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Issues in Managerial Compensation Research

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Abstract
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ISSUES IN MANAGERIAL COMPENSATION RESEARCH

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ISSUES IN MANAGERIAL COMPENSATION RESEARCH

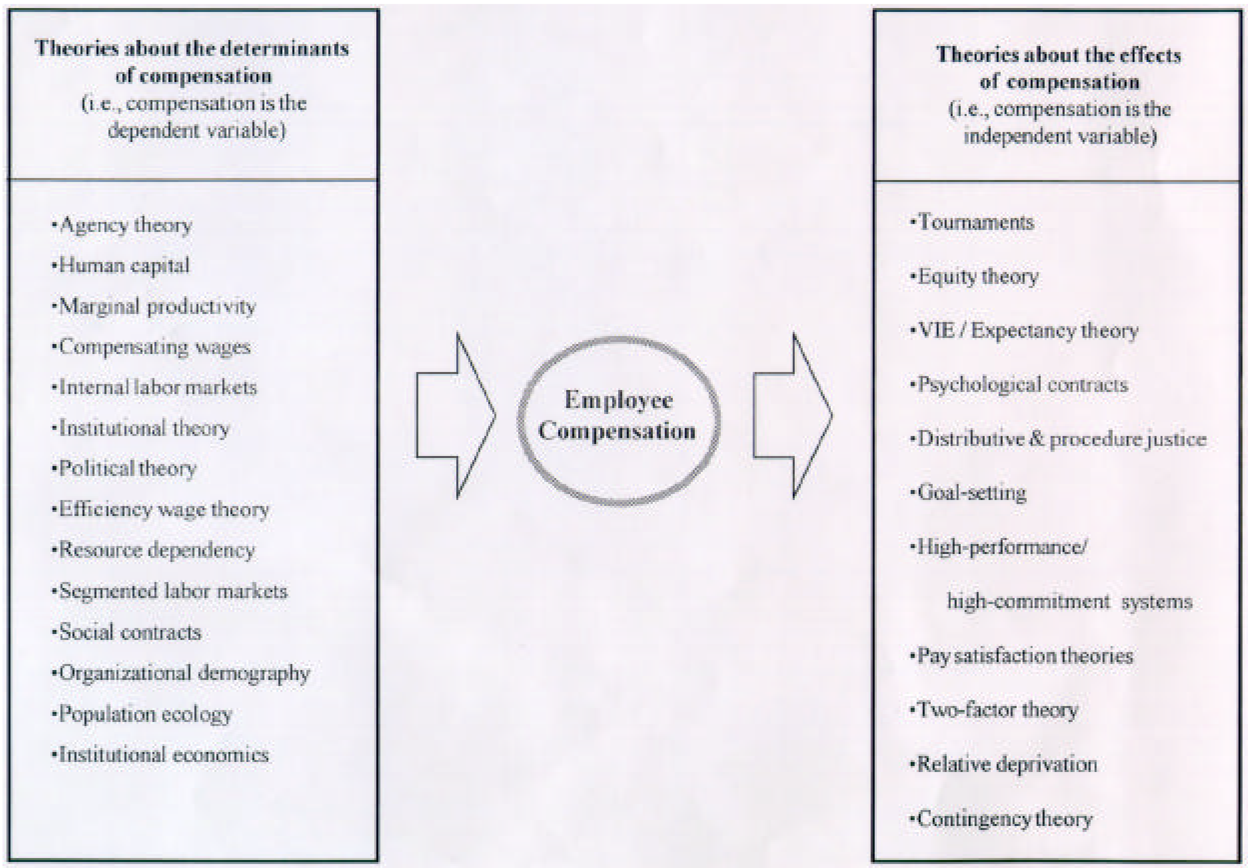
> *The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical (people) who believe themselves to be quite exempt from any intellectual influences are usually slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas (John Maynard Keynes, from R. L. Heilbroner, The Worldly Philosophers).*[1]

Compensation is at the core of any employment exchange (Milkovich & Newman, 1993; Simon, 1951). It is probably the most basic reason people agree to become employees and it serves as a defining characteristic of any employment relationship (March & Simon, 1958). Recently, managers have been bombarded with a profusion of ways to pay employees. There is team-based pay, broad-banding, pay at risk, paying for competencies, paying for skills, and even "The New" pay. Understanding which of these have the potential to add value and which are relatively more effective is a tough task, like untying the Gordian knot. Rather than simply cutting through the problem (Alexander the Great's tack), managers often seek guidance from research. Yet, researchers have also been bombarded - not just with new practices, but also with new theories. Included in this theoretic barrage is agency theory, tournament models, contingency theory, institutional theory, procedural justice, political influence theory, organizational demography, resource dependency, psychological contracts, and the resource-based view of the firm. The list seems almost endless. If Lord Keynes is correct that theories drive practical peoples' decisions, understanding which of these theories is useful and which is not is important for both compensation researchers and practical decision makers.

Traditionally, theories about compensation have been classified according to the questions they address (Gomez-Mejia & Balkin, 1992; Mahoney, 1979). Some treat managerial pay and pay systems as outcomes (i.e., the dependent variable), offering answers to questions about what factors explain differences in managerial pay (Figure 1). Others treat pay and pay systems as causes (i.e., the independent variable), answering questions about how compensation decisions will affect managers' attitudes and behavior and, ultimately, organizational performance.

