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REWARD SYSTEMS

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Reward systems are central to the Human Resource Management function. Their purpose is to attract talented individuals, motivate them and retain those that have a better fit with the organization. Reward systems have a direct impact (and in most firms the most important one) on the cost side of the organization's financial statement. They are strategic as they influence people's attitudes, behavior and performance (Gomez-Mejia *et al*., 2010). Here we provide an overview of reward systems and their main components.

INTRODUCTION

Literally, the term *rewards* can be defined as a particular monetary return, object or event that an employee receives in exchange for his/her work or for having done something well (Schultz, 2006). A trader makes a significant profit for their bank and as a result receives a substantial bonus. A sales person improves their clients' satisfaction scores and in exchange he/she is rewarded with a trip to a Caribbean Island. This definition of rewards implies that when a reward is offered after a behavior occurs the probability of that behavior occurring again increases (Pavlov, 1927; Skinner, 1953). However, there is a second conception of rewards that relates to the subjective feelings of liking, pleasure or satisfaction (also referred to as the hedonic function of rewards (Schultz, 2006)). An employee does something because it is rewarding and produces a pleasant feeling. The first definition of rewards is normally labeled as extrinsic rewards whereas the second definition is known as intrinsic rewards (Deci and Ryan, 2002). Both types of rewards attract and retain different individuals and have distinct effects over employee motivation.

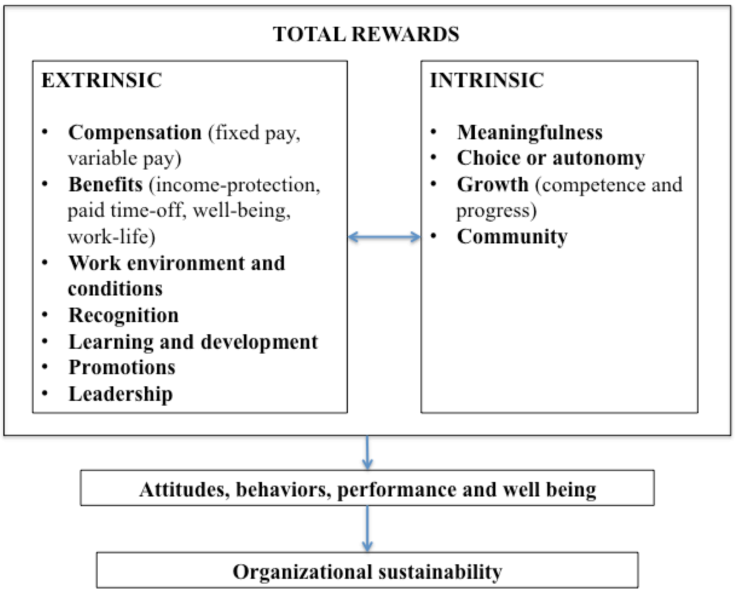
Motivated employees are willing to go the extra mile when their job requires it. They tend to be more productive, energized and creative. Unmotivated employees are likely to exert little effort and avoid additional work assignments as much as possible. Work motivation is desired but it is not a constant phenomenon that every employee possesses. Individual characteristics and organizational factors influence motivation. Thus, organizations require mechanisms that encourage a consistent level of motivation to ensure their sustainability. Extrinsic rewards encourage an employee to be motivated to do the work being rewarded because of its instrumental value. A mechanical engineer will be motivated to improve the quality of products if higher quality is externally rewarded (e.g., through a bonus). The organization's emphasis on intrinsic rewards will also enhance an employee's motivation (e.g., due to the enjoyment of the work it-self). Using the mechanical engineer example, the engineer will be motivated to improve the quality of products if he enjoys doing it.

For some time, organizations mainly relied on extrinsic rewards as their main mechanism to influence motivation. Intrinsic rewards were not formally considered in reward policies and practices because they were seen as psychological phenomena that pertain to the individual (the organization could only influence them indirectly through other HR practices). Besides, the predominant view until recently was that extrinsic rewards work in opposition to intrinsic rewards (Deci and Ryan, 2002). When strong extrinsic rewards are provided for engaging in a particular job, intrinsic rewards to do that job decline. We now know, however, that extrinsic and intrinsic rewards can coexist. They can be synergetic and organizations can combine them to improve performance (Amabile, 1993). But to create a high-performing workforce intrinsic and extrinsic rewards cannot simply be 'loaded up'. Organizations need to find the right balance between the two.

