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DOES THE SIZE OF THE ORGANIZATION AFFECT COMPENSATION STRATEGIES? AN EMPIRICAL ANALYSIS

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ABSTRACT

Little is known about how compensation strategies in small businesses differ from those in large firms. Based on past research involving organizational characteristics and pay strategies, assumptions were initially made that small firms would exhibit more flexible, egalitarian and non-traditional pay strategies, serving to maximize pay-at-risk and minimize pay levels to reduce the fixed costs of employment. Consequently, data on compensation policies were analyzed from 148 successful small and large businesses. Contrary to predictions, there were no differences between small and large organizations in pay level, pay structure, emphasis on market competitiveness or emphasis on paying for performance. Implications of these findings are discussed in terms of their relevance to the small business decision maker.

INTRODUCTION

Increased national and global competition have pressured American businesses to revamp key pay practices to ensure that workforce productivity is maximized while fixed costs of the workforce are minimized. Whether successful organizations use more innovative approaches to pay seems to depend to some degree on the characteristics of the organization (Balkin & Gomez-Mejia, 1984; Balkin & Gomez-Mejia, 1987; Gerhart & Milkovich, 1990; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992; Lawler & Jenkins, 1992). For example, successful organizations in start-up and growth stages tend to adopt "experiential" (Balkin & Gomez-Mejia, 1987; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992) compensation strategies that put more emphasis on variable pay that is linked to the achievement of specific long-term individual, group or corporate goals. Since growing organizations tend to have fewer resources and need to respond more quickly to competitors and the environment to succeed, they use pay strategies that lower the fixed costs of base pay and increase "variable pay" leveraged by long-term, strategic goal accomplishment. These growth management strategies (or "experiential strategies," as Gomez-Mejia calls them) are both decentralized and flexible in order to meet the unique requirements of individual business units. Successful mature organizations tend to use more traditional "algorithmic" pay (Balkin & Gomez-Mejia, 1987; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992) which emphasizes base pay, hierarchical relationships, seniority or short-term individual performance results (such as typical merit pay programs). These mature businesses are in less volatile competitive environments and generally have more resources as well as a large employee base that may utilize and benefit from extensive hierarchies. Thus they are able to provide higher base salaries that permit a long-term, stable workforce. These algorithmic plans tend to be uniform throughout the organization's business units, designed and supported by a centralized compensation function.

Although some research exists regarding how pay strategies are used by organizations at different growth stages, sales levels and degrees of diversification (Balkin & Gomez-Mejia, 1984; Balkin & Gomez-Mejia, 1987; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992), very little is known about differences in compensation strategy between small and large organizations, except that larger organizations usually pay at higher levels than smaller comparable organization (Gerhart & Milkovich, 1992).

There are several reasons why differences in compensation strategies would be expected between small and large businesses. First, small businesses usually lack extensive hierarchies and multiple business units, and thus it could be expected that small business compensation programs would be more experiential than algorithmic. Second, small businesses usually have lower sales and hence are less likely to want to spend many financial resources in high fixed salary costs, preferring to link variable pay to the accomplishment of key organizational objectives. Third, since small businesses are often faced with competitive and environmental pressures that are more pronounced and challenging than those found in large organizations, it would be expected that their employees would be paid so that strategic business goals would be met through the use of incentive systems and a large amount of "pay at risk." Fourth, since small firms are less likely to have internal labor markets from which to choose labor (Doeringer & Piore, 1971), we would assume they would be more likely to have pay systems more closely aligned with competing in the external labor market. Fifth, smaller organizations have fewer institutionalized cultural characteristics that are usually reinforced by compensation practices in larger firms.

Although these predictions make sense, no research currently exists that includes the size of the organization as a differentiating factor in compensation strategies. Understanding the differences between the pay strategies of successful small and large organizations would be useful to the small business human resource manager or consultant in prescribing optimum compensation policies. Thus, this paper presents data comparing four key compensation policy decisions between successful small and large organizations from a sample of Midwestern employers.

