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A SHRM Perspective on International Compensation and Reward Systems

Matt Bloom
University of Notre Dame

George T. Milkovich
Cornell University

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Abstract

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Keywords

human resource, SHRM, research, theory, organization, work, compensation, China, system

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A SHRM Perspective on International Compensation and Reward Systems

Matt Bloom
George T. Milkovich

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A SHRM PERSPECTIVE ON INTERNATIONAL COMPENSATION AND REWARD SYSTEMS

Matt Bloom
Department of Management
College of Business Administration
University of Notre Dame
Notre Dame, Indiana 46556-0399
(219) 631-5104
FAX: 631-5255
mbloom@nd.edu

George T. Milkovich
Center for Advanced Human Resource Studies
ILR School/Cornell University
Ithaca, New York 14850-3901
(607) 255-4470
FAX: (607) 257-6639
gtm1@cornell.edu

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This paper has not undergone formal review or approval of the faculty of the ILR School. It is intended to make results of Center research available to others interested in preliminary form to encourage discussion and suggestions.

ABSTRACT

We re-examine the efficacy of the SHRM perspective from the vantage point of a specific HRM system, international compensation and rewards, to gain new insights into existing conceptual models. Looking at SHRM from the ground up suggests that, to continue informing our understanding of the HRM-organizational effectiveness (OE) relationship, research will need to adopt richer theory and measures of specific HRM systems and extrapolate important contextual factors that influence relationships between OE and specific HRM systems.

An accepted view of strategic human resource management (SHRM) is that there is a large positive relationship between organization effectiveness (OE) and HRM practices (Becker and Gerhart, 1996; Becker and Huselid, in press; McMahan, Virick and Wright in the companion volume). Several recent empirical studies support this view (see Becker and Gerhart, 1996 for a review; Arthur 1994; Huselid 1995; Huselid and Becker 1996). Gerhart (in the companion volume) summarizes these studies; "...one standard deviation increase in HRM variables is associated with a 20 percent increase in profitability." However, he urges caution before accepting or acting on these findings, noting significant methods (single HR manager as rater) and measurement (random and systematic) error concerns. Others throughout this and the companion volume raise similar and additional concerns about the validity of these findings. Addressing these concerns requires re-examining and challenging existing conceptual models.

While all the other papers in this collection take the macro perspective, we re-examine SHRM from the ground up, still asking what is the efficacy of strategic models of HRM, but from the vantage point of a specific HRM system — international compensation and rewards. We are studying the changes that international compensation and reward systems are undergoing, seeking to understand what factors are contributing to these changes, and which changes support organizational effectiveness and which do not. One focus of our research is systems — investigating how international compensation and rewards are being transformed to fit or support OE and are linked to other HRM systems. We take the search for synergies among HRM practices into compensation and reward systems. Another focus of our research is context — examining how compensation systems in multinational organizations are changing in response to global economic pressures, changing social contracts and evolving cultures. Over twenty years ago Mahoney (1979) urged that compensation systems cannot be understood abstracted away from the context in which they occur. Since that time, compensation research has produced evidence to support this assertion (Gerhart & Milkovich, 1992; Gomez-Mejia & Balkin, 1992). Yet, context is overlooked in much SHRM research. Concentrating on context and systems helps extend the strategic perspective of SHRM into a global context and simultaneously narrows the focus to particular HR decisions, those involving compensation and rewards. Like the other papers in this volume, we pursue the core issue in SHRM research — understanding the HRM-OE relationship. Two challenges guide our reexamination: (1) Explore the importance of going in-depth into HR systems to measure

relevant attributes, and (2) Demonstrate the need to extend strategic perspectives of HRM to include critical contextual factors found in international settings.

Going Deeper into HRM Practices: Is the Devil in the Detail?

One approach to increasing the usefulness of SHRM is to improve our understanding of why OE may be related to HRM. Dyer and Schafer (in this volume) call this a “theoretical and empirical black box.” We suggest that one way to make that box more transparent is to better understand, theoretically and empirically, what matters in each HR system and under what conditions it matters. SHRM research has tended to define and measure so-called “strategic” attributes of compensation and reward systems dichotomously and sparingly, as in those that are/are not based upon performance (MacDuffie, 1995; Huselid, 1995). The notion of group-based pay may be included in SHRM research, but only in the broadest sense. This skimming of the surface risks missing the relevant richness of HRM practices.

