Key concepts and terms

- Base pay
- Contingent pay
- Employee benefits
- Grade and pay structure
- Job evaluation
- Market rate analysis
- Non-financial rewards
- Relational rewards
- Reward management
- Reward strategy
- Reward system
- Total remuneration
- Total reward
- Transactional rewards

Learning outcomes

On completing this chapter you should be able to define these key concepts. You should also know about:

- The aims of reward management
- The economic theories explaining pay levels
- The content of reward strategy
- Developing reward strategies
- Implementing reward strategy
- The philosophy of reward management
- Total reward
- Guiding principles for reward
- Components of an effective reward strategy
- Developing line management capability
Introduction

This chapter provides an overview of reward management. The concept of reward management, its aims and its philosophy, are discussed initially. Reference is also made to the economic factors that affect levels of pay. This is followed by a description of the elements of a reward management system and the concept of total reward. The chapter continues with an examination of the process of strategic reward and concludes with a discussion of the role of line managers in reward management.

Reward management 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. 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. Reward can be regarded as the fundamental expression of the employment relationship.

The aims of reward management

- 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 behaviours 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; 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’.
- 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 Jaques (1961)).
The philosophy of reward management

Reward management is based on a well-articulated philosophy – a set of beliefs and guiding principles that are consistent with the values of the organization and help to enact them. These include beliefs in the need to achieve fairness, equity, consistency and transparency in operating the reward system. The philosophy recognizes that if HRM is about investing in human capital from which a reasonable return is required, then it is proper to reward people differentially according to their contribution (i.e., the return on investment they generate).

The philosophy of reward management recognizes that it must be strategic in the sense that it addresses longer-term issues relating to how people should be valued for what they do and what they achieve. Reward strategies and the processes that are required to implement them have to flow from the business strategy.

Reward management adopts a ‘total reward’ approach which emphasizes the importance of considering all aspects of reward as a coherent whole which is integrated with other HR initiatives designed to achieve the motivation, commitment, engagement and development of employees. This requires the integration of reward strategies with other human resource management (HRM) strategies, especially those concerning human resource development. Reward management is an integral part of an HRM approach to managing people.

The philosophy will be affected by the business and HR strategies of the organization, the significance attached to reward matters by top management and the internal and external environment of the organization. The external environment includes the levels of pay in the labour market (market rates) and it is helpful to be aware of the economic theories that explain how these levels are determined as summarized in Table 46.1.

<table>
<thead>
<tr>
<th>Apply equitably – people are rewarded appropriately in relation to others within the organization, relativities between jobs are measured as objectively as possible and equal pay is provided for work of equal value.</th>
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<tbody>
<tr>
<td>Function consistently – decisions on pay do not vary arbitrarily and without due cause between different people or at different times.</td>
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<tr>
<td>Operate transparently – people understand how reward processes operate and how they are affected by them.</td>
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Table 46.1 Economic theories explaining pay levels

<table>
<thead>
<tr>
<th>Name of theory</th>
<th>Summary of theory</th>
<th>Practical significance</th>
</tr>
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<tbody>
<tr>
<td>The law of supply and demand</td>
<td>Other things being equal, if there is a surplus of labour and supply exceeds the demand, pay levels go down; if there is a scarcity of labour and demand exceeds the supply, pay goes up</td>
<td>Emphasizes the importance of labour market factors in affecting market rates</td>
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<tr>
<td>Efficiency wage theory</td>
<td>Firms will pay more than the market rate because they believe that high levels of pay will contribute to increases in productivity by motivating superior performance, attracting better candidates, reducing labour turnover and persuading workers that they are being treated fairly. This theory is also known as ‘the economy of high wages’</td>
<td>Organizations use efficiency wage theory (although they will not call it that) when they formulate pay policies that place them as market leaders or at least above the average</td>
</tr>
<tr>
<td>Human capital theory</td>
<td>Workers have a set of skills developed by education and training that generates a stock of productive capital</td>
<td>Employees and employers each derive benefits from investment in creating human capital. The level of pay should supply both parties with a reasonable return on that investment</td>
</tr>
<tr>
<td>Agency theory</td>
<td>The owners of a firm (the principals) are separate from the employees (the agents). This difference can create ‘agency costs’ because the agents may not be as productive as the principals. The latter therefore have to devise ways of motivating and controlling the efforts of the former</td>
<td>A system of incentives is needed to motivate and reward acceptable behaviour. This process of ‘incentive alignment’ consists of paying for measurable results that are deemed to be in the best interests of the owners</td>
</tr>
<tr>
<td>The effort bargain</td>
<td>Workers aim to strike a bargain about the relationship between what they regard as a reasonable contribution and what their employer is prepared to offer to elicit that contribution</td>
<td>Management has to assess what level and type of inducements it has to offer in return for the contribution it requires from its workforce</td>
</tr>
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</table>
The reward system