Pay Level Policy

Organizations typically develop policies, formally or informally, about the level of pay in relationship to pay for similar jobs in the broader labor market. Smaller organizations often will be less able to lead the market in salaries due to more limited resources. Although traditional compensation philosophy has asserted that higher pay levels will attract, retain and motivate higher quality employees, which in turn will lead to enhanced organizational effectiveness, this idea has been called into question in today's more innovative compensation climate (Lawler & Jenkins, 1992). Our assumptions about smaller organizations lead to the conclusion that they would offer lower base salaries in favor of higher "pay-at-risk." Since smaller organizations must exist in more competitive and rapidly changing environments where fixed costs must be controlled, we would anticipate they would offer lower base salaries so that they could drive key behaviors through some type of incentive pay. Thus, we would expect smaller organizations to adopt lower fixed pay policies than larger organizations.

Additionally, base pay and benefit levels, particularly for managers and professionals, will be higher in organizations with higher sales levels (Balkin & Gomez-Mejia, 1984). Since higher sales are usually associated with organizational size and success, it could be expected that smaller organizations would exhibit lower pay levels.

Pay Structure

A very limited amount of research has been published on how pay structures are related to organizational characteristics. As Gerhart and Milkovich (1992) point out, the pay structures found across organizations often differ in both type and number, and little is known about the impact of such differences on organizational effectiveness. Pay systems can be found on a continuum from egalitarian to hierarchical (Gerhart & Milkovich, 1992; Milkovich & Newman, 1996), with egalitarian pay systems having fewer levels and narrower differentials between levels than found in hierarchical structures. The popular notion is that more egalitarian structures lead to increased teamwork, cooperation and trust, more creativity, innovation and commitment. Egalitarian structures are also associated with experiential pay strategies, since they reject the large hierarchies that are typical of algorithmic pay plans. However, egalitarian structures are more likely to cause salary compression and difficulty in recruitment, problems which would be minimized in small organizations since fewer employees are involved. Hierarchical structures, while efficient, emphasize status, lower initiative, creativity and risk-taking (Milkovich & Newman, 1996). Since small businesses by definition have fewer employees and thus usually fewer jobs, they will be less likely to have hierarchical pay structures featuring many salary grades. Additionally, the smaller number of employees often require workers to "wear more than one hat" and thus be flexible and team-oriented in working relationships in order to respond to competitive pressures, qualities that an egalitarian structure would be more likely to support. Thus we would expect small firms to have more egalitarian pay structures, including fewer grades and smaller differences between the grades.

Emphasis on Internal Versus External Equity

Traditional salary plans have incorporated both internal equity and external competitiveness (or external equity). These plans have sought to balance market pressures with the strategic, unique job values of each organization. While external equity is established through market surveys and analysis, internal equity has typically been established through complicated job evaluation plans. These plans often use "compensable factors" (such education or experience required, supervisory responsibility, decision making requirements, etc.) divided into degrees which are worth varying numbers of points and a hierarchy is created based on the total point values of each job across a number of compensable factors.

Contemporary literature and progressive compensation consultants often state that an emphasis on internal equity inappropriately accentuates status differences, focusing employee attention on irrelevant objectives (Lawler, 1990) and emphasizing power and resource acquisition instead of the accomplishment of organizational objectives (Emerson, 1991;

Schuster & Zingheim, 1992). Job evaluation is often considered to be an administrative dinosaur in contemporary businesses. Alternatively, emphasizing market pay rates when determining salary programs is seen as more complementary to current competitive pressures and more cost-effective in attracting and retaining productive workers. However, it is acknowledged that all organizations must take both internal and external equity into account, in varying degrees, to create effective pay systems.

Since smaller organizations are less likely to develop extensive hierarchies and are more impacted by external competitive pressures, an emphasis on internal equity through job evaluation is more likely to be found in large, hierarchical organizations. Additionally, we would assume that smaller businesses would be more likely to emphasize market-based pay over internal equity concerns (although the actual pay level may be set at below market rates to achieve optimum flexibility through incentives), given that their more limited resources would restrict the amount of time and money available for extensive job evaluation procedures.