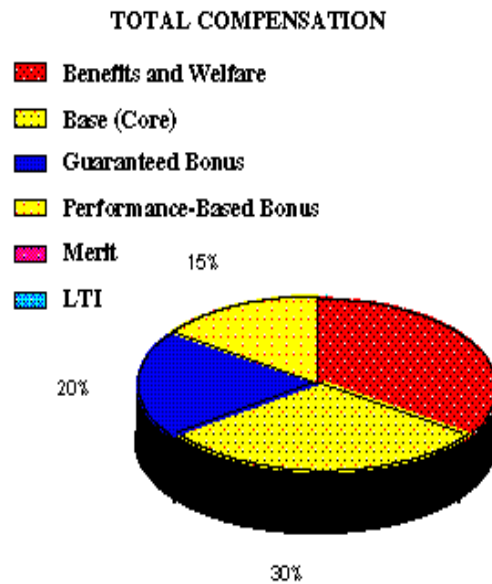
Compensation research (based primarily on U.S. data) has clearly demonstrated that whether or not compensation is performance-based is only one of several relevant dimensions of compensation and reward systems. Indeed, the preponderance of research evidence is that other aspects of the compensation system and the context in which they operate influence the effects of incentives. Factors found to influence the pay-organization performance relationship include organizations’ past profitability (Abowd, 1990), ownership and governance (Werner and Tosi, 1995), financial risk (Beatty and Zajac, 1994; Bloom and Milkovich, in press) and international marginal tax rates (Bognanno and Abowd, 1992). Factors found to influence the individual pay-performance relationship include trust in the relationship (Collins, Hatcher and Ross, 1993), size of the pay increase (Mitra, Gupta and Jenkins, 1992), line of sight (Pritchard, DeLeo, and von Bergin, 1976) and so on.

Recently published evidence illustrates this concern. The long-held belief that there is essentially no correlation between firm performance and CEO pay may be based upon incomplete measurement of CEO compensation. The “zero correlation” findings are based only on measures of base salary plus annual cash bonus (Murphy and Jensen, 1990). By including the value of stock options, which form a substantial percent of U.S. CEO compensation, Hall and Liebman (1997) report very large CEO pay-to-organization performance sensitivity. Our point is not whether CEO pay is or is not related to performance; it is that including relevant variables and measures is a necessary condition for making the HRM-OE black box more transparent. The richness of the findings in compensation research is often abstracted away in SHRM research. While parsimony may be required, including

theoretically and empirically relevant variables is a necessary condition for specifying strategic models.

Another way to increase the usefulness of SHRM is to apply its concepts to each HR system. Patterns are important in SHRM. As noted, recent SHRM research evidence reports significant relationships between organizational effectiveness and sets of HRM systems (Becker and Huselid, in press). The logic is that HRM systems can contribute to organizational success when there is a coherent pattern of links between systems and organizational strategy. Recent SHRM research also finds that synergies exist among HRM systems (e.g., high performance work systems) and may be integral to fostering organizational effectiveness. Huselid (1995) calls these patterns “systems of HRM practices” and MacDuffie (1995) and Cappelli and Singh (1992) refer to them as “HR bundles.” Regardless of the terms, the underlying premise, supported by some research, is that the inter-relationships among HRM systems are critical so that the systems hang together, support a common set of objectives, and are all directed toward acquiring, developing, and maintaining human resources. Thus, it is basic to SHRM that there must be some underlying pattern that creates coherence *among* HRM systems.

Extending this concept to patterns *within* a single HRM system may improve understanding of the HRM-OE relationship. Organizations typically offer a variety of returns, both financial and non-financial, with the expectation that they will somehow contribute to organization effectiveness. As one looks across organizations, a wide variety of total returns are offered. These can include, as Figure 1 illustrates, total remuneration (cash, allowances, and long-term incentives) as well as employment security conditions, flexible work schedules, opportunities to learn, and so on. If patterns do matter, then the variety of returns offered by an organization should also adhere to some pattern to be of strategic consequence. Extending SHRM logic, coherence (a pattern) among the total returns may be more likely to send mutually supporting signals and have congruent motivational effects. The various patterns of returns, financial and non-financial, may influence peoples’ willingness to share the insights and tacit knowledge required to achieve and sustain competitive advantage (Milkovich and Bloom, 1998; Osterman, 1992). Financial returns alone may not extract the unique, value-adding ideas and behaviors possessed by employees.



Extending SHRM Theory: Trying to Boil the Ocean?

Rather than accepting organization strategy as the primary determinant of SHRM, we join with Kochan (in this volume; Lock, Kochan, and Piore, 1995) and others in this volume to stress the importance of extending SHRM to include additional contextual factors if a strategic perspective is going to be useful in understanding and informing changes in international compensation and reward systems. However, enumerating all the potentially relevant contextual factors without support from empirically grounded theory is dangerous; “strategic perspectives” may simply be determined by whoever can weave the best descriptions or anecdotes. Our particular solution to this dilemma is to rely on the international compensation and reward research literature to extract contextually relevant factors for understanding changes in international compensation and reward systems.

Our thesis is that examining the changes underway in international compensation and reward systems can aid us in assessing the efficacy of adopting a strategic perspective on HRM. We believe that the usefulness of SHRM will require (1) drilling deeper into specific HR systems to study the coherence of decisions within each system; (2) identifying the contextual factors, particularly in global setting, which affect the HRM-organization effectiveness relationship, (3) improving the specification of the relationships between specific HRM systems (in our case compensation and rewards) and organization competitive advantage, and (4) elaborating the SHRM perspective to include employment relationships.

