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## **Abstract**

[Excerpt] The management of change remains the challenge of the 1990s. The objectives of this change are to foster better performance, control costs, and enhance flexibility--all necessary to successfully compete in fierce markets. All managers are challenged by the pace and magnitude of this change. Human resource managers are not excepted, being confronted daily with questions about how to manage employees to support changes in technology, changes in organization structures, and changes in business strategy. And employees themselves are changing: in their values and expectations, their demographic diversity, their education, and their willingness to accept change.

## **Keywords**

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**DEVELOPING A COMPENSATION STRATEGY**

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**WORKING PAPER #89-19**

**CENTER FOR ADVANCED HUMAN RESOURCE STUDIES**

**SCHOOL OF INDUSTRIAL AND LABOR RELATIONS**

**CORNELL UNIVERSITY**

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## Developing a Compensation Strategy

George Milkovich and Renae Broderick

The management of change remains the challenge of the 1990s. The objectives of this change are to foster better performance, control costs, and enhance flexibility--all necessary to successfully compete in fierce markets. All managers are challenged by the pace and magnitude of this change. Human resource managers are not excepted, being confronted daily with questions about how to manage employees to support changes in technology, changes in organization structures, and changes in business strategy. And employees themselves are changing: in their values and expectations, their demographic diversity, their education, and their willingness to accept change.

When confronted with the need for rapid and large-scale change, human resource managers, like their counterparts in marketing, finance, and production, tend to adopt strategies that enable them to manage their work forces effectively in the face of uncertainty. Developing a human resource strategy requires *defining* the work force performance goals needed to support the organization's overall business strategy and the human resource implications of these goals; *diagnosing* the organization's internal and external environment to pinpoint human resource strengths and weaknesses relative to these goals; and *designing* the mix of human resource policies and programs that exploits strengths and downplays or corrects weaknesses. The aim is to shape a work force focused on strategic performance goals and capable of achieving them.

Compensation is a critical piece of overall human resource strategy. Because compensation is both visible and important to employees, a compensation program designed to communicate and reward strategic goals increases the probability that employees will not only understand what those goals are but also will achieve them. Because employees also understand that compensation dollars are important to the organization, the strategic intent of other human resource efforts, such as performance management, recruiting, career development, and the like, is also clearer if their designs are consistent with the compensation program. In short, realization of compensation strategy requires that the money match the message.

Developing a compensation strategy requires the same process of definition, diagnosis, and design described above for human resource strategy. This chapter provides some guidelines for beginning this process.

### **WHICH COMPENSATION DECISIONS ARE STRATEGIC?**

Strategy refers to the fundamental directions of an organization. Strategies serve to guide the deployment of all resources, including compensation expenditures. But not all compensation decisions are strategic. Only those decisions that are critical to the success of the business are strategic, such as those that affect labor costs and performance. Decisions about techniques, such as which job evaluation plan to use or where to slot the compensation manager in the pay

structure, are probably not strategic. Policy decisions, such as linking a portion of pay increases to corporate and unit performance and determining the competitive position in the market, probably are. We propose five basic decisions, shown in Figure 1, as a place to begin. The following decisions are considered strategic by those who manage compensation systems.

(Insert Figure 1 here)

**Compensation's Role in Human Resources** Compensation is only part of the policies and programs organizations use to manage employee relations. Decisions regarding employment security, development and training, career opportunities, employee assistance programs, and organization design, along with compensation, form patterns of human resources policies. These patterns may be well-integrated or so disjointed as to work at cross-purposes. Compensation can act as an instrument of change or simply act to support the overall human resources strategy. The implementing of profit sharing plans, for example, acts to signal competitive environments, encourage employees to identify with corporate performance, and support corporate values. Alternatively, other human resources initiatives, such as transforming organization structures, forming work teams, and other flexible arrangements, may act as the change agent in the overall human resources strategy. In such cases, compensation's role may be to support, rather than be on the cusp of the human resources strategy.

Determining compensation's role in the larger human resources picture is a familiar message. All managers nod in agreement but often neglect it when making decisions. Compensation decisions are part of the pattern of human resources decisions; they do not operate in a vacuum. The rush to implement pay programs, particularly incentive pay, without first examining their role in the total human resources strategy, often results in failure and employee distrust. Hence, determining compensation's role in the overall human resources strategy is a strategic decision.