Pay Mix

Traditional compensation strategies have emphasized base pay for the majority of employees, providing variable pay (through incentive payments, bonuses, etc.) based on goal accomplishments only for top executives. Although there are large variations in how organizations deliver pay to individuals (Gerhart & Milkovich, 1990), there has been a general trend for businesses to put more pay "at risk" for employees at all levels. These pay systems usually offer a base salary that is at or below market rates, and allow employees to earn lump-sum bonuses if and when certain predetermined objectives are achieved. Since these bonuses do not increase base salary, such pay systems are seen not only as motivational tools, but as methods to hold down the fixed costs of employment, sort of an "economic insurance" against harder times.

According to some contemporary compensation theorists, larger organizations will be less likely to have incentive systems, since the administration of incentives in large organizations becomes problematic due to the importance of extensive checks and balances needed to achieve procedural and distributive justice across a broad variety of jobs and employees (Balkin & Gomez-Mejia, 1987; Gerhart & Milkovich, 1990). Additionally, because some large organizations generally have more financial resources, they are less concerned with holding down fixed costs than are small businesses. Conversely, since small organizations must ensure that business objectives are accomplished in a volatile competitive environment, they will be more likely to encourage goal accomplishment through variable pay systems.

There are four research questions that emerge from this discussion. Since organizational maturity and sales have previously shown relationships with a number of characteristics of pay policies as well as organizational size (Balkin & Gomez-Mejia, 1987; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992), these variables will be considered in the analyses.

1. Pay level policy:
After controlling for organizational maturity and sales, successful small businesses will be more likely to express lower pay level strategies than will larger businesses.

2. Pay structure
a. After controlling for organizational maturity and sales, successful small businesses will be more likely to have fewer salary grades than larger businesses.
b. After controlling for organizational maturity and sales, successful small businesses will be more likely to have smaller differentials between salary grades than larger businesses.

3. Internal versus external equity:
After controlling for organizational maturity and sales, successful small organizations will be more likely to emphasize market rates over internal equity considerations than will larger organizations.

4. Pay mix:
a. After controlling for organizational maturity and sales, successful small businesses will be more likely to offer incentive pay than will larger businesses.
b. After controlling for organizational maturity and sales, successful small businesses will be more likely to emphasize a pay-for-performance strategy than will larger businesses.

METHOD

A questionnaire was sent to 1,121 organizations, taken from two samples, a Dun & Bradstreet database and the membership roster of a local HR manager's professional organization. There were no significant differences in the major variables between the two samples in sales or whether they were publicly or privately owned. Respondents did represent slightly larger companies (about 225 more employees) and longer business tenure (about 10 years longer). However, these differences are to be expected, since larger, more established companies probably have more staff available to complete such questionnaires. Since this study is interested only in companies that are considered to be successful, organizations were selected from the sample for which the respondent reported that they were "very successful" or "somewhat successful" in achieving both profitability and operational goals (see Table 1).

Measures

Compensation managers completing the survey were asked a number of questions describing the structures and policies associated with their pay programs. To assess pay level policy, respondents were presented with an item from Gomez-Mejia and Balkin's (1992) compensation strategy scale, "Over most of our jobs, the preferred position of our organization's salary levels with respect to competitors is:," with five possible responses from "substantially below the market" to "substantially above the market." To assess the pay structure, respondents were asked to indicate the number of salary grades they had, and to

Table 1
Description of Samples

Sample	Number in Sample	Respondents	Response Rate
Dun & Bradstreet	866	121	14%
HR Manager Asso.	255	52	20%
Total	1121	173	15%

Of 148 firms that reported themselves to be at least "somewhat successful" in meeting profitability and operational goals:

Industry:		Full-time Employees:		Sales:		Maturity Stage:	
Health care	30%	Fewer than 100	10%	Under $50 million	30%	Start-up	2%
Manufacturing	25%	100 to 499	40%	$51 to $500 million	37%	Growth	31%
Service	18%	500 to 999	20%	Over $500 million	34%	Mature	62%
Banking, finance	16%	1000 to 499	24%			Decline	5%
Wholesale/retail trade	6%	5,000 or more	6%				
Transportation, utilities	5%						

report their average midpoint differential, or the average difference between the midpoints of the salary grades, expressed as a percentage of the minimum. This "midpoint differential" is a commonly accepted measure of pay level differences. Internal versus external equity emphasis was assessed through the question, "In general, if you had a job where market data and job evaluation points each indicated different pay levels, which would you do?" to which respondents could answer, "rely totally on the job evaluation point score," "rely mostly on the job evaluation point score," "compromise equally between job evaluation results and market data," "rely mostly on market data" or "rely totally on the market data."