[1] We note that Lord Keynes' remarks apply equally well to psychologists, sociologists, and statisticians whose ideas find their way into use and misuse by practical people.

FIGURE 1: Classification of Compensation Theories



While such classifications are useful, they may also mislead. To better understand the potential consequences of any pay system requires that we *simultaneously* account for the features of the pay system itself (treating pay as an independent variable) and related contextual features that may influence the consequences and outcomes of the pay system (treating pay as a dependent variable) (see Figure *2). The point is that context matters.* The impact of any managerial pay plan is influenced by the environment in which it operates (e.g., tax codes, economic conditions, public policy), the organization adopting the plan (e.g., ownership structure, level of firm risk; organization size), and the individual managers covered by the plan (e.g., risk taking attitudes; human capital factors; personal needs and goals). These contextual factors are the essence of theories which treat pay as an outcome. For example, human capital theory suggests managerial attributes which affect individual earnings (e.g., experience, education, skills); resource dependency and internal labor market theories offer guidance about factors in the organization and work itself which affect managerial pay (e.g., control over critical resources, hierarchy, required skills); and agency theory introduces factors such as risk aversion and information availability which drive the compensation preferences of managers and organizations.

When we consider the range of theoretical views which have been applied to compensation, we question how much leverage each provides us in terms of understanding both context and consequences and whether there are any fundamental principles linking them. Twenty-five years ago Mahoney (1979:4) pointed out that:

> [n]o comprehensive theory of employee compensation exists at present. Rather, there exists a number of segmented theories or models of compensation and employee behavior as well as numerous empirical observations focusing on specific aspects of compensation and employee behavior. These segmented approaches to analysis and understanding of compensation issues largely reflect the fact that each is directed toward answering a relatively specific question, a question different from questions addressed by other approaches.

The only difference between then and now is that more "segmented approaches"-additional theories-have been added to the list. Lord Keynes leaves little doubt that theories can be important guides for decision makers and scholars. Theories specify what is important and why, how things are related, and the conditions which effect these relationships (Campbell, 1990). Mahoney (1979: ix) concurs, "I believe that a good theory will outlive any specific application of that theory in practice. Practice will change with varying circumstances, yet good theory is independent of those circumstances and ought to guide changes in practice." Theory ought to be able to explain what works and what does not, for sure. But if theory is to be useful, it must also help us solve problems, meet changing conditions, anticipate the impact of important trends, and inform us about the impact of changes in compensation systems and policies. Therein lies the need to include both context and consequences when we examine managerial compensation. In this chapter we highlight some of the important issues we believe compensation theory and research should address. Our list is not exhaustive, but it does capture some of the most important problems, changing conditions, and challenges that are shaping the compensation decisions managers will be facing. We begin by reconsidering the definition of compensation.

REDEFINING COMPENSATION

Adam Smith was among the first to propose a formal theory of the relationship between compensation and work. He characterized pay in terms of the `net advantage' resulting from an exchange of multiple returns which, when added and subtracted, determine what the worker will provide to the employer (Mahoney, 1979; Smith, 1776/1976). Smith's original formalization notwithstanding, researchers have largely treated compensation as unidimensional. Fostered by psychological and economic views which emphasized the exchange of pay for effort (Ehrenberg & Smith, 1991; Opsahl & Dunnette, 1966; Lawler, 1971), compensation has for many years been narrowly defined as the pecuniary returns an organization offers its employees. Recently, a few emerging theories are returning to a broader view, defining compensation as a *bundle of valued returns* offered in exchange for a *cluster* of *employee contributions* (Bloom, 1995; Cappelli & Rogovsky, 1994; Gerhart & Milkovich, 1993; Tsui, Pearce, Porter, & Hite, 1995). Under this ‘bundle of valued returns' view, the set of returns an organization offers is an interrelated collection - a set of reparations, benefits, and items of value. Both practice and theory inform us about possible elements of this bundle. Certainly cash pay is one. Benefits such as health care, disability, and life insurance, vacations, sick leave, sabbatics, and perquisites such as country club memberships, car allowances, and expense accounts are others (Miceli & Lane, 1991). Theories suggest elements such as employment security (Osterman, 1988), mutual support (Eisenberger, Faslo, & Davis-LaMastro, 1990), trust (Smith, 1992), opportunities for self-actualization (Schein, 1980), working toward mutually valued goals, and even the joys of being part of an ongoing commitment which one values (James & James, 1992) are too. Rather than viewing the employment relationship as a series of bivariate associations (e.g., pay for work), the bundle of valued returns view shifts our attention from an exclusive focus on cash-based pay to the relationship among all valued returns. Implicit in this view is Adam Smith's premise about net advantage; that the outcomes of almost any compensation decision are influenced to a greater or lesser extent by other valued returns included in the bundle. For example, the effects of incentive pay on managerial behaviors probably depend upon employment security, autonomy to affect results, and the degree of trust underlying the employment exchange (Baker, Jensen, & Murphy, 1988; Bloom & Milkovich, 1995; Huselid, 1995). Certain bundles may elicit one set of employee responses quite different from the outcomes of another bundle. Beyond beliefs and anecdotes, very little is known about the profile of these bundles, the potential trade-offs among valued returns, and what they mean for both the organization and manager. Barringer and Milkovich (1995) report that managers are highly sensitive to changes in the mix of elements comprising total compensation. Reductions in employment security and earnings appear to be associated with lower job and pay satisfaction and increased interest in finding a new job. Excluding this study there is virtually no empirical work examining compensation as a bundle of valued returns.