STRATEGIC PERSPECTIVES ON INTERNATIONAL COMPENSATION

Much of the existing work on strategic perspectives in international compensation takes the contingent model—that compensation systems must fit with (support) organizational goals and objectives—as a given. While this model offers a framework for discussion and thinking about strategic choices in compensation, it suffers all the problems raised by others in this volume (ambiguous levels of analysis, unreliable and deficient measures, temporal vagaries, unspecified definitions of fit and alignment, lack of strong theoretical models). Applying the strategic-contingent framework in an international setting increases the importance and complexity of these issues. Most of the current work attempts to overcome these international complexities by one of two approaches. The first is to examine developments in a single nation or region that the researcher implicitly or explicitly compares to their own. Giacobbe-Miller, Miller, and Victorov's (1998) survey of compensation approaches in Russia, Globokar's (1997) study of an automobile plant in Slovenia and Locke's (1998) study of the decline of solidarity in which he reports the increasing wage differentiation emerging in Sweden and Italy are examples. The second is to contrast a number of countries in a single study. Gomez-Mejia and Welbourne's (1996) account of compensation strategies in a global context and Luthans, Marsnik, and Luthans' (1997) application of a contingent matrix model to international HRM illustrates the multiple nation approach. Each has advantages and disadvantages. Concentrating on a single country allows more in-depth analysis but risks generalizability by abstracting away relevant details which may help improve understanding of developments in compensation and reward systems. Comparative analysis of a set of countries gains perspective but at a cost of depth of knowledge about any variability within countries.

A related literature (Ferner, 1997; Guest & Hogue, 1996) examines the effects country of origin has on the compensation and rewards systems adopted by multinationals in their foreign operations. A “national business systems” view is that multinationals remain rooted in their country of origin and their “national systems” are exported, insofar as local institutions permit and can absorb them. The national culturalists, on the other hand, seem persuaded that local cultural values are the primary influence on compensation and reward systems and how well multinational systems will travel. Are the alleged long term and egalitarian policies of Japanese and German organizations exported to their foreign compensation and reward practices or do local cultural factors prevail? The dominant belief in the literature is that both nationality of ownership and local cultures are significant contextual factors and hence must be included in an extended SHRM model. Roth and O'Donnell (1997) studied if greater cultural

distance between a firm's headquarters and its foreign subsidiary created greater agency problems (information asymmetry and risk aversion) and, therefore, affected the subsidiaries compensation system. They reported that cultural distance was not related to the percent of incentives in subsidiary manager pay, but the extent to which they identified with their nation relative to the company was related to pay. Their findings further muddy the waters in understanding the relative effects of ownership and so-called national versus organizational culture.

While studies of national culture and national business models of compensation may be an important first step in understanding international compensation and reward systems, they face the same serious limitations as traditional comparative models of HRM (Brewster, Tregaskis, Hegewisch, & Mayne, 1996; Locke, Kochan, & Piore, 1995): that national borders largely define the important contextual features (e.g., national economic, demographic, and cultural conditions) that must be considered when developing HRM systems that fit (i.e., support organizational strategy); that the differences between nations are greater and more salient to understanding international compensation than differences within nations, and that something called "national culture" or national HR systems exist and are a significant determinant of international HRM (e.g., compensation) approaches.

Nations and Regions Versus Organizations and Markets

Does it make sense to study international compensation as distinctly national systems when there appears to be considerable variation in compensation and reward systems within nations as well as between them? Can we derive more useful models to understand the HRM-organization effectiveness relationships if we include within-nation variations? Recent studies describing systems in modern China report substantial differences in pay and reward systems based on the governance and ownership of the enterprise (Chow, 1989; Groves, Hong, McMillan, & Naughton, 1994; Verma & Zhiming, 1995). In general, the pay packages provided in state-owned enterprises emphasize services, benefit allowances (housing, food, health care, child care, etc.) and relatively lower cash, whereas joint ventures and wholly-owned foreign subsidiaries use widely divergent approaches, some emphasizing highly risky variable pay, others emphasizing careers, training opportunities, and moderate cash. Morishima's (1995; this volume) study of Japanese companies' HR strategies reports differences in compensation approaches associated with organization profitability, size, degree of unionization, capital-labor ratio, and exposure to global competitive forces. For example, Japanese companies operating in protected domestic markets are more likely to use the more traditional *nenko* system than

those competing in global and less protected market which reported using more performance- and ability-based schemes (Morishima, 1992, 1995; Sano, 1993). Lee, Scarpello, and Rockman (1995) found that factors such as labor market conditions, customer and supplier relations, economic conditions and technology accounted for differences in compensation strategies among Korean chaebols. Pearce, Branyiczki, & Bakacsi's (1994) study of compensation systems in Hungarian and US companies suggests that political, economic, and institutional forces, rather than national cultures, explain differences in compensation practices. Yeung and Wong (1990) assert that organizational goals, political forces, labor market conditions, and demographic factors explain differences in pay and other HRM systems in Japan and the People's Republic of China. Recent surveys in Central European countries such as Slovenia and Slovakia also report differences in the use of variable performance-based pay schemes, allowances and services, and even in the ratios of top managing directors' salaries to the average workforce (Bajzikova, 1996; Zupan, 1995). Although the recent evidence does not suggest national boundaries (national pay systems) can be ignored or overlooked, it does suggest that sufficient discretion for individual organizations exists within these national systems to allow organizations to adopt compensation and reward systems to align them with the organization's business strategies. We believe that from a strategic perspective, organizations and markets are more appropriate units of analysis for understanding changes in international compensation and rewards.

