Intrinsic and extrinsic rewards defined business essay

This chapter will review the academic literature required to study the research topic. The key areas for discussion are on intrinsic & extrinsic rewards, rewards schemes & strategies and theories on motivation.

2. 1 Intrinsic and Extrinsic rewards defined

Rewards can be treated as some offerings in addition to pay. Traditional reward systems were based on positions and longevities. But now a day's profit sharing, gain sharing and stock option plans are being practiced as a reward. Modern reward systems include stock grants, certificate of appreciation, even personal thank you notes (Nelson, 1994).

According to Walker et al (1979), rewards are classified into extrinsic and intrinsic rewards. Extrinsic rewards include basic salary and allowances which is needed to fulfill psychological and safety needs. Intrinsic rewards help individuals' feelings and perceptions about the job situation which is needed to fulfill self-esteem, competence, self-actualization etc. There are several financial rewards commonly found in sales organizations are salary and commission, bonus, fringe benefits, stock options, retirement plan which fulfills both extrinsic and intrinsic needs of employees.

Coli (1997), describes classification of reward and recognition under three types of rewards. They are monetary, awards and developmental rewards. Monetary rewards includes individual bonus for project completion, stock grants, skill-based pay, gain sharing, targeted total cash, special individual increase, non-discretionary incentives for the beginning of the project etc. According to Lyons & Ora (2002), financial performance includes basic salary, variable pay, other compensations, perquisites and benefits.

Different individuals have different perceptions of rewards. For instance, some individuals may consider cash as a sufficient and adequate reward for their efforts at work, while others may consider holidays and material incentives (such as a car) as more rewarding in exchange for their work. Others still, may consider a shift in the treatment that they get from their leaders to be a more rewarding experience. For instance, some employees consider being recognized by their leader as more rewarding than financial incentives (La Belle, 2005).

2. 1. 1 What are Financial Rewards?

Zammit (2004), best described financial rewards. A reward strategy is an integrated approach to reward employees according to their contribution, skill and competence and their market worth.

The author classified four types of financial reward.

Basic salary

Performance related pay

Allowances

Other financial rewards

The basic salary is determined according to management position, standard of living, job market, qualification of the receivers. The dimensions of performance consist of bonuses, commissions and special skills. Allowances are most commonly provided for substitution, workstation transfer and transportation, free or discounted benefits, cultural or religious holidays, telecommunications. Other financial rewards are mostly practiced by offering stock options, pension schemes.

2. 2 Reward strategy

Reward strategies provide answers to two basic questions for an organization ‘ Where do we want our reward practices to be in a few years’ time?’ and ‘ How do we intend to get there?’. Therefore, they deal with both ends and means. ‘ Ends’ they describe a vision of what reward processes will look like in a few years’ time and ‘ means’ on the expectation of how the vision will be realized.

2. 2. 1 Reward strategy defined

Reward strategy is ultimately a way of thinking that you can apply to any reward issue arising in your organization, to see how you can create value from it (Brown, 2001). Reward strategy is a declaration of intent which defines what the organization wants to do in the longer term to develop and implement reward policies, practices and processes which will further the achievement of its business goals and meet the needs of its stakeholders. It provides a sense of purpose and direction and a framework for developing reward policies, practices and process. It is based on an understanding of the needs of the organization and its employees and how they can best be satisfied. It is also concerned with developing the values of the organization on how people should be rewarded and formulating guiding principles which will ensure that these values are enacted.

Reward strategy is underpinned by a reward philosophy which expresses what the organization believes should be the basis upon which people are valued and rewarded. Reward philosophies are often articulated as guiding principles.

2. 2. 2 The content of reward strategy

Reward strategy may be a broad-brush affair simply indicating the general direction in which it is thought reward management should go. Additionally or alternatively, reward strategy may set out a list of specific intentions dealing with particular aspects of reward management.

