zingheim, 1992). Variable pay is sometimes referred to performance pay. Performance pay has various forms as: 1) performance-related pay bound up payment to performance. 2) Incentive pay refers to payments linked with the achievement of prior-set targets. 3) Commission is usually offered to sales people. 4) Team reward is to rewards to individual employees for their team work. 5) Merit pay is payments offered to distinguishing past performance. 6) Skill-based pay is offered to employees with skills and can use effectively. 7) Organisation performance pay is payment to employees based on the organisation's profit. (Bratton and Gold, 2003)

In addition to base pay or performance pay, some employee benefits paid indirectly are also included in the total reward package, such as pension, health coverage, life insurance and social welfare programs.

Financial reward apparently influences extrinsic motivation, while non-financial reward enhances intrinsic motivation. Non-financial rewards have the forms of autonomy, civilised treatment, employer commitment, challenge, trust, and etc. (Ryan and Pointon, 2007). Extrinsic rewards can sometimes be more effective than monetary rewards because they are directly related to employees' achievement and are less likely to be considered as unfair. Intrinsic rewards are more likely to affect employees in a longer-term because they are inherent.

Theoretical Foundations

Reward system is designed to motivate employees performance to meet the employer's strategic target. Therefore, it is significant to understand the underlying theories on reward so that we can understand why rewards are effective and how to design a reward system to meet both the employers' and employees' need.

In terms of economics and managerial context, the Agency Theory explains the agency dilemma arise under conditions of asymmetric and incomplete information when a principal (owners or managers who delegate responsibilities) hires an agent (managers or employees who manage firm assets for owners or other principals) to, persumably, pursue its interets, such as the problem of conflict of interst or potential moral hazard (Eisenhardt, 1989). Various mechanisms may be used to align the interests of the agent with those of the principal, in which, linking payment to performance is most effective way.

Pay is consider as a 'hygiene factor' in terms of psychoogy. That is, if you have it, you may not be happy, but if you do not have it, you will definitely be unhappy. In Federick Herzberg's motivator-hygiene theory, he argued that hygiene factors would not motivate employees to exert effort, but only prevent them from being dissatisfied. Besides, intrinsic reward is also important in his motivator-hygiene Theory. he stated that people are motivated by the degree that a job is challeging and the extend to which a job shows recognition. (Roath and Schutt, ???) This theory implies that the motivation through recognition and self- fulfillment should coincide with meeting economic needs.

Victor Vroom (1964) argued in his Expectancy Theory that people tend to exhibit those work behaviors lead to most valued rewards and outcomes. He consider the perfomance-reward relationship and the reward- personal growth relationship are key componets in this theory as related to rewards. Thus, the theory implies the importance of performance- reward link and that the reward should be attractive enough for maximizing employees' performance. Furthermore, Robbins and Judge (2007) suggest in Reinforcement Theory that a rewards system is predominant in creating the desired behavior.

Adams (1965) asserted in Equity Theory that people seek to maintain equity both internal, comparing inputs they bring to the job and the outcomes they receive from the organisation; and external, comparing to those around him, called referents. Obviously, if pay allocation is perceived to be fair, thus, the reward motivation is sustained. However, if employees consider themselves underpaid, they will seek justice, in result, the work motivation is disrupt. On the other hand, if employees consider themselves overpaid, the inefficiency problem occurs. This theory implicates that the internal and external tension do exist in pay equity (Kessler, 2005), consequently, the reward system leader should monitor internal pay structure and position in the labour market for consistency.

These motivational theories contribute to better understanding of how rewards motivate employees. And, it is obviously that that intrinsic rewards are as significant as extrinsic rewards.

The External Factors

Labour market price

Smith (1983) defined labour markets is an area that employers recruiting labour force and employees seeking employment. Dual labour market theory arise the notion of primary and secondary labour market. In the primary labour market, it is common that jobs are characterized by high salaries, stability of employment, good working conditions and good career prospects. And the workers in this sector are well qualified, with skills and highly productivity. On the other hand, in the secondary labour market, jobs are in low salaries, poor working conditions, lack of any prospects and high turnover. Apparently, the workers working in secondary sector are often including women, teenagers and ethnic minorities, because the workers are confined to the secondary labour market by inadequate education, residence, training and skills and discrimination. (Craig et al., 1982)