Two theories may offer some guidance here: psychological contracts theory (Macneil, 1980; 1985; Rousseau & McLean Parks, 1993) and resource-based theory (Barney, 1990; Wright, McMahan, & McWilliams, 1994). Psychological contracts theory views the relationship between employer and employee as a collection of promises; a set of obligations to exchange contributions for returns. As this exchange becomes less like a simple sales transaction and more like an ongoing relationship, the location of valued returns moves from an exclusive focus on cash wages to a variety of socio-emotional benefits (Macneil, 1980; 1985; Rousseau & McLean Parks, 1993). Psychological contracts theory asserts that what the organization offers (i.e., the bundle of valued returns) is crucial for understanding what the employee contributes in exchange. Psychological contracts are schemas (Cantor, 1990) which give meaning to the bundle and direct individual reactions to it. Simple monetary returns evoke basic effort to met current work conditions. Mutuality and commitment on behalf of the organization elicits reciprocal commitment and also, perhaps, creativity and innovation from the manager (Eisenberger, Huntington, Hutchison, & Sowa, 1986; Eisenberger, et al. 1990). Consequently, psychological contracts theory might offer some leverage for understanding the effects of various bundles of valued returns (see Rousseau & McLean Parks, 1993 and the special issues of *Human Resource Management,* 1994, vol. 33, no. 2). Investigating how differences in these bundles affect managers' psychological contracts may be one approach to this issue.

Resource-based theory (RBT) shifts the focus to the organizational level of analysis. It predicts that sustaining a competitive advantage derives from gaining preferential access to and maximizing unique resources, including human resources (Barney, 1990; Wright, Smart, & McMahan, in press). The organization determines what unique human resource capabilities (e.g., innovativeness, sophisticated technical knowledge) it possesses and chooses a particular bundle of valued returns to optimize their use (Cappelli & Singh, 1992; Wright, et al., 1994). RBT is a twist on the strategic-contingent model which asserts compensation must be tailored to "fit" the business strategy and environment of the organization (Gomez-Mejia & Balkin, 1992; Milkovich & Newman, 1993). Under RBT, an organization's HR capabilities may determine its business strategy. Hence, the bundle of valued returns must be tailored to "fit" these HR capabilities, simultaneously attracting, retaining, eliciting, and directing them toward organizational goals. If innovativeness is a unique capability, the bundle should elicit its use to achieve and sustain the organization's competitive advantage. One research direction provoked by RBT is to study how changes in the bundle affect the exhibition and use of HR capabilities and what bundles do indeed support a sustained competitive advantage.

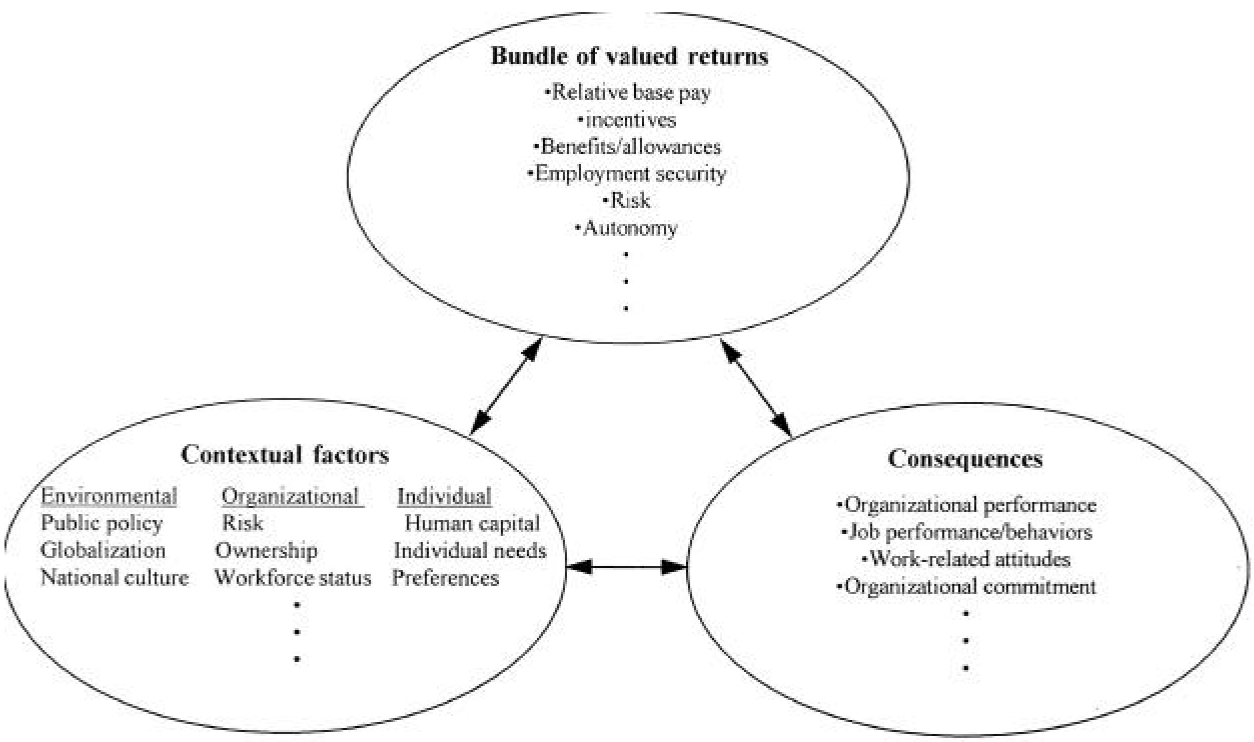
Research into the bundle of valued returns is just beginning and even the most basic questions remain to be answered:

- What should be included and excluded from the bundle? What are the critical elements and interrelationships?