Broad-brush reward strategy (Armstrong (2007), pg. 635)

A broad-brush reward strategy may commit the organization to the pursuit of a total rewards policy. The basic aim might be to achieve an appropriate balance between financial and non-financial rewards. A further aim could be to use other approaches to the development of the employment relationship and the work environment which will enhance commitment and engagement and provide more opportunities for the contribution of people to be valued and recognized.

Examples of other broad strategic aims include:

1. Introducing a more integrated approach to reward management – encouraging continuous personal development and spelling out career opportunities;

2. Developing a more flexible approach to reward which includes the reduction of artificial barriers as a result of over-emphasis on grading and promotion;

3. Generally rewarding people according to their contribution;

4. Supporting the development of a performance culture and building levels of competence

5. Clarifying what behaviors will be rewarded and why.

2. 2. 3 Specific reward initiatives

As Cox and Purcell (1998) write: ‘ The real benefit in reward strategies lies in complex linkages with other human resource management policies and practices’. The selection of reward initiatives and the priorities attached to them will be based on an analysis of the present circumstances of the organization and an assessment of the needs of the business and its employees. The following are examples of possible specific reward initiatives, one or more of which might feature in a reward strategy:

- The replacement of present methods of contingent pay with a pay for contribution scheme;

- The introduction of a new grade and pay structure, e. g. a broad-graded or career family structure;

2. 2. 4 Developing reward strategy

The formulation of reward strategy can be described as a process for developing and defining a sense of direction. The main phases are:

1. The diagnosis phase, when reward goals are agreed, current policies and practices assessed against them, options for improvement considered and any changes agreed.

2. The detailed design phase when improvements and changes are detailed and any changes tested (pilot testing is important).

3. The final testing and preparation phase.

4. The implementation phase, followed by ongoing review and modification.

2. 2. 5 Implementing reward strategy

The aim of implementation is to make the reward strategy an operating reality by building the capacity of the organization to put into practice the proposals worked out in the development stage. As Armstrong and Brown (2007) stress: ‘ It is always essential to design with implementation in mind’.

Purcell (1999), believes that the focus of strategy should be on implementation. As explained by Thompson and Strickland (1990): ‘ Implementation entails converting the strategic plan into action and then into results’. An effective reward strategy is a living process and, in the words of Rosabeth Moss Kanter (1984), an ‘ action vehicle’, formulation is easy; implementation is hard. A pragmatic approach is required – what’s good is what works.

Implementing reward strategy is much more about process than design – how it will be done rather than what will be done. The principles of procedural and distributive justice apply.

People must feel that the procedures used to determine their grades, pay level and pay progression are fair, equitable, applied consistently and transparent. They must also feel that the awards distributed to them are just in terms of their contribution and value to the organization.

2. 3 Rewards management strategy defined

Reward management is concerned with the formulation and implementation of strategies and policies in order to reward people fairly, equitably and consistently in accordance with their value to the organization.

As Duncan Brown (2001) emphasizes, the ‘ alignment of your reward practices with employee values and needs is every bit as important as alignment with business goals, and critical to the realization of the latter’. It deals with the development of reward strategies and the design, implementation and maintenance of reward systems (reward processes, practices and procedures) which aim to meet the needs of both the organization and its stakeholders. Rewards can be regarded as the fundamental expression of the employment relationship.

2. 3. 1 The aims of reward management

Armstrong and Brown (2006), pg. 33, identifies the following;

- Reward people according to what the organization values and wants to pay for.

- Reward people for the value they create.

- Reward the right things to convey the right message about what is important in terms of behaviors and outcomes.

- Develop a performance culture.

- Motivate people and obtain their commitment and engagement.

- Help to attract and retain the high quality people the organization needs.

- Develop a positive employment relationship and psychological contract.

- Align reward practices with both business goals and employee values.

- Operate fairly – people feel that they are treated justly in accordance with what is due to them because of their value to the organization (the ‘ felt-fair’ principle of Eliot Jacques (1961)).