THE TOTAL REWARD SYSTEM

The Total Reward System comprises the extrinsic and intrinsic reward mechanisms available to an employer to motivate, attract and retain employees. Different combinations of rewards will generate different employer-employee relationships. Figure 1 shows the variety of reward mechanisms organizations may use.

Figure 1. Total Reward System



It is useful to think about the relationship between extrinsic and intrinsic rewards in terms of foreground and background (Thomas & Velthouse, 1990). Extrinsic rewards come into the foreground when employees are in need of economic resources, when issues of unfairness arise or when they face major life choices. Extrinsic rewards fade into the background the rest of the time whilst intrinsic rewards take the foreground in day-to-day work. The following subsections describe each of the extrinsic and intrinsic reward mechanisms comprised in a Total Reward System.

Extrinsic Rewards

Extrinsic rewards can be categorized into seven groups: compensation, benefits, workplace environment, recognition, development and feedback, promotion and career opportunities, and leadership. Each group is described in turn.

Compensation

Compensation refers to those financial returns (in cash or shares) that employees receive directly from their employers as part of their contractual relationship. Compensation returns can be fixed (base pay) and variable (short-term and long-term incentives). These two types of compensation are now described in greater detail.

- *Fixed Pay*

Fixed pay (also referred to as based pay or salary) is the cash compensation that an employer pays in return for the work performed by an employee. It reflects the value of the job or the person performing the job (his/her skills and knowledge). Its main purpose is to attract talented individuals, retain them and foster their long-term commitment to the organization. In some industries base pay levels for non-executive jobs are established based on collective-bargaining agreements. This type of pay has a direct impact on the amounts received in other reward components, especially variable pay, as it is used as the basis for their calculation (e.g., short-term incentives tend to be calculated as a percentage of base pay). It is important to highlight that in some parts of the world specific allowances, such as allowances for transportation or meals, are included in the calculation of base pay, which may have implications for tax purposes.

Annual adjustments to the base pay can be made according to changes in the overall cost of living or changes in the job market (i.e., what other employers are paying for similar jobs). Adjustments can also be linked to individual performance, competencies or values. These adjustments are known as *merit increases, competency-based and value-based increases* respectively. They are administered via a single matrix (or grid) that uses both the agreed level of employee's performance, competencies or values (assessed in a particular review meeting or performance appraisal) and the employee's position in the pay grade to determine a pre-set percentage increase in base pay. In the past, merit pay increases based on the achievement of specific performance goals or targets were very popular. Currently, most organizations relate their base pay increases to the achievement of higher-order competencies (normally using a particular competency framework) or to the demonstration of specific behaviors whilst performing the work. The rationale for this change is based on the idea that competencies and behaviors have a permanent nature (they add long-term value to the individual) whereas performance goals are of a variable nature (they can be achieved one year and missed the next one). Thus, performance goals are more appropriate in the variable pay component rather than in the fixed pay component.

- *Variable Pay*

Variable pay (also known as pay at risk) is a payment in cash or equity contingent on individual, group or organizational performance assessed objectively or by discretion. Variable pay does not have a permanent effect on labor cost. That is, if performance goals are not achieved, the payment is not granted. Its main purpose is to: focus employees on critical aspects of performance; to motivate them to work harder to achieve their goals; to reward employees that go above and beyond their job description; to share some of the company risk with the employees. In most countries variable pay is considered as taxable income.