A reward system consists of a number of interrelated processes and activities which combine to ensure that reward management is carried out effectively to the benefit of the organization and the people who work there. These are described below.

Reward strategy

Reward strategy sets out what the organization intends to do in the longer term to develop and implement reward policies, practices and processes which will further the achievement of its business goals.

Reward policies

Reward policies address the following broad issues:

- the level of rewards taking into account ‘market stance’ – how internal rates of pay should compare with market rates, eg aligned to the median or the upper quartile rate;
- achieving equal pay;
- the relative importance attached to external competitiveness and internal equity;
- the approach to total reward;
- the scope for the use of contingent rewards related to performance, competence, contribution or skill;
- the role of line managers;
- transparency – the publication of information on reward structures and processes to employees.

Total reward

Total reward is the combination of financial and non-financial rewards available to employees.

Total remuneration

Total remuneration is the value of all cash payments (total earnings) and benefits received by employees.
Base or basic pay

The base rate is the amount of pay (the fixed salary or wage) that constitutes the rate for the job. It may be varied according to the grade of the job or, for manual workers, the level of skill required.

Base pay will be influenced by internal and external relativities. The internal relativities may be measured by some form of job evaluation. External relativities are assessed by tracking market rates. Alternatively, levels of pay may be agreed through collective bargaining with trade unions or by reaching individual agreements.

Base pay may be expressed as an annual, weekly or hourly rate. For manual workers this may be an hourly rate which is called a time rate. Allowances for overtime, shift working, unsocial hours or increased cost of living in London or elsewhere may be added to base pay. The base rate may be adjusted to reflect increases in the cost of living or market rates by the organization unilaterally or by agreement with a trade union.

Job evaluation

Job evaluation is a systematic process for defining the relative worth or size of jobs within an organization in order to establish internal relativities and provide the basis for designing an equitable grade structure, grading jobs in the structure and managing relativities. It does not determine the level of pay directly. Job evaluation can be analytical or non-analytical. It is based on the analysis of jobs or roles which leads to the production of job descriptions or role profiles. Job evaluation is described in Chapter 47.

Market rate analysis

Market rate analysis is the process of identifying the rates of pay in the labour market for comparable jobs to inform decisions on levels of pay within the organization. A policy decision may be made on how internal rates of pay should compare with external rates – an organization’s market stance. Market rate analysis is described in Chapter 48.

Grade and pay structures

Jobs may be placed in a graded structure according to their relative size. Pay levels in the structure are influenced by market rates. The pay structure may consist of pay ranges attached to grades which provide scope for pay progression based on performance, competence, contribution or service. Alternatively, ‘spot rates’ or ‘individual job grades’ structure may be used for all or some jobs in which no provision is made for pay progression in a job. The various types of grade and pay structures are described in Chapter 49.
Contingent pay

Additional financial rewards may be provided that are related to performance, competence, contribution, skill or service in the grade. These are referred to as ‘contingent pay’. Contingent payments may be added to base pay, i.e. ‘consolidated’. If such payments are not consolidated (i.e. paid as cash bonuses) they are described as ‘variable pay’. Contingent pay schemes are described in Chapter 50.