The fundamentals of reward management

Recognizing the importance of the part played by line managers in implementing reward strategy and the need to ensure that they are committed and have the necessary skills;

Paying close and continuous attention to communicating with employees and involving them in the development as well as the implementation of reward strategy;

Being absolutely clear about the objectives of the strategy and resolute about evaluating its effectiveness.

The following Reward strategies & theories can be applied when developing a reward scheme in an organization.

Pay people right (Zingheim and Schuster)

Zingheim and Schuster (2000) have laid down the following six principles for ‘ paying people right’:

1. Create a positive and ‘ natural’ reward experience.

2. Align rewards with business goals to achieve ‘ a win-win partnership’.

3. Extend people’s ‘ line of sight’ between effort and outcome, motivating ‘ smart working’ over simply expending extra effort.

4. Integrate reward with strategic aims and the kind of contribution desired.

5. Reward individual ongoing (input) value to the organization with base pay.

6. Reward results (outputs) with variable pay.

Dynamic pay (Flannery, Hofrichter and Platten)

Flannery, Hofrichter and Platten (1996) expounded the concept of ‘ dynamic pay’ and suggested that the nine principles that support a successful pay strategy are:

1. Align compensation with the organization’s culture, values and strategic business goals.

2. Link compensation to the other changes.

3. Time the compensation programme to best support other change initiatives.

4. Integrate pay with other people processes.

5. Democratize the pay process.

6. Demystify compensation.

7. Measure results.

8. Refine. Refine again. Refine some more.

9. Be selective. Don’t take to heart everything you hear or read about pay.

2. 3. 3 Components of an effective reward strategy

An effective strategy is one in which there are clearly defined goals and a well-defined link to business objectives; well-designed pay and reward programmes, tailored to the needs of the organization and its people, and consistent and integrated with one another; and effective and supportive HR and reward processes in place.

Brown (2001) has suggested that effective reward strategies have three components:

1. They have to have clearly defined goals and a well-defined link to business objectives.

Recognize the value of everyone who is making an effective contribution, not just the exceptional performers.

Allow a reasonable degree of flexibility in the operation of reward processes and in the choice of benefits by employees.

Devolve more responsibility for reward decisions to line managers.

2. There have to be well-designed pay and reward programmes, tailored to the needs of the organization and its people, and consistent and integrated with one another.

3. Perhaps most important and most neglected, there needs to be effective and supportive HR and reward processes in place.

Armstrong and Brown (2006), have further suggested the following approach to reward strategy. This has the following characteristics:

Appreciating that a good strategy is one that works and therefore focusing on implementation programmes;

‘ Planning with implementation in mind’ – recognizing during the design process that plans have to be converted into reality and taking steps to anticipate the problems involved;

Aligning reward strategies with the business and HR strategies;

Ensuring that reward strategy fits the culture and characteristics of the organization, meets business needs and takes account of individual needs and preferences;

Being aware of good practice elsewhere but not being seduced by the notion that it is best practice, i. e. universally applicable and easily replicated;

Paying more attention to using strategic reward initiatives to support the engagement and commitment of people so that they are motivated and productive, rather than focusing on the mechanics of new reward ‘ fads’;

Bearing in mind that the development and implementation of reward strategy is an evolutionary process – it is about doing things better at a manageable pace rather than extraordinary new developments;

Providing ‘ flexibility within a framework’, i. e. developing a flexible approach to the reward of different people but always within a framework that provides for consistent treatment;

Appreciating that implementing reward strategy will require a comprehensive change management programme.

2. 4 What is Motivation?

Many contemporary authors have defined the concept of motivation as; the psychological process that gives behavior purpose and direction (Kreitner, 1995); a tendency to behave in a purposive method to achieve specific, unmet desires (Buford, Bedeian, & Lindner, 1995); an inner force to gratify an unsatisfied need (Higgins, 1994); and the will to accomplish (Bedeian, 1993).