The Significance of National Cultures for Compensation and Reward Systems

The assumption that HRM systems must fit national cultures is based on the belief that "most of a country's inhabitants share a national character..." that is "...the collective programming of the mind which distinguishes one category of people from another...the category of people is the nation (Hofstede, 1993: 89)." This belief leads to a search for distinct national cultures whose influence is critical, if not the most important, for understanding international compensation systems (Earley & Erez, 1997; Hofstede, 1993; Rousseau & Tinsley, 1997). Typical of the national culture model is Gomez-Mejia and Welbourne's (1996) work in which they caution scholars and managers about exporting theories and practices derived from U.S.-based research and experience. Their strategic model relies on national cultural attributes such as those proposed by Hofstede (1980; power distance, individualism-collectivism, uncertainty avoidance, and masculinity/femininity) or Trompenaars (1994; individualism versus collectivism, achievement versus ascription, universalism versus

particularism, neutral versus affective, specific versus diffuse). Luthans et al. (1997) explicate this international HRM contingency model using national cultural attributes as the dominant determinant. Accordingly, countries with high power distance scores (Malaysia and Mexico) should exhibit more hierarchical pay structures, while those manifesting low power distance (Australia and the Netherlands) would choose more egalitarian systems. In nations identified as individualistic (US, UK, Canada), compensation and rewards would support employability and individual and performance-based pay. Those in more collectivist nations (Singapore, Japan) would choose more group-based approaches, and so on (Welbourne & Gomez-Mejia, 1996). This literature on national culture models is implicitly prescriptive; it dictates that compensation and reward policies must be developed to align with and reinforce national cultural attributes. The national cultural model predicts these *national* level attributes will be more significant than *organizational* level attributes. One reaction to such thinking is that it engenders blatant stereotyping. We fear it parallels biased notions that all women desire time off because of their caring and nurturing values, while all men desire more time at work to pursue their more aggressive values.

It has long been recognized that compensation and reward systems, because of their social as well as economic significance, exemplify and reinforce cultural norms (Mahoney, 1979; Tolles, 1964; Belcher, 1955; Schloss, 1898). However, none of these early writers suggested that social and cultural norms necessarily coincided or were equivalent with national boundaries. Indeed, 100 years ago, Schloss (1898) recognized that organizations (e.g., mining and textile companies) developed their own unique social norms, and that the compensation systems of these companies were related to these norms. We believe that the national culture model requires a leap of logic by defining social norms and cultural values as primarily national in character rather than held by smaller groups of people. Geopolitical boundaries do not alone determine cultural values and social norms. This obvious point matters when examining a strategic perspective toward international compensation. Anecdotal and empirical evidence suggests that organizations and local cultural values *within* a nation are probably necessary contextual variables to consider. Nations are comprised of subgroups and cultures. The former Czechoslovakia included Czechs and Slovaks; now each of these two republics includes groups which are reported to exhibit Hungarian and Roman cultural characteristics. Historically, China is a composite of several groups and even today in modern China, Chinese make culturally laden distinctions between Shanghai, Beijing, and Hong Kong. Listening to political pundits during election time, one quickly realizes that the United States is comprised of many

different subcultures which do not conform to geographic boundaries (for example, in the U.S. groups with strong cultures may include orthodox Jews, Amish & other Mennonites, jazz musicians, professional athletes, and academics). As pluralism and other influences of globalization increase around the world, some cultural researchers believe that the cultures of small subgroups will continue to become much more important for shaping human behavior than norms at larger societal or national levels (Berger & Luckmann, 1995). Even when viewed at the national cultural level, revisions may already have occurred. Chen's (1995) data suggest that work-related values are changing in China and the U.S. and that these changes are related to differences in reward allocation preferences.