**Competitiveness** What level of pay--base, benefits, incentive, perquisites--should be offered relative to competitors? What mix of these forms should be offered--base, flexible benefits, stock options, cash bonuses, stock appreciation rights, etc.? What should the proportion of guaranteed compensation (base, benefits) relative to riskier returns (incentives) be? Choices on market position, mix, and the proportion of guaranteed compensation directly affect managers' ability to meet strategic performance goals. The competitive position managers chose affects the quality of the work force and its overall costs.

Choices about **competitive position** also communicate to both prospective and incumbent employees. Savvy employees, for example, can discern the organization's ability and willingness to recognize their needs based on the flexibility and tax protection offered in benefit plans or the opportunity to share in the firm's success through stock- and performance-based plans.

**Internal Structures** Decisions on internal structures determine the distribution of base pay to different jobs or skills. In some cases, this distribution is determined by market pricing, through matching competitors' structures reported in the market. In others, the number and uniqueness of jobs and skills and the strength of organizations' values dictates sensitivity to both internal and market factors.

Figure 1 lists several decisions associated with the internal structure of compensation systems. These range from the number of structures (national and local, technical and nontechnical, and managerial, etc.) and the number of levels in each pay structure to the size of differentials among levels. Objective data show that these decisions differ among organizations in different industries and in vastly different markets with no reference to business strategies. For example, businesses that are highly labor-intensive, such as space and defense contractors, tend to exhibit more levels, smaller differentials, and greater emphasis on internal norms and traditions. In contrast, business units with less labor-intensive technologies, such as chemicals and plastics, tend to have fewer levels and wider differentials. However, even business units competing in the same industries and markets may exhibit very different internal pay structures consistent with their particular business strategy.

Internal structures let employees know the relative value of their jobs and skills and delineate career paths. Consequentially, dual ladders, technical

and managerial, are believed to signal the technical contributors' value to an organization. The extent to which employees view these decisions as equitable--with reference to either market values or internal norms--will influence their sense of fair treatment and their motivation to perform. Structural decisions also influence the flexibility managers have in reassigning employees without changing their pay. To illustrate, General Electric Co.'s plastics division adopted an exempt pay structure with only four levels: executive, director, leadership, and technical and professional. Managers believe that it provides greater flexibility to move employees without requiring pay changes. It also communicates to employees a relatively egalitarian philosophy about the value (base pay) of different skill groups. However, to be successful, the increased flexibility must be managed effectively. Inconsistencies within levels can result in anarchy and quickly will lead to employee dissatisfaction and distrust.

GE's competitors typically opt for more meritorious hierarchical-based structures, with more levels and/or larger pay differentials linked to employees' jobs and skills. The circumstances under which these egalitarian vs. hierarchical structures may be most effective is currently under study. Without such evidence, structural decisions seem to be based more on following fads, beliefs, and conventions than on strategic considerations.

**Employee Contributions** Determining the whys, hows, and whens of employee pay increases is perhaps the most important strategic pay decision.

Increases in pay are powerful communicators. For example, bonus plans tied to exceeding annual operating plans, such as those recently adopted by DuPont Co., Union Carbide Corp., Scott Paper Co., and others, are believed to focus employees' attention and efforts on the unit's performance. Across-the-board increases based on a cost-of-living index, on the other hand, make inflation more salient, and merit increases make performance appraisals and competitors' practices important. The nature of pay increases signals what an organization values. Retaining experienced and talented employees, rewarding their contributions, recognizing unit performance, and even offsetting inflation are all, to some degree, objectives of pay increases. The art of strategic management involves choosing the pay increase plans that best serve the unit's business strategy and complement its overall human resources strategy.

**Administration** Decisions about how to administer pay may also be strategic. They can influence managers' sense of ownership and employees' views of the fairness of their pay. Both ownership and fairness are thought to be achieved through decentralization, participation, and communication. For example, one currently popular axiom is that deciding "how best to compete" rests with business unit managers; hence, ensuring that pay systems help them compete should also be their responsibility.

Decentralization, however, is not a universal good--more is not necessarily better. Determining which decisions should be decentralized and to

which organization level involves experienced judgement. Benefits seem to be best managed corporatewide, incentives are best managed at various levels, depending on the type of plan, and choices about structures and competitive positions seem to depend on the skills and product markets in which units compete. Hence, decentralization decisions probably must be customized to fit each organization's unique situations.

Employees' sense of fairness regarding their pay is thought to be heightened if its administration is internally consistent, if communication is perceived as open, and if employees believe they have the opportunity to participate. Thus, while many decisions involved in the administration of pay are operational, the basic policies underlying the nature of the administration seem critical to employee performance and the success of the business.