In this study, motivation is operationally defined as the inner force that drives individuals to achieve personal and organizational goals. Understanding what motivates employees is one of the key challenges for managers. Although it is not possible directly to motivate others, it is nonetheless important to know how to influence what others are motivated to do, with the overall aim of having employees identify their own welfare with that of the organization (Bruce and Pepitone, 1999).

While motivation is determined by both monetary & non-monetary factors, money has come to play an overly important role in our thinking about the causes of behavior. In most companies, very limited time & effort are spent on considering non-monetary sources of motivation (Gratton, 2004). For organizations to address these expectations an understanding of employee motivation is required (Beer et al., 1984). Carnegie (1975) emphasizes the human aspects of management. They postulate that as it is people who make a business succeed – or fail – it is the organization's chief responsibility to motivate their people so that they will assure success. The author believes that each human being has the potential for creativity, contribution and achievement of business goals.

Therefore, the infinite question is how organizations reach this potential and how they stimulate creativity and foster in their people the desire to succeed and to achieve self-fulfillment through their work. The common theme of all the above authors is the belief that people need to be respected and treated as precious human capital, more essential to an organization's effectiveness than its financial capital.

Organizations are under constant pressure to enhance and improve their performance and are realizing that an interdependent relationship exists between organizational performance and employee performance. In the following section the focus will be on the motivational theories and the impact that these theories have on enhancing employee performance.

2. 5 Theories on motivation

The process of motivation as described below is broadly based on a number of motivation theories that attempt to explain in more detail what it means. Some of the distinctive theories will be discussed below.

2. 5. 1. Needs (content) theory

The basis of this theory is the belief that an unsatisfied need creates tension and disequilibrium. To restore the balance a goal is identified that will satisfy the need and a behavior pathway is selected that will lead to the achievement of the goal. All behavior is therefore motivated by unsatisfied needs.

The best-known contributor to needs theory is Maslow, A (1954). He formulated the concept of a hierarchy of needs, which start from the fundamental physiological needs and lead through safety, social and esteem needs to the need for self-fulfillment, the highest need of all. He said that ' man is a wanting animal'; only an unsatisfied need can motivate behavior, and the dominant need is the prime motivator of behavior. This is the best-known theory of needs, but it has never been verified by empirical research.

2. 5. 2. Herzberg's two-factor theory

Herzberg's two-factor model theory states that the factors giving rise to job satisfaction (and motivation) are distinct from the factors that lead to job dissatisfaction. It is sometimes called the ' motivation-hygiene theory'.

There are two groups of factors. The first consists of the satisfiers or motivators, which are intrinsic to the job. These include achievement, recognition, the work itself, responsibility and growth. The second group comprises what Herzberg calls the ' dissatisfaction avoidance' or ' hygiene' factors, which are extrinsic to the job and include pay, company policy and administration, personal relations, status and security. These cannot create satisfaction but, unless preventive action is taken, they can cause dissatisfaction. He also noted that any feeling of satisfaction resulting from pay increases was likely to be short-lived compared with the long-lasting satisfaction from the work itself. One of the key conclusions derived from the research is therefore that pay is not a motivator, except in the short term, although unfair payment systems can lead to demotivation.

Herzberg's two-factor model draws attention to the distinction between intrinsic and extrinsic motivators, and his contention that the satisfaction resulting from pay increases does not persist has some face validity. But his research and the conclusions he reached have been attacked – first because, it is asserted, the original research is flawed and fails to support the contention that pay is not a motivator, and secondly because no attempt was made to measure the relationship between satisfaction and performance.

As Guest, D (1992) has written: ' Many managers' knowledge of motivation has not advanced beyond Herzberg and his generation. This is unfortunate. Their theories are now over thirty years old. Extensive research has shown that as general theories of motivation the theories of Herzberg and Maslow are wrong. They have been replaced by more relevant approaches'.

2. 5. 3. Equity theory

To explain how employees judge the fairness of rewards received in proportion to resources invested for completing a task by assessing one's on investment-reward ratio " Equity theory" (John Stacey Adams) is used, This theory is compared against the ratio of another colleague holding a similar position (McShane et al. 2000 pg 79).