Indeed, management research is beginning to present evidence that suggests national cultures may not be the correct level of analysis. For example, Wagner (1995) found significant variation in values toward individualism within one culture and that this variation predicted differences in cooperation within groups. Bloom, Milkovich & Zupan (1997) studied values toward individualism-collectivism and risk taking among employees from four companies, two in the U.S. and two in Slovenia. Distributions of the scores from measures of these two values were created for each country. The means of these intra-country distributions were slightly different; Slovenian employees tended to be more risk-taking and individualistic than U.S. employees (We note that Hofstede's [1980] work suggested that Yugoslavs, of which Slovenia is a former republic, should be risk averse and collectivistic). The striking feature, however, was that the variances of the distributions were virtually the same. Thus, there is significant overlap between the two distributions: One can find risk averse collectivists and risk taking individualists in the U.S., Slovenia, and most likely many other national cultures. This research suggests it may be misleading to pay attention to mean levels across national cultures without accounting for the significant variation *within* countries. Studies by Fahr, Early, and Lin (1997) and Wagner (1995) show effects of cultural diversity (individualistic versus collectives, risk aversion, etc.) can be studied within a nation rather than among nations. Consequently, it may be erroneous to use national origin as a proxy for cultural attributes. Closer scrutiny may reveal that political, economic, institutional, and other forces rather than national culture explain a significant amount of variation in the expressed desires of employees from different countries (Lee, et al., 1995; Pearce, et al., 1994; Yeung & Wong, 1990). For example, U.S. workers want two weeks vacation, not because of culture, but because that is the norm in the U.S. In Germany, it is likely to be one month of vacation. Transfer a U.S. worker to a German company, and s/he will likely grow accustomed to and want the month; two weeks is no longer

sufficient. Transfer a German to the U.S. and health care insurance, bonuses and options become more important than vacation, which the worker couldn't use anyway.

National Systems: The Importance of Differences Within versus Differences Between

Are compensation and reward systems in a global context better understood by examining competitive strategies of specific enterprises as well as by focusing on differences in national culture and institutions (e.g., national and industry-wide wage agreements)? Obviously, national public policy—which reflects social contracts among unions, employers, financial institutions and people—are important influences on compensation and reward systems.

Comparative description and analysis continues to dominate the international compensation literature (see chapter 18, Milkovich & Newman, 1996; Freeman & Katz, 1995; Katz, forthcoming). Differences in laws, collective negotiations, ownership and governance, financial and labor markets, and union-managerial discretion all presume that national systems are most important and differences among organizations within these national systems receive little attention. Consequently, the research involves understanding differences, such as comparing Sweden's and Australia's (until recently) *national* settlements to *industry-wide* settlements in German trade union association agreements to Korean and Japanese *conglomerate* and *company* union settlements. Typically, comparative studies explain national differences in terms of economic development, socio-political institutions and forces, and historical events. Under the comparative model, international compensation seems more a strategic issue for national public policy than for understanding and informing the HRM-OE relationship.

Differences in the use of stock options in Germany and Japan versus the United States and United Kingdom are directly related to national tax and regulation policies. Differences in marginal tax rates are directly associated with the use of variable-based pay schemes. In Korea or Japan, for example, large changes in bonuses and allowances (not based on performance) are preferred over large changes in base pay because social security and national health insurance rates paid by employers are based on basic pay, not bonuses or allowances (Hayashi & Ohta, 1997; Matamura, 1996; Ohtaki, 1996; Sano, 1993). In the U.S., many benefit forms are not subject to income tax and are, therefore, a relatively tax effective way to increase the value of employment for people. The degree of discretion available to managers when they respond to governmental initiatives is often not a straightforward matter of compliance. Except in rare cases, firms usually have alternatives about the strength and

pervasiveness of their response to governmental actions. For example, structuring compensation practices around U.S. tax laws has led to some very creative and innovative new compensation schemes (e.g., deferred compensation plans, ESOPs, phantom stock options) which are utilized by some, but certainly not all, firms. Gerhart & Milkovich (1990), Groshen (1988), Levine (1991), and others have found the persistence of firm effects when studying the structure of compensation systems. Organizations operating in similar competitive environments make different choices about how to structure compensation, but these differences are not strongly associated with different degrees of organization success (Gerhart & Milkovich, 1992; Gomez-Mejia, 1997). This evidence raises the possibility of equifinality in compensation system design and suggests that the way organizational decision makers meet public policies is a strategic choice.

Under a SHRM perspective, rather than meeting external factors first, effective international compensation systems might be those that match internal contingencies (e.g., fit the organization's goals and culture) first and then respond to external forces within the constraints of strategic alignment. Schnieder's (1987) attraction-selection-attrition (ASA) model asserts that the human resource management policies and practices at the organizational level create a distinctive and unique culture of people with homogeneous work values, norms, and tastes. Schnieder (1987) and Schein (1992) both argue that these ASA processes and the resulting homogeneity create the organization's distinctive culture. Those that do not fit the culture because they possess different values and tastes will either not join or will soon leave the organization. Other complementary work (Cable & Judge, 1994; Turban & Keon, 1993) suggests that compensation systems are a primary signal of the organization's culture and values. As such, the compensation system contributes to creating a culture of homogenous values which is different and distinct from the culture and values of other competing firms. Hewlett Packard and Microsoft both compete vigorously for software engineers, yet each company exhibits a different corporate culture which is signaled by and reinforced in their respective compensation systems (Beers, Harvard Business School case). The same logic applies to Toyota and Toshiba—the same national culture, different organizational cultures, and different compensation and reward systems (Milkovich & Newman, 1996). Given sufficient variation in values among the people in the labor pool of a nation, firms can, according to the strategic choice model, structure compensation policies which are consistent with the firm's culture and simultaneously attract individuals from the applicant pool that have congruent values, norms, and tastes. When considered from a strategic perspective, organizations could

structure compensations systems that help create a culture, and thus a work force, that possesses the values, knowledge, skills, and abilities that support its strategic goals and objectives. By aligning total value of returns and including non-economic elements, the compensation system could bind this strategically aligned human capital to the firm and extract its unique, inimitable, value-adding capacity to further the organization's goals and objectives.