- What factors (environmental, organizational, individual) determine the nature of this bundle?
- How does the bundle of valued returns exert its influence on managerial attitudes and behaviors? Do differences in the bundle an organization offers affect managerial attitudes and performance (Barringer & Milkovich, 1995)?

In sum, the bundle of valued returns changes our definition of compensation. It suggests that the interactions among the components of the employment contract are critical (and largely unstudied) determinants of employee attitudes and behaviors and organizational performance. As Figure 2 suggests, the critical challenges is determining if such a broad view adds to our understanding of workplace behaviors and performance. Or, does it simply muddy the waters? Once the bundle of valued returns is defined-what should be included and excluded, what are the key interrelationships-research can address the likely outcomes of these bundles and the contextual factors which affect both the relationships and their outcomes.

FIGURE 2: The Bundle of Valued Returns, Context, and Consequences



THE IMPORTANCE OF CONTEXT

We have already noted that context permeates issues about why compensation systems are structured as they are and what they are likely to end up producing. In so doing we join others who have called for scholars to take up issues related context in organizational research (Gerhart & Milkovich, 1993; Jackson & Schuler, 1995; James, Demaree, Mulaik, & Ladd, 1992) In this section we explore some of these contextual factors and consider how they might influence both the components of the bundle of valued returns and its related outcomes.

The missing role of risk.

Theory and practice tell us that risk-uncertainty about future events-is critical for understanding compensation (Eisenhardt, 1989; Levinthal, 1988). The popular business literature warns that constantly changing competitive environments impose uncertainty on organizations and employees (Drucker, 1992; Hammer & Champy, 1993). Organizational strategy researchers have demonstrated that risk influences business strategies, organizational performance, and the decisions managers make (Bromiley & Curley, 1992; Hill, Hitt, & Hoskisson, 1992; Miller & Bromiley, 1990). Yet, little is known about the relationships among risk, compensation, managerial behaviors, and organizational performance.

Two recent studies indicate that risk does have important effects on compensation decisions and outcomes. Using data from initial public offerings, Beatty and Zajac (1994) find organizational risk is negatively associated with the use of performance-based pay (e.g., stock options). A study by Bloom and Milkovich (1995) also indicates that business risk is negatively related to the use of performance-based compensation, this time in a sample of 360 large, established companies. Their evidence further suggests that business risk mitigates the erects of incentive pay plans on organizational performance; businesses operating in high risk situations which also rely more heavily on incentive pay exhibit poorer performance. Apparently risk does matter, at least for understanding performance-based pay.

Risk might also be responsible for the persistent problem of motivating managers to take future-oriented actions. Compensating managers so they will make decisions with the long-run interests of the organization in mind is difficult since these decisions often impose greater risk on managers' income (Hoskisson, Hitt, Turk, & Tyler, 1989; Walsh & Seward, 1990). Too much risk might induce managers to spend time trying to reduce it rather than focusing on critical organizational goals (Amit & Wernerfelt, 1990). Or, it might have the opposite effect-inducing managers to become reckless in their risk taking. Context again seems to play a part. Managers seem to be more risk taking when faced with losses and risk averse when faced with gains (Kahneman, Slovic, & Tversky, 1982). Kanfer (1990) suggests some form of volitional, self--regulating process underlies the goal-pay-performance relationships. Following her logic, uncertainty in organizations will mediate the effects of performance-based pay on managers' behaviors. Indeed, there may be an optimal level of compensation risk-variability in pay up to a point is motivating, but beyond that point it becomes dysfunctional. This optimal level of risk may be discretionary, given the components of the bundle of valued returns.

So far we have discussed risk as a component of context. Risk might also be an element of the bundle of valued returns. Internal labor markets theory stresses the importance of stable employment and the potential trade-offs higher security might provide (Kochan & Osterman, 1994; Pfeffer, 1994; Osterman, 1988). Here, increased security (less risk) is a return offered to managers. On the other hand, some people seem to like risky situations, viewing them as opportunities to be exploited (Lopes, 1987; Schneider & Lopes, 1986). This might explain why some managers choose commission-based jobs and others prefer jobs with base pay alone. Although compensation theories offer limited direction, we need to begin addressing whether risk is a component of the bundle of valued returns. If so, understanding how risk can be balanced against other returns could be important information for organizational decisions makers. It might, for example, help decision makers anticipate the consequences of changing the risk level of a bundle of valued returns (Brown & Huber, 1992).

If we believe, as pundits keep telling us, that rapidly changing business environments are becoming the new reality, issues about uncertainty and risk will be even more important. However, important questions remained unanswered:

- What is risk? How it should be defined and measured? How do definitions of risk change when we are speaking about risk at the organization- versus individual-level?
- Do different sources of risk have different affects on compensation systems and managerial behaviors (Miller & Bromiley, 1990)?
- Does risk influence the composition of the bundle of valued returns? Must greater risk from one source (e.g., greater use of variable pay) be offset by lower risk in another (e.g. job security pledges)?