Employee benefits

Employee benefits include pensions, sick pay, insurance cover, company cars and a number of other ‘perks’ as described in Chapter 52. They comprise elements of remuneration additional to the various forms of cash pay and also include provisions for employees that are not strictly remuneration, such as annual holidays.

Performance management

Performance management processes (see Part VII)) define individual performance and contribution expectations, assess performance against those expectations, provide for regular constructive feedback and result in agreed plans for performance improvement, learning and personal development. They are a means of providing non-financial motivation and may also inform contingent pay decisions.

Non-financial rewards

Rewards which do not involve any direct payments and often arise from the work itself, for example, achievement, autonomy, recognition, scope to use and develop skills, training, career development opportunities and high quality leadership.

The interrelationships of these elements of the reward system are shown in Figure 46.1.

Total reward

The concept of total reward is exerting considerable influence on reward management. This section of the chapter begins by defining what it means. The importance of the concept is then explained and the section continues with an analysis of the components of total reward. It concludes with a description of how a total reward approach to reward management can be developed.
Total reward defined

As defined by Manus and Graham (2003), total reward ‘includes all types of rewards – indirect as well as direct, and intrinsic as well as extrinsic’. Each aspect of reward, namely base pay, contingent pay, employee benefits and non-financial rewards, which include intrinsic rewards from the work itself, are linked together and treated as an integrated and coherent whole. Total reward combines the impact of the two major categories of reward: 1) transactional rewards – tangible rewards arising from transactions between the employer and employees concerning pay and benefits, and 2) relational rewards – intangible rewards concerned with learning and development and the work experience; see Figure 46.2.
A total reward approach is holistic; reliance is not placed on one or two reward mechanisms operating in isolation, account is taken of every way in which people can be rewarded and obtain satisfaction through their work. The aim is to maximize the combined impact of a wide range of reward initiatives on motivation, commitment and job engagement. As Sandra O’Neal (1998) has explained: ‘Total reward embraces everything that employees value in the employment relationship’.

An equally wide definition of total reward is offered by WorldatWork (2000) who state that total rewards are ‘all of the employer’s available tools that may be used to attract, retain, motivate and satisfy employees.

**Total reward, defined by Thompson (2002)**

Definitions of total reward typically encompass not only traditional, quantifiable elements like salary, variable pay and benefits, but also more intangible non-cash elements such as scope to achieve and exercise responsibility, career opportunities, learning and development, the intrinsic motivation provided by the work itself and the quality of working life provided by the organization.

The conceptual basis of total rewards is that of configuration or ‘bundling’, so that different reward processes are interrelated, complementary and mutually reinforcing. Total reward
strategies are vertically integrated with business strategies, but they are also horizontally integrated with other HR strategies to achieve internal consistency.

The significance of total reward

Essentially, the notion of total reward says that there is more to rewarding people than throwing money at them. For O’Neal (1998), a total reward strategy is critical to addressing the issues created by recruitment and retention as well as providing a means of influencing behaviour: ‘It can help create a work experience that meets the needs of employees and encourages them to contribute extra effort, by developing a deal that addresses a broad range of issues and by spending reward dollars where they will be most effective in addressing workers’ shifting values.’

A powerful argument for total rewards, Pfeffer (1998b)

Creating a fun, challenging, and empowered work environment in which individuals are able to use their abilities to do meaningful jobs for which they are shown appreciation is likely to be a more certain way to enhance motivation and performance – even though creating such an environment may be more difficult and take more time than simply turning the reward lever.