Policies toward pay mix were measured in two ways. First, respondents were asked if they offered employees annual incentives or bonuses based on specific performance standards. Second, eight items were taken from Gomez-Mejia and Balkin's (1992) compensation strategy survey that are listed in Table 2. These items were analyzed using principal component analysis and loaded on one factor (eigenvalue = 4.00) which account for 50 percent of the variance. A scale was summed from these items which exhibited adequate reliability (a = .85).

Table 2
Items in Pay Mix Scale[1]

1. We have a strong commitment to distribute rewards based upon contributions to the organization.
2. In this organization, a portion of an employee's earnings is contingent upon group or organization performance goals being achieved.
3. We designed our compensation system so that a substantial portion of our compensation costs is variable pay in the form of incentives, bonuses or related rewards.
4. We believe that employees should be risk-takers with some of their pay.
5. Corporate performance is used as a criterion for pay decisions and aggregate incentive programs (e.g. gainsharing, profit sharing) for employees.
6. Pay incentives such as a bonus or profit sharing are an important part of the compensation strategy of this organization.
7. Pay incentives are designed to provide a significant amount of an employee's total earnings in this organization.
8. Bonuses are provided often; the frequency of bonuses is viewed at least as importnat as their magnitude.

Responses were on a five-point scale from "strongly disagree" to "strongly agree"

[1] Items are taken from Gomez-Mejia and Balkin's (1992) compensation strategy scale.

To assess the independent measure, size of the organization, respondents were asked to indicate the number of full-time employees at their firms. The control variable of organizational maturity stage was determined by an item, "How would you characterize the stage your organization is in?" with the responses of "Start-up: A new company five or fewer years old that is small in size and run by an entrepreneur; anticipates most growth in the future," "Growth: Sales are growing rapidly at about 20% or more annually, in real terms. Technology and company structure is changing due to rapid growth," "Mature: Growth is stable and slow. Products or services are familiar to the vast majority of prospective users" and "Decline: Growth is declining. The company is competing in declining markets" (Balkin & Gomez-Mejia, 1990; Gomez-Mejia, 1992; Gomez-Mejia & Balkin, 1992; Rumelt, 1974). Sales was assessed by the item, "What were your firm's sales or revenues last year?" with five choices from under $50 million to $501 million or more.

Analyses

The independent variable, size of the organization in number of employees, was split into two groups, small organizations (having fewer than 500 full-time employees) and large organizations (500 or more employees). Although this variable was continuous, because the primary focus of this study is differences between small and large businesses, we believe this split was justifiable. We tested these differences by conducting an analysis of covariance for each of the dependent variables (for research questions 1, 2a, 2b, 3 and 4b) in which organizational stage and sales were covariates. However, since the size variable was continuous, supplementary regression analyses were conducted to ensure that splitting this continuous variable into a categorical variable did not significantly alter the results (Aguinis, 1995; Pedhazur, 1982). The control variables (organizational stage and sales) were entered first and the independent variable, number of full-time employees, was entered second. Question 4a, which investigated differences in the frequency that small versus large organizations offered incentives above base salary, was analyzed using a simple chi-square statistic.

RESULTS

Means, standard deviations and the correlation matrix can be found in Table 3. Table 4 shows the analyses of covariance. As can be seen, none of the propositions was supported by these data. There were no significant differences between small and large companies in their pay level policy, number of salary grades, average size of midpoint differentials between grades, the emphasis on internal versus external equity, or pay for performance emphasis. The supplementary regression analyses revealed the same results. The chi-square analysis testing proposition 4a, which predicted that small organizations would be more likely to offer incentives than large organizations, also was not supported. Forty (54%) small businesses reported offering incentives, and 46 (62%) of large businesses offered them, a difference that was not statistically significant (c^2 = .999; $p = .319$).