There are two types of variable pay elements: incentives and bonuses. *Incentives* are based on predetermined performance goals and must be re-earned each performance period. Incentives can be short-term (dependent on annual performance results) or long-term oriented (dependent on multi-year performance results). Short-term incentives are normally paid in cash and determined as a percentage of base pay. Long-term incentives, although they can take the form of cash payments, tend to be paid in equity (e.g., stock options, restricted stock, phantom stock). *Bonuses* are one-off payments that are also subject to individual, group or organizational performance, but they are given after-the-fact, after performance has been assessed. With bonuses, the employee does not know how much he or she will received until the performance is evaluated. With incentives, the individual knows the amount he/she can obtain if the pre-set performance goals are attained. There are numerous variable pay programs, including among others: profit-sharing, gain-sharing, peer incentives, etc. (a thorough review of these programs, their functioning, issues and impact can be found in Gomez-Mejia *et al*., 2010 or Milkovich *et al*., 2010).

Benefits

Benefits are non-cash or services that employees receive in exchange from their employment relationship (some benefits are provided indirectly by the employer through service providers such as insurance companies). The purpose of benefits is mainly to help retain employees in the long-term by providing them with a certain level of security related to their health, welfare, retirement and time-off. Some benefits are mandatory by law, although it varies from country to country (e.g., unemployment insurance, social security insurance, disability insurance). In places such as Australia or New Zealand some benefits are subject to specific benefits taxes. The amount of benefits received usually depends on the hierarchical level of employees but many organizations now offer their benefits programs to all their employees regardless of their hierarchical status as it is more cost-effective and fair. Benefit programs can be categorized into income-protection, paid time-off, well-being, work-life balance programs and working environment.

- *Income-Protection*

These benefits are meant to protect employees from the financial risks inherent in their lives. Some examples of this type of benefit are: retirement plans, medical plans, life insurance, etc. Due to economies of scale, organizations can provide these protections to their employees at a lower cost than employees can get them for themselves.

- *Paid Time-Off (PTO)*

PTO programs reward employees with time rather than money. Traditionally, organizations separated paid time-off plans according to specific categories (e.g., vacation, sickness, personal time, etc.). Currently, many organizations are adopting what is called a paid time-off bank. They give employees a cumulative number of days off that employees can use as they wish.

- *Well-being*

These are programs that promote employees' physical, mental and social health. Examples of these programs are healthy menus in the canteen, subsidized gym membership, support to stop smoking, access to counseling services, massages or physiotherapy. The rationale for these programs is that they help create a healthy environment that benefits employees' state of mind and performance.

- *Work-life*

Work-life balance programs aim to help employees to better balance their time and commitments at work with their family and community responsibilities. These programs tend to be grouped into four categories: workplace flexibility, special leave, community involvement and caring for dependents. *Workplace flexibility* plans (also known as alternative work arrangements) comprise a variety of flexible work options (e.g., telecommuting, job sharing, part-time employment, flex-time) that enable employees to have more control over where, when and how their work is done. *Special leave* refers to personal time away from work to spend with family, friends or self. Some leaves are subject to governmental regulations in certain countries (e.g., maternity and paternity leaves); others vary depending on the organization (e.g., sabbatical, study leave). *Community involvement* practices allow employees to spend some of their working time as volunteers for community causes or, in some countries, they facilitate tax-free monetary donations from employees through the organization pay system. *Caring for dependents* refers to those programs offered by the organization to support the employees parenting and elder care (e.g. childcare vouchers, summer camps, disable adult care, geriatric counseling).

More and more organizations are using *flex plans* (also known as cafeteria benefits or flexible benefits) to address the needs and desires of their employees. Flex plans are based on the idea that not every employee appreciates the benefits provided by the organization in the same way. Therefore, rather than offering the same benefits to all, the organization can give each employee the option to choose the benefits they value the most (keeping the overall value of the benefits adopted constant). For example, some employees may prefer to receive a better company car than a particular healthcare insurance. To date, giving employees the option to choose their own rewards is mainly applied to benefits. However, Hallock and Olson (2009) have started to study organizations that are giving employees complete choice over their total reward package (i.e., base pay, variable pay, benefits, etc.). This type of flexibility is rare, but Hallock and Olson (2009) suggest that it will be a growing phenomenon in the future.