The behavioral issues are particularly important. We need to know more about how employees process risk in the employment relationship-especially risk related to pay and other employment returns, how perceptions of risk in the employment relationship are formed, and how these perceptions influence the relationships among compensation, behaviors, and attitudes.

The politics of pay

The literature on organizational politics indicates attempts to manage impressions and influence important people may be more consequential than some would like to admit (Ferris & Judge, 1991). Ungson and Steers (1984) posit that CEO performance is, in part, dependent upon identifying, fostering, and maximizing strategic alliances with financial institutions, governments, and other key players. This political role is multi-faceted; part diplomat, lobbyist, negotiator, sales person, and even figure head, representing the company at important events. Lee Iacocca's ability to procure government loans to bail out Chrysler Motor Company is an example. These political roles may be as important as the decision-making responsibilities traditionally associated with senior management and, Ungson and Steers argue, are important determinants of managerial compensation. However, context, especially the organization's environment (industry, economics, international setting) likely has a lot to do with the relative importance of political roles. For example, political roles might be particularly important for organizations facing major challenges or threats. Executives of firms in the tobacco industry come to mind, as well as those in the banking and brokerage industries with the possible repeal of the Glass-Steagall Act. Ungson and Steers center their discussion on CEOs, but their framework could be applied to managers in general.

A very different approach to organizational politics is taken by Tosi and his colleagues (Gomez-Mejia, Tosi, & Hinkin, 1987; Tosi & Gomez-Mejia, 1989, 1994; Werner & Tosi, 1994). Tosi's work focuses on the ability of owners to monitor and control managerial actions. Their studies report distinct differences in compensation choices and outcomes between owner- and manager-controlled firms. Manager-controlled firms are those in which the company's stock is so widely held there is no single large stockholder who can exercise power over managers. In this case managers are able to exert excessive control over company decisions. The pay-performance link is much weaker in manager controlled firms which indicates these managers are able to influence the performance contingency of their pay (Gomez-Mejia, et al., 1987). This extra control may allow managers to engage in other activities which enhance their compensation, but are simultaneously detrimental to their organizations (Amihud & Lev, 1981; Walsh & Seward, 1990). Westphal and Zajac (1994) used political theories to explain the paradoxical adoption of long-term CEO incentive plans that are not put into actual use. When managers have excessive control they may also be able to manipulate their company's board of directors (BOD) (Lambert, Larcker, & Weigelt, 1993; Walsh & Seward, 1990; Westphal & Zajac, 1994). For example, the number of BOD members appointed by the CEO may be positively related to the CEO's ability to manipulate his or her compensation and that of other senior executives (Crystal, 1991; Lambert, et al. 1993). This research is complementary to Tosi's because it depicts managers as willing to manipulate their income through political means.

It appears that managers in manager-controlled firms may have greater opportunities to exercise excessive control on their own behalf and the organization's detriment. Research needs to identify contextual conditions under which managers are more (or less) likely to use this power to their own advantage. One of the important consequences of this research is that it indicates behavioral theories can explain variance in managerial compensation not accounted for by economic theories. It also highlights limitations of the segmented proliferation of compensation theories and the need to expand our theoretical purview to include cross-disciplinary developments.

The changing workforce: Compensating contingent managers

Transferring work from permanent, full-time workers to contingent or contract workers, called externalization, seems to be increasing (Belous, 1989; Davis-Blake & Uzzi, 1993; Pfeffer & Baron, 1988). Externalization has profound affects on the work performed by managers. Companies are shifting more work to contingent workers to avoid the costs associated with permanent workers (e.g., screening, selecting, hiring, training, and promotion expenses) and gain the ability to adjust work force levels quickly at little direct expense (Davis-Blake & Uzzi, 1993; Pfeffer and Baron, 1988). Contingent workers are usually paid on a different, often lower, salary schedule compared with similar core (i.e., permanent, full-time) workers. Benefits and employment security also differ. There may, however, be a dark side to externalization. Differences in compensation may increase internal pay inequalities. Contingent workers may be less committed to organizational objectives, either to compensate for their different bundle of valued returns or because they lack loyalty to the organization (Kidwell & Bennett, 1983; Pfeffer, 1994). If core and contingent employees must work interdependently, such inequalities may lead to increased conflict (Davis-Blake & Uzzi, 1993; Harrison & Bluestone, 1990; Pfeffer & Davis-Blake, 1992).

Contingent workers are not a homogeneous group. They differ not only in their knowledge, skills, and abilities, but also in the type of employment relationship they desire. Handy (1990) suggests that not all contingent workers seek core worker status. Some people appear to be more committed to their field than their organization and may prefer a more flexible contingent status (Meyer, Allen, & Smith, 1993). The bundle of valued returns necessary to induce desired behaviors from these workers is likely to be different. At a company located in Ithaca, New York a wife-husband team share the job of Personnel Manager, each working part of the day and assuming a portion of the responsibilities. The notion of a flexible compensation scheme, analogous to a flexi-benefit plan, may fit with organizations employing a significant proportion of contingent workers, especially if they cut across functional roles and organizational levels. Furthermore, beyond the conventional core-contingent dichotomy, all employees are in some sense contingent. Contingent becomes a matter of degrees-the employment relation is a continuum of more to less contingent. One end of this continuum is represented by General

Electric whose CEO Welch asserts "...the new psychological contract, if there is such a thing, is that jobs at GE are the best in the world for people who are willing to compete." Such employability is clearly different from GE's competitors like Toshiba or Hyundai who offer careers and more long-term, if not lifetime, employment relationships. The contingent nature of the employment relationship becomes part of the bundle of valued returns.