For firms, it is necessary to consider about which position the organisation is in this market or industry and which labour market the employees are recruited from. For example, if an organisation is in a leading position in its market or industry, the pay level in this organisation should also be in a relevant high level than other product and labour market competitors. The 'efficiency wage hypothesis' (Akerlof and Yellen, 1986) explained why pay above-market wage may improve firm effectiveness. First, since workers want to maintain employment with their employer if they can pay above-market, it is less possible the workers will have performance problems. Second, above-market salary will help by reducing turnover. Third, employees may improve their performance out of a sense of equity. Fourth, organisations using above-market pay level may enjoy an advantage in terms of attracting more talented applicants. (Guthrie, 2007)

If the organisation recruits people from primary labour market, the pay of them should have distinction with those who are recruited form secondary sector. The underlying rationale is Equity Theory developed by Adam (…), which implicates that people seek to maintain equity both internal and external. It is just when employees consider the pay is equity in their mind, the pay and reward system motivation is sustained. Also, the overview pay level in an industry or a region should be taken into account when design a pay and reward system. Therefore, the organisation could better design a reward system as a comparative advancement in recruitment or performance motivation.

Supply and demand of labour market

The equilibrium in the labour market is other factor that affects pay level. As talked above, labour market is a market like any other product market, including supply and demand--employees and employers. Therefore, in some classical wage theory, Supply and Demand Theory can also applies to pay, in labour market. The assumption of classical wage theory is that the supply of labour is fixed, and so as the demand (at least in the short term). Hence, supply and demand are assumed to converge in an equilibrium price for a certain type of labour, which is the pay rate (Wootton, 1962). In result, organisations should be concern of supply and demand changes in labour market to change their pay level accordingly. However, Wootton also pointed out that the achievement of equilibrium point of supply and demand in labour market has proved difficult in practice.

Government

Robinson (1970) developed administered model and provide the essence of this model as 'the action of managements in all the companies and of the government and the trade unions together determine who gets employed where, and on what terms and conditions'. In fact, the pay determination in the company now seems to receive interventions of government and institutions rather than the economic theory. Government is an important actor in remuneration system as employers of an important part of the nation's labour market, and furthermore, pay affects the macro-economic environment. The reason is that the pay level can influence the circulation of money in the national economy, the level of consumption and demand, the level of inflation, strikes. (Smith, 1983)The emphasis on intervention has become concerned with social aspects of labour markets, justice, and equity. For example, minimum wage legislation, equal pay and pay control programmes. In addition, government can influence pay setting process indirectly through actions affecting supply and demand of labour market.

Through successive pay policies, the governments have influenced reward system not only for their own employees in public sector, but also in private sector. The organisations should obey the rules in a country as they operating in this country. Therefore, when design pay and reward system, one should consider about relevant legislations in the operating country.

Regional price level

The primary reason why employees work is because pay is the source of their living. Pay means, for employees, purchasing power, standard of living, fairness or relativity and status' (Smith, 1983). In some country, the governments setting the minimum wage legislation is to protect the basic living standard for low wage workers. The organisation should take living cost and price level in to account when design the pay and reward system. For example, in assumption that a company sets two similar positions both in UK and India, obviously, the pay for these two positions will not be the same. In this case, it does not mean inequity, for the living standard and living cost in UK is much higher than it in India. According to CIA data, the GDP- per capital (purchasing power parity) in India is 3, 400 dollars in 2010, while that in UK is 35, 100 dollars in 2010. If the organisation set the pay level of the position according to the price level in UK and apply it in the same position in

India, it could be internal inequity according to Equity Theory, which means the employee will consider the pay is far more than his/her input according to the living standard. Thus, this reward system has met the needs of the employees but loses motivation and vice versa. In consequence, the pay level should match the regional price level when design pay system.

Internal Factors

Employers

It is obviously that there is a relationship between reward and company performance. The reward system should be designed reasonable in a concern with policy and strategies so that can attract, retain and motivate employees to pursue the same objectives as the companies. However, for many companies, reward system, especially pay system, represents a large element of cost added in cost of production in many companies. In resulting, the reward system, including pay and other benefits can be a major factor in determination of profitability. Thus, the dilemma between chasing maximum profit and motivate employees' and organisational performance exists in reward system design. It is common to find that an organisation copies pay and reward structure from other firms. The reason for this phenomenon is that management's eager to remain its competitiveness in attracting and retaining people. However, inevitable, the structures fit in one organisation may not fit for the other. Therefore, for pay and reward system design, it is necessary to consider about a company's capability on the cost of labour. Admittedly, pay above market price is a good way to retain and motivate employees. However, if this cost is not within the company's capability, the company will lose profit in a long run. Additionally, for some companies, it will lead to deficit and a vicious circle. Moreover, the company should take its industry and business strategy into account. For example, investment financial bank or consultant companies mainly use variable pay structure, while manufactory companies mainly use base pay structure. Consequently, pay and reward system should be affordable to a company in a first place and fits its industry and business strategy.