ACHIEVING AND SUSTAINING COMPETITIVE ADVANTAGE THROUGH COMPENSATION PORTFOLIOS

A strategic perspective to understanding global compensation and reward systems focuses on organizational context. This perspective is based on the premise that managing total compensation in a global context is significantly more complex than simply relying on stereotypic notions of national culture systems. Rather, it is based on transforming employment relationships, regardless of the country, in response to the changing product and financial markets, manufacturing and distribution processes, technological innovations, the revolution underway in information networks, and other relevant factors. The SHRM perspective asserts that to achieve a competitive advantage within international contingencies requires HRM practices that focus on acquiring, retaining, and extracting unique, value-adding, firm-specific assets rather than HRM policies that align predominantly with national cultural contingencies. That is, developing compensation and reward policies that are consistent with organizational goals rather than those that match global competitors; policies that create a unique, value-adding organizational culture rather than those that mesh with national cultural norms; policies that meet public policies but first support organizational goals rather than those that are simply most efficient in meeting legislated rules. According to the strategic view, responses to external contingencies should be directed by how such responses support or interfere with the organizations' goals and context rather than responding externally first, and then trying to adopt the system into the organization's contextual uniqueness.

This perspective flows from the dominant models in current strategic management thought which assert that firms achieve competitive advantage by capitalizing on their unique, inimitable (difficult to copy or substitute for), value-adding assets (Barney, 1991; Rumelt, 1984; Wernerfelt, 1984). The assets which meet these criteria are organizational knowledge, processes, alliances, know-how, and the relationships among resources, all of which are possessed or controlled by people (Black & Boal, 1994; Teece, Pisano, & Shuen, 1997). When prescribing optimal management practices, these models turn attention inside the organization first, seeking to understand how to draw out and utilize unique, inimitable, value-adding

resources. External forces must be contended with, but market tactics or positions cannot be the source of sustained competitive advantage (Rumelt, Schendel, & Teece, 1991). The SHRM model flows from an acceptance that organizational strategy is useless unless it is logically linked to activities at lower levels in the organization. Since the focus is on firm-specific assets, these strategic models call for firm-specific human resource management processes—HRM systems that support, extract, and direct firm-specific assets toward firm objectives (Simon, 1993; Wright & McMahan, 1992). Simply buying those assets on the open market, if they can be purchased, does not create uniqueness nor does it allow firms to build the coherence and interrelationships among various value-adding, firm specific assets that is thought to be the source of competitive advantages (Black & Boal, 1994; Teece, et al., 1997; von Krogh, Roos, & Slocum, 1994). These models suggest that optimal human resource management should focus on creating a shared mindset, extracting tacit knowledge, encouraging innovation, creativity, and responsiveness, and stimulating the development of important relationships among people rather than strictly focusing on motivating high performance on a specified set of tasks (Cappelli & Singh, 1992; Simon, 1991, 1993). That is, *competitive advantage comes from crafting compensation and reward systems to create employment relationships that extract the value of firm-specific resources.*

We think about these issues in terms of their implications for compensation and reward decisions. That is, we seek to understand how organizations will structure the portfolio of returns to build and utilize firm specific assets. The notion of a 'portfolio of returns' directs attention to all elements of the compensation and rewards system offered by an organization, and how the effects of any one return (e.g., incentive pay) might be influenced by the other returns; we seek to understand if the pattern of returns matters. We use a conceptual model that has been a powerful tool for understanding compensation: Viewing the employment relationship as an exchange (Barnard, 1938; Simon, 1951). According to this view, both the employer and employee make contributions and extract returns from the exchange relationship. A critical principle of the model is that the returns offered by the employer are important and primary determinants of the contributions provided by employees. That is, what employees are willing to contribute to the organization is determined in large part by what the employer is willing to give to the employee. Causality is clearly articulated under this view: The employer's choices come first and determine the employee's response. However, once this relationship is underway, it becomes dynamic and recursive. The models articulated by Macneil (1974; 1980), Greisinger, (1992), Simon (1991, 1993), Tsui, Pearce, Porter, and Hite,