These five basic decisions--compensation's role, competitiveness, internal structures, employee contributions, and administration--only serve as a starting point. Tailoring to each organization's unique situation is required. The choices made affect every organization's success.

## **KEY STEPS IN DEVELOPING A COMPENSATION STRATEGY**

Developing compensation strategies is a simple process. One familiar to any manager is the generic decision model:

- Analyze compensation implications
- Establish objectives
- Compare actual conditions with objectives to identify gaps
- Develop actions to close gaps
- Follow through.

Figure 2 shows this model applied to developing compensation strategies. It involves (1) analyzing the compensation implications of the organization's business strategy, external environment, and internal human resources conditions; (2) establishing the desired strategic compensation position involving the five strategic choices discussed above; (3) determining any gap between the implications derived from the analysis and the desired strategic position; (4) designing compensation programs to close the gap and to translate the compensation strategy into practice; and (5) following through. These steps are explained below in greater detail.

(Insert Figure 2 here)

**Analyzing Compensation Implications** The changing forces of the external environment through which organizations must navigate were examined in the previous chapter. Here, we only re-emphasize that they are crucial to developing compensation strategies. Perhaps a major issue is whether these

environmental forces allow any room for managers to adopt different compensation policies in support of their business strategies. Legislation on health benefits, pensions, and deferred contributions have reduced the viable choices for executive and manager compensation. Yet, we do know that firms pursue different options in responding to changes accompanying advances in technology, changing population demographics, and shifting regulatory concerns. Again, managers charged with developing compensation strategies must innovate compensation strategies that offer competitive advantages within the changing pressures that operate in the external environment.

Business strategies' implication for compensation reside in the work force's performance and the sustainable labor costs associated with its successful implementation. For example, the decision to enter a new market requires a work force that is willing to take risks, put in long hours, and quickly solve problems not previously encountered. At the same time, especially for new ventures, cash flow is often restricted. A compensation strategy that attracts and motivates the necessary work force while dealing with cash limitations--all else being equal--will increase the new venture's chances of success.

Proponents of compensation strategy development maintain that different business strategies vary in their work-force performance requirements and sustainable labor costs, and, thus, in the compensation strategies that best support them.

**Developing a Strategic Position** Two related levels of business strategy need to be considered when developing compensation strategy: the corporate unit and the business unit. Compensation strategy is most directly related to the business unit's strategy, but, as depicted in Figure 3, both the corporate and human resource strategies also influence compensation strategy development.

(Insert Figure 3 here)

Business unit strategies are designed to answer the question, "How should we compete in this particular product or service market?" Many approaches exist, but most classify business unit strategic types in terms of two predominant strategies. One is labelled "Growth," the other, "Maintenance." The discussion of both these strategies is ideal in the sense that actually very few organizations completely exhibit the patterns to be described. However, these two types do serve to guide the development of compensation strategies under different business strategies.

Managers pursuing a Growth strategy make high investments and take significant financial risks to expand their market shares. The ideal organization design allows for maximum flexibility in dealing with new markets and technologies. Division of labor is product or service-centered with little job or functional specialization. Decisionmaking is decentralized; there are few formal controls such as budget, inventory, or even human resource programs.

Hierarchies, supervision, and work rules are minimal. Information flows freely and informally throughout the organization. Performance criteria focus on market outcomes, such as expanding sales and market share.

A Maintenance strategy emphasizes maintaining current market shares while minimizing costs and improving customer satisfaction. Here, the ideal organization design exploits the organization's past learning and success in dealing with a particular market and technology. The division of labor is functional with relatively high job specialization. Decisionmaking is more centralized, and more formal control, hierarchy, supervision, and work rules exist here than in the Growth strategy. Information flows through well-established communication channels and is more restricted. Performance criteria focus on cost savings, quality, and customer satisfaction.

The strategic compensation decisions thought to best support the Growth and Maintenance strategies are shown in Figure 4 and are derived from studies of compensation strategy in Growth and Maintenance organizations. The logic underlying these results is readily apparent when considering the performance and labor cost implications associated with each strategy. The Growth strategy, for example, requires heavy investments in marketing and development without the benefits of high cash income--at least over the short term. This means that dollars are not available for high base salaries and benefits, but significant performance and ownership incentives can be offered. In order to realize incentive potential, employees must be willing to take risks, work long hours,

creatively solve problems, and focus on the market outcomes critical to Growth strategy success.