A comparison can be made using the formula below:

Outcomes (Individual) = Outcomes (Other)

Inputs (Individual) Inputs (Other)

Above formula can be explained, that employees seek to maintain equity between the inputs that they put in to a job and the outcomes they receive from it against the perceived inputs and outcomes of others. The belief in equity theory is that people value fair treatment which causes them to be motivated to keep the fairness maintained within the relationships of their co-workers and the organization.

The main concern however is “ payment”; this therefore is the cause of equality or inequalty in most cases. In any position within the organization, an employee wants to feel that their contributions and work performance are being rewarded with their pay. According to equity theory, if an employee feels under-paid then it will result in the employee feeling hostile towards the organization and perhaps their co-workers, which may result the employee not performing well at work anymore.

But Adams’ Equity Theory is very much more complex & sophisticated motivational model, in this model more than merely assessing effort put in (inputs) and rewards (outputs). Equity Theory gives prominence to an additional perspective of comparison, were employees compare themselves with others (people who consider in a similar position). ‘ Referent’ others are used to describe the reference points or people with whom we compare our own situation, which is the Highlight part of the theory.

The three primary assumptions applied to most business applications of Equity Theory can be summarized as follows:

“ Equity norm”- Where Employees expect a fair return for what they contribute in their jobs.

“ Social comparison”- Employees determine what their equitable return should be after comparing their inputs and outcomes with those of their coworkers.

“ Cognitive distortion” – Employees who perceive themselves as being in an inequitable situation will seek to reduce the inequity either by distorting inputs and/or outcomes in their own minds, by directly altering inputs and/or outputs, or by leaving the organization.

2. 5. 4. Vroom’s expectancy theory

Vroom’s expectancy theory basically separates effort (which arises from motivation), performance, and outcomes. Its assumption is that behavior results from conscious choices among alternatives. Vroom realized that an employee’s performance is based on individual factors such as personality, skills, knowledge, experience and abilities. He stated that effort, performance and motivation are linked in a person’s motivation. He uses the variables Expectancy, Instrumentality and Valence to account for this.

Expectancy is the belief that increased effort will lead to increased performance i. e. if I work harder then this will be better.

This is affected by such things as:

Having the right resources available (e. g. raw materials, time)

Having the right skills to do the job

Having the necessary support to get the job done (e. g. supervisor support, or correct information on the job)

Instrumentality is the belief that if you perform well that a valued outcome will be received. The degree to which a first level outcome will lead to the second level outcome. (i. e. if I do a good job, there is something in it for me.)

This is affected by such things as:

Clear understanding of the relationship between performance and outcomes – e. g. the rules of the reward ‘ game’

Trust in the people who will take the decisions on who gets what outcome

Transparency of the process that decides who gets what outcome

Valence is the importance that the individual places upon the expected outcome. For the valence to be positive, the person must prefer attaining the outcome to not attaining it. For example, if someone is mainly motivated by money, he or she might not value offers of additional time off.

The three elements are important behind choosing one element over another because they are clearly defined: effort-performance expectancy (E> P expectancy) and performance-outcome expectancy (P> O expectancy).

E> P expectancy: our assessment of the probability that our efforts will lead to the required performance level.

P> O expectancy: our assessment of the probability that our successful performance will lead to certain outcomes.

Crucially, Vroom's expectancy theory works on " Perceptions" – so even if an employer thinks they have provided everything appropriate for motivation, and even if this works with most people in that organization, it doesn't mean that someone won't perceive that it doesn't work for them.

Thus, Vroom's expectancy theory of motivation is not about self-interest in rewards but about the associations people make towards expected outcomes and the contribution they feel they can make towards those outcomes.