Very little is known about the outcomes of contingent employment relationships or the effects of mixing core and contingent workers. Anecdotal evidence is our primary information source. Compensation issues, particularly those related to the bundle of valued returns, are a primary differentiating factor between the two groups of workers. As such, we need to learn more about how differences in compensation policies affect the outcomes of these two forms of employment relationships.

- Do all managerial and professional workers aspire to become core workers?
- Is the contingent contractual relationship a valued return for some managers?
- Does the inequality in employment relationships between core and contingent workers cause increased conflict, shirking, or even sabotage (McLean Parks & Kidder, 1994)? If so, what type of bundle would mitigate such behaviors?

Right now answers are based on speculation and conjecture, the state of knowledge is very incomplete and the research opportunity is great.

The globalization of compensation

Inuits allegedly have 200 words for snow, presumably reflecting its importance in their culture. U. S. managers may have over 200 words for pay (Fay, 1989), perhaps reflecting its importance in their culture. Fundamental cultural differences influence the lens through which people view compensation. This is echoed in the different meanings compensation has in different languages. For example, the term for pay in Malaysia *ganti rugi* and in Slovak *kompenzacia* means to replace a loss; in Hebrew *shaceer* means reward, in Sweden *utajmnig* means making equal; and an early use of the word `pay' in the English language meant to pacify or please (Remick, *1995;* Shipley, *1984).*

Culture, a learned system of meaning and values, exerts significant influence on work-related attitudes and behaviors (Bhagat, Kedia, Crawford, & Kaplan, *1990;* Hofstede, 1980; Triandis, 1993). Differences in cultural values most likely influence the basic premises underlying compensation theories, yet only two of the theories in Figure 1 (i.e., social and psychological contracts) explicitly include the role of norms and values. Theories of cultural values suggest that the saliency and value of employment returns are influenced by culture (Bhagat, et al, 1990; Triandis, 1993). However, little is known about *how* culture influences the way people view their employment relationships and the returns they receive. Kim, Park, and Suzuki (1990) report that the equity norm is held by employees from Japan, Korea, and the U. S., but the strength of the norm appears to vary across cultures. Hui, Triandis, and Yee (1991) found that cultural differences explained when people used equity- or equality-based reward distributions, but the social situation also seems to influence how rewards are distributed. This raises the point that intra-cultural variation in equity norms may be greater than inter-cultural variation. We simply do not know. How these differences play out in the employment relationship is not well understood but, this research does indicate that cultural differences appear to affect attitudes about compensation. Once again a reoccurring theme emerges: controlling for context is of paramount importance. The effectiveness of international compensation policies must, at least in part, dependent upon how they support or conflict with cultural norms and values (Arvey, Bhagat, & Salas, 1991; Bhagat, et al., 1990; Triandis, 1993). Understanding which cultural values matter and how they effect employees is profoundly important to managers as the globalization of economies continues.

One of Hofstede's (1980; Hofstede, Neuijen, Ohayv, & Sanders, 1990) five dimensions of culture, individualism-collectivism, has a well developed theoretical and research literature and seems well suited to compensation research (see Wagner, 1995 for a review). Individualistic cultures value achievement, competition, and individual over group goals. Equity norms guide the allocation of rewards. Collectivist cultures emphasize security, conformity, and group over individual goals (Triandis, 1993; Wagner, 1995). The I-C dimension was used by Hui, et al. (1991) in their study of reward distribution preferences. Theory predicts that individuals from collectivist cultures prefer equality-based distributions while those from individualist cultures prefer an equity basis (Hofstede, 1980; Triandis, 1993). This rather straightforward hypothesis is still understudied. The supply of research questions expands greatly when one considers that several dimensions of culture may work together to influence key compensation relationships, for example I-C and uncertainty avoidance (UA) (Hofstede, 1980; Triandis, 1993). Managers from a is culture high on collectivism and UA may react more negatively to incentive pay than those from a high individualism/low UA culture. Whether these differences effect the pay-performance relation is not known. Cultural differences might also influence which components in the bundle of valued returns are salient and how various bundles influence work attitudes and behaviors.

There has also been limited exploration into the effects of expatriate compensation on managers' attitudes and behaviors. Expatriates are managers working in a country different from their native home. The considerable expatriate pay literature is mainly descriptive and prescriptive (Reynolds, 1994), little is known about the causes or consequences of expatriate compensation. Expatriate pay is unique in that it is designed, administered, and communicated as a "bundle of valued returns." Typical elements include base plus performance pay, allowances for housing and dependent education, tax equalization, relocation expenses, and premiums for international service. Research suggests that expatriates are sensitive to any changes in the elements of their bundle of valued returns (Guzzo, Noonan, & Elron, 1994). More needs to be learned about the expatriate employment relationship and the role of the bundle of valued returns in it.

There are also global public policies differences. Some returns are taxed heavily in one country, but not in another. There are differences in caps on retirement plan contributions and regulations on the ratio of pay between the top-most and lowest organization levels in some countries, but not in others. What do compensation theories predict will occur under these conditions? Will the importance of non-cash returns in the bundle increase? As the move towards globalization continues, these research issues will gain in importance.