(Insert Figure 4 here)

Compensation plays a dominant, lead role in the overall human resources strategy. It serves to signal the climate of risk and reward. Incentives tied to the organization level and market outcomes with high, annual payout potential help attract and direct the types of employees needed. Internal structures and administrative decisions that allow maximum flexibility are also consistent with the organizational design and administrative style thought ideal for Growth strategy success.

One study of the relationship between human resource strategies and business unit strategies showed that units successfully pursuing Growth were more likely to emphasize the importance of compensation programs than those pursuing Maintenance strategies. While the results of one study are not determining, they suggest that when making choices about developing a compensation strategy for several business units, those pursuing Growth strategies should take precedence because pay appears to play a more dominant role.

Research also confirms that the internal structures and administration of pay are related to the cultures and management styles used throughout the

organization. It follows that any shift toward either a Growth and Maintenance strategy must be supported by similar changes in the organization itself. A compensation strategy at odds with the organizational culture is futile.

**Designing a Compensation Strategy to Close Any Gap** The compensation systems of most organizations will not look exactly like either of the Maintenance or Growth profiles. The Maintenance and Growth profiles shown in Figure 4 really serve as polar guideposts for managing strategic change and development. A simple example illustrates how these profiles can be used to guide strategy development.

The current compensation system profile shown in Figure 5 comes from a unit whose market orientation, structure, and administrative style place it closest to a Maintenance type. The unit's business strategy is to continue its current market orientation: maintenance of market share. It also anticipates, however, that increased levels of market competition mean that minimizing costs and increasing quality and customer service are no longer enough. Internal structure, administrative style, work force performance, and labor costs all need to be more flexible in order to accommodate changes in market demand. Flexibility of the order recommended to support a Growth strategy is not desired. The Maintenance unit just wants a little more flexibility and maybe some correction of past problems: redundant jobs and employees, lackluster performance standards, and overspecialization of jobs.

In order to develop a compensation strategy that promises more flexibility, the compensation profile of the Growth type offers a guide. Figure 5 shows the unit's current compensation profile, the ideal Growth profile, and the recommended compensation strategy.

The recommended strategy infuses a little more risk into the system and potentially lowers labor costs. The pay system role in the total human resources strategy shifts to the role of a change agent. The shift toward a Growth strategy requires a competitive position more sensitive to market pressures and less to internal traditions and norms. A higher proportion of incentives in total compensation is proposed; there is less guarantee that these incentives will be paid. A profit sharing plan ties about 10 percent of potential pay increases to unit performance, and, if realized, this amount will not be added to base salary. Also, more information will be shared with employees. In particular, the profit sharing plan calls for employee education in basic financial concepts, employers' markets, and the like.

(Insert Figure 5 here)

**Following Through** Implementation of these strategic changes is tricky. Compensation changes cannot take place overnight, but most can be accomplished within time framework associated with shifts most business unit strategies. The key is to identify which changes should happen first in order

to ensure that success ~~is subsequent~~. For the recommended strategy in Figure 5, the profit sharing program might have enough visible impact in year two to carry internal support for reductions in job levels, changes in the merit plan, and increased emphasis on external market pressures.

### **THE PAYOFFS FROM DEVELOPING A COMPENSATION STRATEGY**

Why spend the time developing compensation strategy? One recent estimate assessed the development time at about six months. The underlying premise of any strategic perspective is: If managers make pay decisions consistent with the organization's business strategy, responsive to external and internal conditions, and consistent with the overall human resources strategy, then the organization is more likely to be competitive. This statement is based on belief, not systematic evidence. No studies link the implementation of compensation strategy with business success. Indeed, there are so many factors unrelated to compensation that can influence business strategy success that disentangling the effects of compensation strategy is a difficult task.

Recent studies do offer guidelines on the effects of certain decisions, specifically pay-for-performance plans, on firm performance. It has been documented, for example, that Gainsharing plans are related to between 10 percent and 17 percent improvement in performance. Performance in these studies included rates of absenteeism, suggestions, and safety as well as cost

and production measures. The longest period covered by any study was 18 months. It has also been shown that firms distinguish themselves through decisions on incentive pay plans more than they do through decisions about the competitive level of base pay. Thus, the conventional competitive decisions, such as leading or meeting competition, may be obsolete. Rather, firms seem to establish competitive positions based on the nature of their incentive plans. Further, studies show that greater use of bonuses and long-term incentives is associated with better firm performance. Specifically, according to one study of over 250 firms, an increase of 10 percentage points in the bonus/base ratio is associated with .21 to .95 greater return on assets. Some evidence also suggests that such plans are more successful when they are part of a total or strategic approach to compensation.