Workplace Environment and Working Conditions

The key purpose of this reward mechanism is to provide a safe and comfortable environment for employees. Normally, this element of the reward package refers to the physical setting in which employees work (e.g., size of the offices, desk space, temperature, work machinery, work materials). In some countries such as the UK, employers have, by law, a "duty of care" to look after the health, safety and welfare of their employees while at work. They are required to identify potential health and safety hazards and respond to eliminate them. Some organizations, however, provide additional security and comfort to further please their employees.

Recognition

Recognition reward programs provide a formal acknowledgment or give particular attention in the form of cash or non-cash awards (e.g., gifts, prizes, trips, 'thank you' notes) to employees for their special behaviors, performance contributions or length of service. The main purpose of these programs is to motivate employees, recognize their commitment to the organization and improve their morale. Recognition programs are more effective when the employee receives them, or at least is informed that he or she will receive them, soon after the behavior or performance achieved occurs (Kerr, 1999). It is crucial that the employee values the award received (for instance, giving someone that hates football tickets to watch the final of the Premier League as a recognition of excellence might not be very motivating).

Learning and Development

Organizations also offer their employees learning and development opportunities. The purpose of this form of reward is to support employees' sense of competence, self-efficacy and achievement as well as encourage their motivation. Organizations provide development prospects in the form of formal training (to improve on-the-job performance), careerenhancing opportunities such as time and funding to pursue higher education degrees and new or challenging work assignments (e.g., same job in a different country, participating in a strategic task force, etc.).

Promotions

A promotion refers to the advancement of an employee from one rank or position to the next one in the hierarchy system. A promotion is usually desirable to the employee because it brings higher compensation, internal and external status, greater autonomy, interesting challenges and the like. It is important to note that not every employee desires to be promoted. Some employees are content with doing the job they do, especially if they already feel well paid and satisfied. However, by and large, employees view promotion as a positive return that enhances their motivation.

Leadership

Leadership, understood as the process whereby an individual influences the behavior of a group of individuals towards common goals, can also be interpreted as a form of reward. Each organization has leaders (people in powerful positions that are responsible for organizational results), but these leaders may or may not demonstrate good leadership behaviors. Together with other behaviors, good leadership includes showing support; providing recognition, coaching and mentoring; consulting with employees about decisions that will affect them; delegating and empowering people; encouraging cooperation and team-work and discouraging zero-sum internal competition (where the success of one person must come at the expense of another); and building a network of information sources inside and outside the organization. All these behaviors are related to higher motivation, retention, individual and organizational well-being. They reinforce intrinsic rewards, which are now described.

Intrinsic rewards

Intrinsic rewards are based on positively valued experiences that an employee gets when performing his/her job. Based on previous research in this area, we highlight four intrinsic rewards: sense of *meaningfulness* (the degree of importance of the purpose an employee is trying to fulfill and the significance of the work he/she is performing); sense of *choice* (the positive feelings generated when an employee has the autonomy or discretion to choose how to accomplish his/her work); sense of *growth* (the degree to which an employee feels that he/she can perform his/her work skillfully, and due to his/her competence and efforts is accomplishing something important); and sense of *community* (the positive feelings of belongingness within a group) (Thomas and Velthouse, 1990; Deci and Ryan, 2002). When people experience these feelings they report that their work is intrinsically rewarding. These feelings are largely influenced by the social conditions, which in turn are affected by extrinsic rewards. Organizations (their leaders and managers in particular) may formally provide intrinsic rewards by seriously considering them when selecting their extrinsic rewards and when managing their people.

SUMMARY

Reward systems play a key role as they determine the employer-employee relationships. The reward system defines what the employer is willing to give, which has a direct impact on what employees are willing to contribute in exchange. Compensation and benefits alone are no longer effective as motivating mechanisms because they cannot create the employee engagement required to compete in today's complex and fast-moving business environment. To generate an employment relationship that is long lasting and difficult to imitate, organizations can adopt a more comprehensive view of rewards. We suggest a view that considers the full spectrum of rewards, both extrinsic and intrinsic, whilst producing a combination that is able to address employees' needs and desires as well as enable the organization to deal with changing external contingencies.

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