1995(1995), and others provide a framework for understanding how different returns may effect the contributions employees are willing to make. These frameworks explicate how organizational goals and context may require different types of employment relationships. For example, Tsui, et al. (1995) suggest that organizational requirements for different types of flexibility will require different types of employment relationships. Flexibility in varying labor costs will require flexibility in the size of the workforce and, therefore, short-term, job-based employment relationships. Flexibility in work assignments will require longer-term, organization-based employment relationships that build and maintain commitment and loyalty to the organization. Like Tsui, et al. (1995), we take the position that the search for employment relationships will inform our understanding of how to structure compensation and reward (and other HRM) systems for competitive advantage. Under this model, SHRM is a process of managing employment relationships which are congruent with organizational strategy. Compensation and reward systems are central elements of employment relationships and, thus, are important determinants of employee behaviors (Gerhart & Milkovich, 1992b; Milgrom & Roberts, 1992, Simon, 1991, 1993). To the extent they properly focus attention and effort, compensation and reward systems can contribute to organizational success. Compensation and reward systems influence the type of employment relationships an organization obtains and may determine, in part, whether those relationships support or fit the organization's goals.

Simon (1991, 1993) asserts that economic returns alone will not extract the unique, inimitable, value-adding assets possessed or controlled by employees. He argues that economic rewards are ineffective because they cannot create the organizational attachments necessary to achieve the requisite common mindset that directs thinking, decision making, and action choices. One reason might be that a focus on economic returns creates a transactional relationship (Macneil, 1974; 1980) that simply internalizes open market transactions and can be easily copied or purchased away by competitors. Tsui, et al. (1995) point out that exchanges based solely on economic returns are likely to be very different from non-economic or social exchanges in terms of range of employee behaviors and attitudes that are acquired. Economic-based, transactional exchanges are limited to the performance of clearly articulated, proscribed responsibilities and focus only on highly monetizable exchanges. These contracts are rigid, inflexible, and do not involve deep communications or exchanges of tacit, proprietary knowledge (Macneil, 1974; 1980). Tsui, et al. (1995: 120) summarize compensation in these exchanges by stating that "...rewards [are] based entirely upon the employee's performance of specific tasks. Beyond payment for agreed-upon outputs, neither the employee nor employer

is obligated to continue the contract.” As such, they are conceptually antithetical to the exchanges needed to extract tacit knowledge (Simon, 1991; 1993; Tsui, et al., 1995).

Broader exchanges require broader portfolios, ones which are based on non-economic and economic returns (Simon, 1993; Macneil, 1980; Tsui, et al. 1995). Non-economic returns may bind individuals more strongly to the organization because they can meet individuals’ special needs which cannot be met as effectively with economic returns (e.g., providing for childcare via the non-economic return of flexible work schedules vs. the economic return of enough extra salary to pay for child care. The flexible schedule puts a parent, not a care giver, at home). Compensation and reward systems comprising both non-economic and economic returns create broad, flexible exchanges. These relational exchanges encompass a broad range of actions, involve adaptation, create commitment to common goals, and foster the pursuit of mutually beneficial long-term objectives (Macneil, 1974; 1980; Tsui, et al., 1995). Creating the common mindset, willingness to learn, adaptability, and innovation organizations need to survive is not consistent with a transactional contract. It requires binding people through relational contracts and hence, a broader, more individualized portfolio of returns. Brief and Aldag (1989) assert that affective reactions to work seem to be connected to non-economic factors and that a focus solely on economic factors may not achieve the required bonding. Freeman and Gilbert (1988) go so far as to assert that unless members’ individual values and goals are reflected in organizational goals and practices, members will not cooperate to achieve organizational objectives. Kidwell & Bennett (1993) find that compensation systems do indeed influence employee attachment and that this attachment moderates their propensity to withhold effort. Chami (1997, Chami & Fischer, 1996) finds that when mutual altruism under-girds the relationship, agency-based compensation contracts are no longer optimal. In fact, the best compensation systems transfer economic and non-economic assets to the agent over a long period of time (i.e., they consist primarily of long-term, ownership-based returns). We believe that the strategic choice model asserts that organizations can actually create altruism by properly structuring compensation and rewards. The development of trust requires that one party in a relationship extend an initial, although risky, gesture of trust, hoping that the other party will reciprocate. Once underway, trust breeds trust and the altruistic, mutually beneficial relationship grows (Creed & Miles, 1996; Hosmer, 1994; Powell, 1996). Organizations have more resources to take risks and withstand defects. They can also diversify the risk of defection across many employment relationships. Organizations are, therefore, in a position to make compensation decisions that build trust.

Organizations might offer stronger employment stability, competitive wages, and the prospect of greater rewards in the future (which provide a longer-term income stream). The risk for the organization is that employees will not use their unique, inimitable, value-adding human capital on the organization's behalf. However, by creating an employment relationship where the organization is vulnerable to the potential that employees might defect, the organization might start a trust-based exchange that will create competitive advantage (Barney & Hansen, 1994; Lewicki & Bunker, 1995; Powell, 1995).