UNRESOLVED QUESTIONS ABOUT HIERARCHIES & EQUALITY IN PAY

There is an unexplored yet crucial disagreement over the structure of pay differences within an organization: should pay structures (differentials) be compressed and egalitarian or should they be consecutively larger like prizes in a golf tournament (Milkovich & Newman, 1993)? Tournament theory suggests the latter (Lazear & Rosen, 1981). Employees are motivated, tournament theorists argue, not only by their current level of compensation, but also pay at the next higher level in the organizational hierarchy. Like the prizes in a sports tournament, increasingly wider gaps between adjacent levels in the organizational hierarchy are posited to be motivating. Since *relative* performance matters, higher performing managers should garner a larger share of the compensation pie. Data from auto racing (Becker and Huselid, 1992) and professional golf (Ehrenberg and Bognanno, 1990) indicate that tournament structures are important for explaining individual performance. Proponents of more egalitarian pay, on the other hand, argue that managers find tournaments unfair and demotivating (Kochan & Osterman, 1994; Lawler, 1992; Pfeffer, 1994). Egalitarian pay structures (e.g., equal differentials) are said to inculcate feelings of fairness, community, cooperation and team work (Kochan & Osterman, 1995; Pfeffer, 1994). While research contrasting the effects of different structures is rare, Cowherd and Levine (1992) report that the relative difference between top and lower-level employees' salaries is negatively related to product quality.

A key notion in both tournament and egalitarian models is that top managerial pay affects the attitudes and behaviors of employees throughout the organization. Whether through trickle down or more directly, the relative amount managers are paid influences their own motivation as well as that of other employees. The question is, "Do the behavioral premises underlying the egalitarian and hierarchical models hold--and in what contexts?" Virtually all of the research in support of tournaments has sampled work where only individual relative performance matters; there are no work interdependencies[2]. Where work is more highly interdependent, the competition among managers for higher pay fostered by tournament structures may be deleterious. Managerial cooperation appears to be related to the way managers are paid (Hill, Hitt, & Hoskisson, 1992). On the other hand, compressed pay structures are believed to demotivate those at the top; the skills and effort required in upper level work are inequitably compensated compared to lower level work (Milkovich & Newman, 1996). So organizations with compressed pay structures may be beset by poorly performing senior decision-makers or adverse selection ratios for top management positions. Whether and when tournaments are viewed as fair/unfair or egalitarian pay structures are viewed as just/unjust are questions yet to be answered. These theories are also silent about the effects of differences in how managers are paid. For example, does the degree to which senior management's pay is tied to organizational performance vis-a-vis lower-levels make any difference? Other compensation theories (e.g., agency and expectancy theories) place great emphasis on the performance-contingency of pay. Perhaps if managers' pay is more dependent on organizational performance, other employees will perceive the differentials to be fair even though managers are paid relatively more. In other words, justice perceptions might be another important mitigating factor.

Survey evidence indicates that structures clearly vary within industries in the U.S. and across countries (Milkovich & Newman, 1996). The ratio of top executive's pay to that of the lowest level worker is 120-150:1 in the U.S., 20-30:1 in Europe, and 15-20:1 in Japan (Crystal, 1991). In some countries the ratios are regulated by public policy. Again, context (e.g., public policy) plays an important role in understanding different configurations of the bundle of valued returns and their consequences. In the next section we examine public policy in terms of social contracts.

THE SOCIAL CONTRACT

Theories about the social contract-norms about fair treatment, justice, and rights-are among the oldest models applied to work (Locke, 1690/1962; Marx, 1906/1976; Rousseau, 1762/1962). While theories about the social contract may differ in specifics, most share common

[2] We recognize the important contributions of caddies to the performance of professional golfers and pit crews to the performance of auto racers. However, caddie and pit crew pay was not included in the studies cited above.

fundamentals. First, social contract theory stands in opposition to the assumption of opportunism (Williamson, 1985). Cooperation is assumed to be the fundamental motivation behind collective behavior; managers are expected to collaborate since organizational and individual success are inherently intertwined (Keeley, 1988; Lessnoff, 1990; Macneil, 1980).

Second, the social contract is posited to underlie all individual employment contracts; it carries societal norms into the work relationship. Societal norms about ethics, fair dealing, individual rights, and "...due reward[s] in accordance with honor, standards, or law *(The American Heritage Dictionary,* 3rd ed.: 979)" influence the nature and structure of employment relations (Donaldson & Dunfee, 1994; Macneil, 1980; Schein, 1980).

> Contract without common needs and tastes created only by society is inconceivable. Contract between totally isolated, utility-maximizing individuals is not contract, but war ...contract without social structure and stability is-quite literally rationally unthinkable, just as man [sic] outside society is rationally unthinkable (Macneil, 1980: 1).

Social and psychological contracts are distinct. A psychological contact is inherently an individual-level construct, encompassing the relationship between a single manager and a specific organization. A social contract governs the roles and responsibilities of the larger society-it affects and is affected by governmental bodies, public policies, organizations, and individuals. Social contract theories tell us what "ought" to occur in any employment relationship. The focus is frankly normative, reminding us that,

> no amount of empirical accuracy, including an infinite array of facts, can ever itself add up to form an "ought" ....To suppose that one can deduce an "ought" from an "is," or, what amounts to the same thing, that one can deduce a normative ethical conclusion from empirical research , is to commit a logical mistake ...(Donaldson & Dunfee, 1994: 253).