A note of caution: Negative results and failed compensation plans are seldom reported. Consequently, much of the work in this area needs to be treated with some caution. However, a conservative conclusion is that empirical evidence does support the proposition that performance-based pay, as part of an overall strategic approach, does contribute to firm performance.

There are also some potential side benefits of developing a compensation strategy. It provides a business-related rationale for compensation system changes that may be useful in explaining decisions to both employees and outside regulators. The process of compensation strategy development requires the managers involved to stretch their understanding of all aspects of the

organization and the environment in which they are competing and their relationship to pay. The process may spark ideas for much needed change in often overly bureaucratic pay systems.

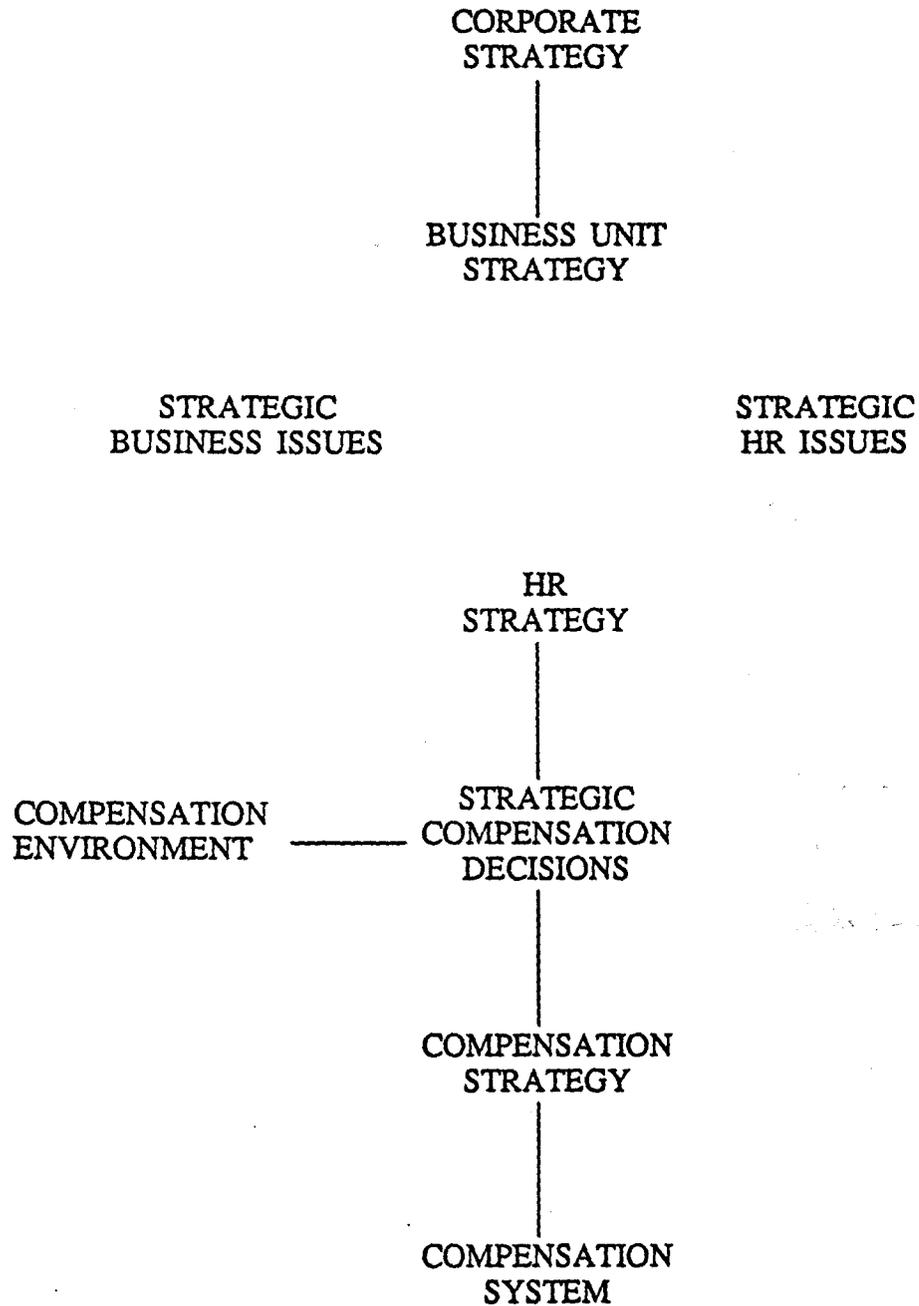
Figure 1: Strategic Compensation Decisions