Properly structured and aligned compensation and rewards may help create and foster trust-based relationships, ones which help extract unique, inimitable, value-adding human resources and direct them toward the organization's objectives. This perspective may help explain international compensation systems. An organization may first analyze its culture and the human resource requirements of its strategic goals and objectives, then select a portfolio of compensation returns that creates employment relationships that support its goals and objectives and are consistent with and fosters its culture. External forces are contended with, but within the strategic compensation framework. National culture is not a major issue when members of the organization express values which are consistent with the organization's strategy.

Strategic Portfolios and SHRM

Applying the SHRM perspective leads us to the notion of strategic portfolios as a possible framework for understanding international compensation and reward systems. The strategic portfolio model shifts thinking from differences between countries to differences within countries. Organizational cultures take precedence over national cultures as most important for shaping a common strategic mindset. Compensation and reward systems are designed to help create and motivate a workforce with the values and capabilities necessary to achieve an organization's unique goals and objectives rather than being designed to meet the national values exhibited by a work force. To be sure, national institutions and laws—particularly tax and welfare regulations—are important forces. Yet the logic is that understanding differences and variability *within* as well as *between* nations is the critical point. The strategic portfolio model presumes the complexities cannot be predetermined, and indeed are in flux. So an adaptive, more flexible approach is required which creates employment relationships that allow organizations to conform to local conditions when necessary while at the same time creating the common mindset among employees required to direct their efforts toward organizational goals and objectives. It recognizes that variations in beliefs, opinions,

and values within countries provide opportunities for organizations to attract, motivate, and retain people who conform to the organization's culture rather than trying to make the organization conform to national cultures. The strategic portfolio model is consistent with the idea that effectively managing human resources requires inculcating a common mindset within an organization that articulates what are the important strategic goals and priorities and provides a guide to employees about how to achieve them (Simon, 1991; 1993). It supports the notion that corporate success does not result from a set of chameleon-like systems tailored to varying conditions, but from systems that focus attention on matters relevant to organizational prosperity and consistently influence the actions of organizational members toward organizational goals (Simon 1991, 1993). The compensation system is viewed as shaping a culture that influences employees rather than being shaped by a national culture. The design emphasis, according to this view, is to create compensation systems that support organizational goals, foster corporate culture, and help motivate employees to contribute their efforts to further organizational success (Milkovich & Bloom, 1998).

The strategic portfolio model suggests that the notion of compensation system "fit" may be a messy construct. Emerging research in biology and physics strongly suggests that the most vigorous, productive, and adaptive systems are those that achieve a balance between order (predictability, structure, ability to make specific plans) and chaos (adaptability, ability to acquire new information, resources, skills, malleability) (Gell-Mann, 1994; Kauffman, 1995; Weiner, 1994). In fact, these systems seem to exist on the edge of chaos. In the biological world, achieving equilibrium or stability is associated with a single state: death. These models may inform our understanding of how organizations can achieve sustained competitive advantage through strategic employment relationships (Brown & Eisenhardt, 1997). That is, there needs to be a little chaos to achieve the flexibility, adaptability, and innovation required for organizations to be successful. It may also suggest that we change our search from one where we are looking for the ideal fit between compensation systems and organizational strategy and context (of which there is likely to be only one and, therefore, one that is very hard to find), to a search for an effective fit (of which there are likely to be many; Kauffman, 1995). To be sure, SHRM researchers must avoid recreating contingency theory in another guise by simply defining an excellent fit optima in terms an employment relationship that extracts the unique, inimitable, value-adding resources an organization needs to survive and prosper. Yet, there may not be a single compensation system (or portfolio of returns) that creates flexible employment relationships. A particular compensation and reward system might

be very effective in some contexts, ineffective in others, and iatrogenic in still others. This suggests that, rather than finding a single best compensation system that perfectly matches organizational context, we might find multiple compensation systems that are "aligned" in the same context.

Of course, using any new model of compensation comes with certain difficulties and the strategic portfolio framework is no different. Companies may find it difficult to overcome the inertia of the national culture and balance sheet approaches so these factors need to be considered in studies of international and strategic compensation. Because it extends decision parameters beyond the strict economic concerns which dominate the balance sheet approach and the reliance on broad stereotypic classifications of employees utilized in the national culture mindset, the strategic portfolio model assumes that decision makers clearly identify and articulate links between compensation systems and organizational goals and culture. Measuring the extent to which these links are identified and articulated is central to assessing the degree of fit between organizational strategy and compensation and reward systems. For example, could we call an accidental or unintentional match between strategic goals and compensation design strategic fit?

SHRM models provide have potential for informing our understanding of how organizations design HRM systems and why those systems may or may not contribute to organizational success. Like many others, we have attempted to create a framework to help constrain the inherent contingency in SHRM models by pointing to when certain portfolios of compensation and rewards might be used and also be more effective. Ours is a first step and further refinements are necessary. We believe that existing models of employment relationships, strategy, and management may not be culturally-laden and may provide the basis for a better understanding strategic human resource management systems.

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