Third, the social contract dictates that all stakeholders in the organization must share fairly in organizational success; benefits from any collective action should be distributed in a just manner to all participants (Donaldson, 1990; Griesinger, 1990). The basis for this distribution may differ across social contracts (e.g., equity vs. equality), nevertheless, justice norms dictate that no one should garner a disproportionate share of the benefits. "As some people improve their situations, others should continue to improve, to become better off (Rawls, 1971/1990)." Donaldson (1990) discusses social contract issues under the rubric of stewardship theory and juxtaposes it with agency theory assumptions. According to Donaldson (1990), under stewardship theory the employer-employee relationship is one of cooperation; under agency theory it is one of conflict driven by opportunism. Under stewardship theory, organizational control mechanisms are directed at encouraging or un-encumbering collaborative action; under agency theory organizational controls (contracts) are implemented to limit conflict or coerce joint effort. These contrasts raise some interesting research opportunities.

The organizational literature is witnessing a resurgent interest in trust as a differentiating factor in employment relationships (Kochan & Osterman, 1994; Pfeffer, 1994; Smith, 1992). Social contract theories offer a guide to analyzing the importance, development, and operation of trust in work relationships (Macneil, 1980; 1985). When there is a need for flexibility, where information is limited, or where conditions are in a state of flux, employment relationships cannot be specified in terms of a written contract (Macneil, 1980). Too many issues and contingencies would need to be covered and the difficulty in writing and enforcing such contracts makes then untenable. The alternative is to base the relationship on trust. Contractual solidarity results from interdependencies between organizations and managers; both parties recognize there is a strong need for future cooperation. Trust, then, ensures both parties will act to preserve the relationship. Psychological contracts theory adopts many of these presumptions and applies them to understanding how social norms pervade and influence managerial attitudes and behaviors (McLean Parks & Kidder, 1994; Rousseau & McLean Parks, 1993; Schein, 1980).

Finally, there are public policies implications of social contracts. The public policies of representative governments theoretically reflect social contract norms. As such, they impose constraints on the employment relationship (e.g., minimum wage, social security, and family leave statutes). Expectations embedded in the psychological contract are probably influenced by public policy and policy debates. For example, recent criticisms of CEO pay may be changing managers' views of what are fair pay differentials in managerial ranks (and underlies our earlier discussion of hierarchical and egalitarian pay structures). The effects of differences in public policies on managers' expectations, the configuration of the bundle of valued returns, and its consequences is unknown. For example, differences in tax and family leave policies in the European Union may impact managerial attitudes the toward variable pay initiatives undertaken by many U. S.-based multinationals. Since research applying the social contract view to the employment relationship is just beginning, opportunities abound.

SUMMARY

Paradoxically, change is becoming a constant in business. In a world where a variety of forces (some of which we discussed) create an almost constantly shifting setting for employment relationships, we believe that what is meant by compensation needs to be reconsidered. We have suggested the bundle of valued returns as a viable starting point. Given a definition of compensation that may include relational as well as economic aspects, we believe that it is important to understand contextual factors which may mitigate the compensation attitude/behavior-performance nexus. In our presentation, we used *practice* to inform us about contextual variables that matter and then turned back to *theory* to predict the potential implications and consequences of those factors. This process highlights that theory and research need to both inform managers' decisions and, in turn, be informed by the consequences of those decisions. Ours is a field of inquiry irrevocably intertwined with the decisions of practical people.

As Mahoney (1979) points out, managerial compensation lacks a unifying theory. Indeed, we believe it is becoming increasingly segmented theoretically. One way around this segmentation might be a focus on compensation in context; understanding how environmental, organizational, and individual contexts influence the configuration and consequences of the bundle of valued returns (Figure 2). The multiple stakeholders to the employment relationship-societies, governments, economies, organizations, families, managers-create the contexts in which compensation systems operate. We illustrated how three such factors might operate.

- Risk at the individual (e.g., manager's preference for risk), organizational (e.g., financial stability of the organization), and environmental (e.g., industry-wide economic conditions) levels is important to theories on both sides of Figure 1. It may influence the relative weight given to performance-contingent pay in the bundle of valued returns, the necessary arrangement of other returns in an incentive-laden bundle, and the way managers react to the variable components of a particular bundle.

- Internal and external politics may operate at the individual (e.g., impression management), organizational (e.g., manipulating corporate governance mechanisms), and environmental (e.g., influencing the decisions of public policy makers) levels. Political factors may impact how much control managers have over their pay or the severity of restrictions imposed on the bundle by government regulations.

- Workforce changes appear to be occurring at the individual (e.g., what the manager wants out of the employment relationship), organizational (e.g., organization's core-contingent mix), and environmental (e.g., public policies regulating the employment relationship) levels. Such changes may be reflected in what returns a manager values, what type of employment exchange the manager wants, or what returns an organization is legally required to provide.

Obviously we encourage more research attention to these contextual variables themselves and, as our discussion of pay hierarchies was intended to illustrate, how they influence substantive areas of compensation research.

It is a challenging time in the field of managerial compensation. There is no shortage of practical innovations or research ideas. Yet, in this flow of innovations and ideas there may be opportunity. A blend of theory, research, and practice holds the promise of expanding knowledge about the forces and processes that shape compensation systems and their links with managers and organizations. Dunnette (1990) calls this the "blend that binds" because collaboration between scientists and practitioners may offer the best opportunity to enhance the effectiveness of both parties. We issue the same call, for a new partnership between managers and scholars to better advance the state of the field and facilitate our understanding of the critical role compensation plays in the employment relationship.

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