The benefits of a total reward approach are:

- Greater impact – the combined effect of the different types of rewards will make a deeper and longer-lasting impact on the motivation and commitment of people.
- Enhancing the employment relationship – the employment relationship created by a total rewards approach makes the maximum use of relational as well as transactional rewards and will therefore appeal more to individuals.
- Flexibility to meet individual needs – as pointed out by Milkovich and Bloom (1998): ‘Relational rewards may bind individuals more strongly to the organization because they can answer those special individual needs’.
- Talent management – relational rewards help to deliver a positive psychological contract and this can serve as a differentiator in the recruitment market which is much more difficult to replicate than individual pay practices. The organization can become an ‘employer of choice’ and ‘a great place to work’ thus attracting and retaining the talented people it needs.
The Towers Perrin model of total reward

A Towers Perrin model of total reward is shown in Figure 46.3.

The upper two quadrants – pay and benefits – represent transactional rewards. These are financial in nature and are essential to recruit and retain staff but can be easily copied by competitors. By contrast, the relational (non-financial) rewards produced by the lower two quadrants are essential to enhancing the value of the upper two quadrants. The real power, as Thompson (2002) states, comes when organizations combine relational and transactional rewards.
Reward strategy

Reward strategies provide answers to two basic questions: 1) where do we want our reward practices to be in a few years’ time? and 2) how do we intend to get there? They therefore deal with both ends and means. As an end they describe a vision of what reward processes will look like in a few years’ time. As a means, they show how it is expected that the vision will be realized.

Reward strategy defined

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.

Why have a reward strategy?

In the words of Brown (2001): ‘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.’

Arguments for developing reward strategies

- You must have some idea where you are going, or how do you know how to get there, and how do you know that you have arrived (if you ever do)?
- Pay costs in most organizations are by far the largest item of expense – they can be 60 per cent and often much more in labour intensive organizations – so doesn’t it make sense to think about how they should be managed and invested in the longer term?
- There can be a positive relationship between rewards, in the broadest sense, and performance, so shouldn’t we think about how we can strengthen that link?
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

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; and 5) clarifying what behaviours will be rewarded and why.

Specific reward initiatives

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, eg a broad-graded or career family structure;

As Cox and Purcell (1998) write: ‘The real benefit in reward strategies lies in complex linkages with other human resource management policies and practices’. Isn’t this a good reason for developing a reward strategic framework which indicates how reward processes will be associated with HR processes so that they are coherent and mutually supportive?
the replacement of an existing decayed job evaluation scheme with a computerized scheme which more clearly reflects organizational values;

the improvement of performance management processes so that they provide better support for the development of a performance culture and more clearly identify development needs;

the introduction of a formal recognition scheme;

the development of a flexible benefits system;

the conduct of equal pay reviews with the objective of ensuring that work of equal value is paid equally;

communication programmes designed to inform everyone of the reward policies and practices of the organization;

training, coaching and guidance programmes designed to increase line management capability (see also the last section of this chapter).

Guiding principles for reward

Guiding principles define the approach an organization takes to dealing with reward. They are the basis for reward policies and provide guidelines for the actions contained in the reward strategy. They express the reward philosophy of the organization – its values and beliefs about how people should be rewarded.

Members of the organization should be involved in the definition of guiding principles which can then be communicated to everyone to increase understanding of what underpins reward policies and practices. However, employees will suspend their judgement of the principles until they experience how they are applied. What matters to them are not the philosophies themselves but the pay practices emanating from them and the messages about the employment ‘deal’ that they get as a consequence. It is the reality that is important, not the rhetoric.

Reward guiding principles

- Develop reward policies and practices which support the achievement of business goals.
- Provide rewards which attract, retain and motivate staff and help to develop a high performance culture.
- Maintain competitive rates of pay.
- Reward people according to their contribution.
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.

A logical step-by-step model for doing this is illustrated in Figure 46.4. This incorporates ample provision for consultation, involvement and communication with stakeholders who include senior managers as the ultimate decision makers as well as employees and line managers.