2. 6 Theoretical framework

2. 6. 1 Relationship between Financial Rewards and Performance

Financial rewards practiced by an organization play an important role in motivating employees to perform depending on the type of business its involved in and require their employees' to be engaged in.. Therefore, organization's financial performance is ultimately dependent on the employees' performance. It is also considered that improper reward practices may result below average financial performance of organizations. Most agree that reward practices act as motivators that shape the employees behaviors. According to prior researches, it is commonly believed that if financial rewards are effectively used, employees are motivated to perform high and that ultimately results financial performance.

Financial performance is improved if there is a carefully crafted reward practice (Allen & Helms; 2001). It is difficult to relate financial reward with organizational financial performance (Kerr, 1999). Reward must positively influence performance (Nelson, 1994). Regardless to ‘ team-based reward’, individual reward is still important as individuals could see that their activities are making difference to the organization.

According to Zingheim& Schuster (2000), a few businesses design their reward system for the optimization of company performance. Basic salary and incentives matches competitive practice and emphasizes performance results. Incentive plans are often used in employment settings to encourage superior performance. While such inducements are found to have positive effects on job performance concerns have been raised over rewards’ influence on task interest and creativity. (Bartol & Locke, 2000; Fay & Thompson, 2001)

In a research, it is found that employees stock ownership plans and profit sharing are widely used reward practice (Lawler et all, 1995). Hale (1998) and Lawler (1981, 1987) recognized rewards have critical importance as a means of employee motivation. Organizations and manager acknowledge reward and recognition consistently as a motivator of individual employees. Employees’ understandings and satisfactions with reward system lead to specific behaviors and actions, finally results operational and financial results (Cacioppe, 1999). According to Saxby (2007), it is an avoidable mistake of management for not rewarding employees for a well done job. Tangible rewards are nicer and more meaningful regarding employee motivation rather than intangible praising and acknowledgement.

Contradiction to the theory, according to LaBelle (2005) in some cases managers may practice rewards for some behaviors which is unexpected or unproductive. Sometimes worker may misunderstand the objective of getting reward. Some cases of mismatches are discussed below:

Safety vs. Productivity: Sometimes, employees do not understand that whether heshe is receiving reward for working safely or for the firm's productivity or for the quality of services rendered.

2. 6. 2 Relationship between Financial Rewards, Motivation and Performance

Financial incentives and rewards can motivate. People need money and therefore want money. It can motivate but it is not the only motivator. It has been suggested by Wallace, M. J and Szilagyi, L (1982) that money can serve the following reward functions:

It can act as a goal that people generally strive for although to different degrees.

It can act as an instrument that provides valued outcomes.

It can be a symbol that indicates the recipient's value to the organization.

It can act as a general reinforce because it is associated with valued rewards so often that it takes on reward value itself.

But doubts have been cast on the effectiveness of money as a motivator by Herzberg et al (1957). As noted, he claimed that, while the lack of it may cause dissatisfaction, money does not result in lasting satisfaction. There is something in this, especially for people on fixed salaries or rates of pay who do not benefit directly from an incentive scheme. They may feel good when they get an increase, as, apart from the extra money, it is highly effective ways of making people believe they are valued. But the feeling of euphoria can rapidly die away. However, it must be re-emphasized that different people have different needs, and Herzberg's two-factor theory has not been validated.

Some will be much more motivated by money than others. What cannot be assumed is that money motivates everyone in the same way and to the same extent.

But do financial incentives motivate people? The answer, according to Kohn, A (1993) is absolutely not. He challenges what he calls the behaviourist dogma about money and motivation. And he claims that ' no controlled scientific study has ever found a long term enhancement of the quality of work as a result of any reward system'. When you look at how people are motivated, claims Kohn, ' It becomes disturbingly clear that the more you use rewards to " motivate" people, the more they tend to lose interest in whatever they had to do to get the rewards.' He quotes research that has ' repeatedly shown that the more salient or reinforcing the reward is, the more it erodes intrinsic interest' and points out that ' various devices can be used to get people to do something, but that is a far cry from making people want to do something'.

Pfeffer, J (1998) also contends that: ' People do work