1. Role in Total Human Resources Strategy
  - Initiate, On the point
  - Follow-supportive
2. Competitiveness
  - Market position
  - Mix-base, benefits, incentive forms
  - Percentage of guaranteed pay
3. Structure
  - Sensitivity to internal and market factors
  - Number of levels in hierarchy
  - Size of differentials between levels
4. Employee Contributions
  - Pay increase criteria: objective/subjective performance, experience, inflation
  - Level of measurement: corporate, division, facility, team, individual
  - Size, frequency of payout
  - Renewal, proportion not added to base
  - Number, mix of increase programs
5. Administration
  - Communication: detail and type of pay information provided
  - Centralization: extent and employee participation in design and implementation of business unit
  - Formalization: extent of written rules, manuals, budget procedures, etc.

Figure 2: A Process: Developing a Compensation Strategy

1. Analyze implications
  - Business strategy
  - External environment
  - Internal human resources conditions
2. Develop a compensation strategic position
  - Compensation's role in total human resources strategy
  - Competitive position
  - Internal structures
  - Employee contributions
  - Administration
3. Determine any gap between strategic position and analysis of conditions and design compensation strategy to close it
4. Follow through

Figure 3: Strategic Perspective: An Illustration



**Figure 4: Suggested Compensation Profiles for  
Business Unit Strategic Types**

<b><i>Strategic Compensation Decisions</i></b>	<b><u>BUSINESS UNIT STRATEGIC TYPES</u></b>	
	<b><i>Maintenance</i></b>	<b><i>Growth</i></b>
(1) <b><u>Role in Human Resources Strategy:</u></b>	Support or Subordinate	Lead, Signals Risks and Rewards
(2) <b><u>Competitiveness: Market position</u></b>	Emphasize base, benefits	Emphasize incentives
Pay mix	Variety and choice in benefits	Variety in incentives, choice in benefits
Percentage of guaranteed pay	Higher	Lower
(3) <b><u>Internal Structure: Mix internal and market pay values</u></b>	Internal and market sensitive	Market sensitive
Number of levels in pay hierarchy	More	Fewer
Differentials	Larger	Smaller
(4) <b><u>Nature of Pay Increases: Criteria</u></b>	Experience, Inflation, Performance Appraisal	Objective Performance
Level of measure	Individual, group	Unit, individual
Size of payout	Smaller	Larger
Renewal	Added to base	Not added to base
(5) <b><u>Administration: Communication</u></b>	Restricted	Open
Centralization	High	Low
Formalization	High	Low

Figure 5: Illustrated Comparison of Current and Compensation Strategy Profile

<i>Strategic Compensation Decisions</i>	<u>COMPENSATION SYSTEM PROFILES</u>		
	<i>Current/Actual</i>	<i>Growth</i>	<i>Recommended</i>
(1) <u>Role in Human Resources Strategy:</u>	Support or Subordinate	Lead, Signals, Risk and Rewards	Shift to Higher Profile, Pay System
(2) <u>Competitiveness: Market position</u>	Lead in base, benefits	Lead with Incentives	Meet in Base, Benefits, and Incentives
Pay mix	Variety of benefits	Variety of Incentives	No change
Percentage of guaranteed pay	High--90 percent	Low	Moderate--85 percent
(3) <u>Internal Structure: Mix internal and market sensitivity</u>	Both used	Market	No change
Number of levels in pay hierarchy	25 levels	Fewer	Reduce
Differentials	Large	Flat	No change
(4) <u>Employee Contributions: Criteria</u>	Performance Appraisals & Seniority	Financials	Mix of both
Level of measure	Individual	Unit Individual	Unit and Individual
Size of payout	Small	Large	Moderate--15 percent of total pay
Renewal	Added to Base	Not Added	Not Added
Mix	Merit, seniority-based plans	Incentives only	Merit (5 percent) Profit sharing (10 percent)
(5) <u>Administration: Communication</u>	Restricted	Open	More open: Info relevant to profit sharing
Centralization	High	Low	No change
Formalization	High	Low	No change

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