Jobs

'The link between pay and job, defined as a stable configuration of organizational tasks and responsibilities, has traditionally been the building block of grading structures.'(Kessler, 2005) Kessler argued that pay determined by the job position in some kind of grading hierarchy, which grouped by job worth. In establishing job worth, a distinction should be drawn between external equity and internal equity. (Evans, 2003)

External job worth depends on state of the outside posts in the labour market. Organisations would like to consider about the supply and demand of this job in the labour market, the 'going rate' for similar jobs as a reference, through a scale of sources including survey reports from relevant organisations, pay surveys undertaken by consultants. (Kessler, 2005)

In terms of establishing internal job worth, the principal mechanism is job analysis and job evaluation. Job analysis is defined by Bratton and Gold (2003) as 'the systematic process of collecting and evaluating information about the tasks, responsibilities and the context of a specific job.' Job analysis contains the information of the nature of a specific job, more specifically, the major tasks, the outcomes that are expected, and the relationships to other jobs. (Milkovitch and Newman, 2002) For job analysis, the two steps of it are collecting data and using the data to develop job descriptions, job specifications and job performance standards.

Job evaluation can be defined as 'a systematic process designed to determine the relative worth of jobs within a single work organisation.' (Bratton and Gold, 2003) job evaluation aims to achieve internal equity by setting a hierarchy of jobs in the organisation, which is used to allocate pay rates to jobs. After gathering data, selecting compensable factors, evaluating the job, the end product is a hierarchy of jobs grouping related to their value for the organisation. And the last step in job evaluation process is assign pay to this hierarchy, simply, price the pay structure. Job evaluation provides the basis for a graded pay system which is equitable, and meets equal pay requirements. Significantly, the proper use of an analytical job evaluation scheme will defend and reduce the risk of equal pay claims.

In result, allocating pay structure, should base on job analysis and job evaluation. The pay would be related to the nature of the job, the requirement of skill, effort, responsibility, the working conditions, efforts and knowledge.

Conclusion

Reward system is important in areas of Human Resource Management. Reward refers to all the financial and non-monetary payment provided to employees for their efforts to organisations. In general, there are two forms of reward, including intrinsic and extrinsic. Intrinsic reward is a psychological satisfaction and personal fulfilment of employees, usually being the forms of non-financial recognition, e. g. autonomy, civilised treatment, employer commitment, challenge, trust, and etc. pay is predominant form of extrinsic reward, besides other benefits such as pension, health insurance and so on. Pay has the forms of base pay (fixed pay), performance pay (variable pay) and indirect pay. Base pay related to job responsibilities and the level of base pay could be established by marketing pricing and job evaluation. Performance pay bound up payments to performance. In terms of designing a pay system, pay level, pay structure, and pay form are key components in pay system.

Pay levels are determined by many factors. Firstly, pay levels are determined by internal and external markets, as market price can influence the level of base pay. Since labour market is similar as other product market, according to Supply and Demand Theory, supply and demand is assumed to converge in an equilibrium price in a certain job market, which is the pay rate. Concentrating on external competitiveness, organisations would pay equal or exceed market pricing to attract and retain more talented employees. Above-market pay is under the rationale of effective wage theory, which implicates that high level of pay will improve employee performance and in resulting, increase productivity. Second, government intervene pay level by direct legislation and indirect control. Such as minimum wage legislation, equal pay. Third, pay level should base on the regional price level to meet the basic living standard of employees. Fourth, within the job evaluation scheme, setting pay level should be consider about the nature of the job, the requirement of skill, effort, responsibility, the working conditions, efforts and knowledge.

In terms of allocating pay structure, job analysis and job evaluation schemes will group jobs in a grading hierarchy and assign pay to this hierarchy, which related to pay structure. Job evaluation provides the basis for a graded pay system which is equitable, and meets equal pay requirements.

The business type of an organisation and business strategy will determine the pay form. For example, investment financial bank or consultant companies mainly use variable pay structure, while manufactory companies mainly use base pay structure. Especially, incentive structures related to organisational performance are used for managers in large firms to motivate and align the interests of agencies with those of the shareholders, according to Agency Theory.

According to herzberg's motivator-hygiene theory, extrinsic rewards can sometimes be more effective and lasts in a longer-term because they are inherent. In a reward system, the motivation through non-financial reward should coincide with meeting economic needs.