In practice, however, the formulation of reward strategy is seldom as logical and linear a process as this. As explained in Chapter 3, strategies evolve. Reward strategists have to respond to changes in organizational requirements which are happening all the time. They need to track emerging trends in reward management and may modify their views accordingly, as long as they do not leap too hastily on the latest bandwagon.

It may be helpful to set out reward strategies on paper for the record and as a basis for planning and communication. But this should be regarded as no more than a piece of paper that can be torn up when needs change – as they will – not a tablet of stone.

Components of an effective reward strategy

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.
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.

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.

**Reward management and line management capability**

The trend is to devolve more responsibility for managing reward to line managers. Some will have the ability to respond to the challenge and opportunity; others will be incapable of carrying out this responsibility without close guidance from HR; some may never be able to cope. Managers may not always do what HR expects them to do and if compelled to, they may be half-hearted about it. This puts a tremendous onus on HR and reward specialists to develop line management capability, to initiate processes which can readily be implemented by line managers, to promote understanding by communicating what is happening, why it is happening and how it will affect everyone, to provide guidance and help where required and to provide formal training as necessary.

**Reward management – key learning points**

**The aims of reward management**

The three most important aims of reward management are to:

1. Reward people according to what the organization values and wants to pay for.
2. Reward people for the value they create.
3. Reward the right things to convey the right message about what is important in terms of behaviours and outcomes.

**The philosophy of reward management**

A belief in the need to achieve fairness, equity, consistency and transparency in operating the reward system.

**The economic theories explaining pay levels**

See Table 46.1.

**Total reward**

Each aspect of reward, namely base pay, contingent pay, employee benefits and non-financial rewards, which include intrinsic rewards from the work itself, are linked together and treated as an integrated and coherent whole.

**Broad-brush reward strategies**

To achieve an appropriate balance between financial and non-financial rewards, develop commitment and engagement and provide more opportunities for the contribution of people to be valued and recognized.
Reward management – key learning points (continued)

**Specific reward strategy areas**
Could include the introduction of a new contingent pay scheme, a new pay structure or job evaluation.

**Guiding principles for reward**
Three key guiding principles are:

1. Develop reward policies and practices which support the achievement of business goals.
2. Provide rewards which attract, retain and motivate staff and help to develop a high performance culture.
3. Maintain competitive rates of pay.

**Developing reward strategies**
The formulation of reward strategy can be described as a process for developing and defining a sense of direction. The main phases are: diagnosis, detailed design, final testing and preparation, and implementation.

**Components of an effective reward strategy**
According to Brown (2001) 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.

**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.

**Developing line management capability**
HR and reward specialists need to develop line management capability by initiating processes which can readily be implemented by line managers, promoting understanding by communicating what is happening, why it is happening and how it will affect everyone, providing guidance and help where required and providing formal training as necessary.

Questions

1. You have been invited to give a brief talk to your local CIP branch entitled ‘Total reward systems: how employees benefit’. Outline and justify the main points you would include in the talk.
Questions

2. What are the key areas in which reward policies need to be formulated? Illustrate your answer with examples from your own organization.

3. Drawing on research evidence and good practice, review reward strategies in your organization in terms of their impact on organizational performance. Outline any changes that you think are necessary.

4. In his highly influential book, Strategic Pay, 1990, Ed Lawler wrote that: ‘The challenge is to develop pay programmes that support and reinforce the business objectives of the organization and the kind of culture, climate and behaviour that are needed for the organization to be effective’. How can reward policies and practices support the achievement of business goals?

5. In another influential book, The New Pay, 1992, Jay Schuster and Patricia Zingheim wrote that: ‘Employees have the right to determine whether the values, culture and reward systems of the organization match their own’. What does that tell us about an organization’s reward practices?

References

Brown, D (2001) Reward Strategies; From intent to impact, CIPD, London
Thompson, A A and Strickland, A J (1990) *Strategic Management: Concepts and cases*, Irwin, Georgetown, Ontario