Table 3
Means, Standard Deviations and Correlation Matrix

		Mean	SD	1	2	3	4	5	6	7
1	Size of organization [1]	1327.69	2612.55	1.00						
2	Organizational growth stage [2]	2.70	.59	.04	1.00					
3	Company sales [3]	2.87	1.47	.46 ***	.19 *	1.00				
4	Pay level policy [4]	3.25	.66	.19 *	.02	.20 *	1.00			
5	Number of salary grades	28.98	20.39	.09	-.05	.03	.23 *	1.00		
6	Size of salary grade differentials	10.21	4.02	.08	-.18	.03	-.23 *	-.12	1.00	
7	Emphasis on ext. or int. equity [5]	3.36	.93	.05	.20 *	-.04	.16	.09	-.09	1.00
8	Emphasis on pay for perf. strategy	20.96	7.13	.25 **	-.15	.23 *	.26 **	-.09	.11	-.15

+ p < .10; * p < .05; **p < .01; ***p < .001

[1] Number of full-time employees
[2] 1 = start-up; 2 = growth; 3 = mature; 4 = decline
[3] 1 = up to $50 million; 2 = $51 to $100 million; 3 = $101 to $150 million; 4 = $151 to $500 million; 5 = $501 million or more
[4] 1 = substantially below the market; 2 = somewhat below the market; 3 = generally equal to the market; 4 = somewhat above the market; 5 = substantially above the market
[5] 1 = rely totally on job evaluation; 2 = rely mostly on job evaluation; 3 = compromise; 4 = rely mostly on market data; 5 = rely totally on market data

Table 4
<u>Analyses of Covariance</u>

	Small Organizations N = 74		Large Organizations N = 74			
	Mean	**Std. Dev.**	**Mean**	**Std. Dev.**	**F**	**p**
Prop. 1: Pay Level Policy						
Main Effect: Org size	3.08	.72	3.42	.55	2.649	.106
Covariates[1]					.826	.440
Prop. 2a: Number of Salary Grades						
Main Effect: Org size	26.79	24.94	30.55	16.42	.136	.714
Covariates[1]					.080	.924
Prop. 2b: Average Midpoint Differential						
Main Effect: Org size	10.79	5.44	9.87	2.93	.404	.527
Covariates[1]					1.345	.267
Prop. 3: Internal versus External Equity						
Main Effect: Org size	3.25	1.05	3.45	.83	.250	.618
Covariates[1]					1.170	.315
Prop. 4b: Pay Mix						
Main Effect: Org size	20.19	6.71	21.75	7.51	.290	.591
Covariates[1]					2.779	.004

Since some organizations adopt a "total compensation" strategy in which the competitive level of benefits is used to balance the level of pay policy, an analysis of the benefit levels offered was conducted, again using analysis of covariance and multiple regression. These results were also not significant, indicating that small and large business also do not differ in the competitive level of either the pay or benefits they offer.

Indeed, the similarity in compensation strategies between these successful small and large organizations is striking. Of note is that before controlling for organizational growth stage and sales, smaller organizations were significantly lower in pay level policy than larger organizations ($F = 10.598$, $p = .001$). Thus, differences between small and large firms in level

[1] Includes organizational growth stage and company sales

of pay seen in previous research (Gerhart & Milkovich, 1992) may be due to the differences in sales and maturity rather than size itself. However, there were no differences between small and large firms in the other dependent variables before controlling for maturity and sales.

Also of interest is that the control variables showed little effect on the dependent variables. However, as can be seen in Table 4, a pay for performance emphasis was predicted by the control variables. The supplementary regression analysis for this dependent variable showed that organizational growth stage was significantly related to a pay for performance strategy ($b = -.184$, $t = -2.044$, $p = .043$) although sales was only marginally related ($b = .173$, $t = 1.705$, $p = .091$).

DISCUSSION

Contradicting contemporary assumptions about how compensation strategies relate to organizational characteristics, this study has found that there are very few differences between small and large organizations in salary structures, emphasis on internal versus external equity, emphasis on pay for performance or frequency of incentives offered. Surprisingly, differences in pay levels between small and larger employers disappeared after controlling for sales and organizational maturity, indicating that pay level may be more associated with sales and maturity than with size of the organization. Thus, this study shows that the organizational characteristic of firm size is not related to compensation strategy, at least among these successful companies.

There are several issues worth developing when interpreting these results. First, on average, the organizations represented in this sample seem to exhibit fairly traditional pay systems. The mean of pay level policy across the sample was 3.25, reflecting a level that is "generally equal to the market" or a little higher. Additionally, salary structures were generally descriptive of hierarchical rather than egalitarian strategies. There were on average a large number of salary grades (28.98 was the overall mean) and the average midpoint differential (10.21 percent) was reflective of a traditional salary structure. The average response to balancing internal and external equity was also typical of traditional systems: compromise between the two, with a slight tendency to focus on the market (mean across the sample was 3.36). Similarly, the tendency to focus on pay for performance was moderately low, with an overall mean of 20.96 (a total dependence on pay for performance would be 40; total non-dependence on pay for performance would total 8; the middle ground would total about 24). Thus, the organizations in this sample seem to be fairly conservative in their compensation strategies, regardless of number of employees.

Why did we find no differences in compensation policy and practice between small and larger employers? One possible explanation is that our sample may not represent the scope of all American businesses. First, we were interested in Midwestern employers, and thus sampled only databases from Missouri, Nebraska, Iowa, Arkansas and Kansas. A larger sample from across the nation may have provided data that would have shown differences based on firm size. Since the popular thinking is that the Midwest lags the coasts in adopting new business strategies, it may be that all Midwestern firms, both small and large, tend to be more conservative in pay practices. Second, our sampling method may have selected employers who tend toward more conservative pay. Using the Dun & Bradstreet database may have selected employers who use pay policies that historically have been successful for themselves or other organizations. Third, because the completion of this questionnaire required someone who was fairly knowledgeable about compensation issues, it may have been that organizations that did not have a compensation staff did not complete the survey. If compensation professionals are more "comfortable" with traditional pay practices, it may be that they have designed pay policies that reflect more conservative strategies. Finally, both databases used may be skewed toward larger organizations, for some of the reasons just mentioned. Organizations with 100 employees or fewer made up only 10% of the analyzed sample. It may be that the smallest organizations would contrast more distinctly from larger firms.

A further concern about this study lies in the method of measuring organizational success. The self-report method is open to the subjective opinions and tendencies toward impression management of the respondents. However, since these HR managers were responding to a university researcher the motivation to "look good" was probably minimal. Nevertheless, further study into compensation strategies of successful organizations should seek to devise a more objective measure.

Implications for Small Business Owners, Managers and Consultants

The results of this study, although possibly somewhat limited by the sampling method, show that small organizations that have been identified as successful in both profitability and operational goal achievement did not differ from their larger competitors in pay level, salary structure design, focus on internal versus external equity or pay mix. Thus, prudent professionals who find themselves in the role of making pay decisions for small organizations should be cautious when considering discarding traditional pay practices. Both small and large employers in this study were successful, and both groups used very similar pay strategies. Thus differences in compensation strategies based on size should not be assumed. Rather, small business decision makers should carefully evaluate the strategic needs of their organizations and design pay systems that can effectively support the behaviors and motivations needed to accomplish these strategic needs. Some suggestions that these policy makers should consider are:

1. Do not assume that the only relevant competitors for labor are other small employers. Since small firm pay strategies are quite similar to large firm pay strategies, competitive pressures may demand looking beyond the small firm labor market. Similarly, professionals who have experienced job losses at larger organizations should not eliminate themselves from the small business job market.

2. Do not try to design a compensation structure that is too simple to be effective. The successful small employers in this study did not differ from larger employers in the number of grades and degree of differential between them. While simpler structures can be effective, they must provide adequate differentiation for effective promotional, career and supervisory needs.

3. A pay system that incorporates a significant amount of emphasis on internal equity is not necessarily a "organizational dinosaur." The successful organizations in this study, both large and small, on average made fairly even compromises between balancing internal equity and external competitiveness.

4. Offer variable pay only if it achieves the goals of the business strategy. Only a little over one-half (54%) of the successful small businesses in this study offered some kind of incentive, not statistically different from the incidence of incentives offered by larger firms. Incentive programs are effective only when performance can be adequately identified and measured, when the time dimension within which the results are achieved coincides with the incentive pay-out and the incentive pay out is meaningful to participants.

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