



How can a high-performance company align its compensation system with its new work environment?

The Case of the Unpopular Pay Plan

by Tom Ehrenfeld

Gilbert Porterfield, vice president for compensation at Top Chemical Company, watched nervously as the special committee for compensation redesign gathered to discuss the proposed pay plan. Members from top and middle management, as well as peer group representatives from throughout the company, settled into their seats holding copies of his plan for this 93-year-old, \$2 billion company. TopChem CEO Sam Verde opened the meeting.

"Three years ago, when we launched our Quality For All program at TopChem, we expected a great deal of resistance from our troops," Verde began. "People don't like to have their jobs questioned, let alone redesigned. But now they are listening. We're starting to make real changes in the way people work together. And we're making progress in speeding products to market, improving product quality, and routing out inefficiencies."

"But as you all know, change is a process, not an event. That's why we've gathered this committee to in-

vestigate how to develop a pay system congruent with the philosophy of QFA. Because employee involvement is critical to everything we do under this new mind-set, all of you have been gleaned information from your peers. Gil's plan reflects your preliminary feedback. Now that it is on the table, I want to move toward implementation. Gil, why don't you give us some background?"

Porterfield stood and addressed the group. "As you know, under QFA we've reorganized employees into product-oriented teams. We had a solid business reason for that: to allow and encourage employees at all levels to develop products quicker, better, and cheaper. As Sam said, the company's organization is starting to reflect that philosophy.

"But," he said, pausing for effect, "our compensation hasn't. Our old system just doesn't work anymore. It pays by the old values of hierarchy, rank, seniority, hours worked, and a lot of other standards that don't mean much in the new organization. We have moved to an all



salaried work force, which caused grumblings, sure. It's time to go way beyond that."

Porterfield flicked off the lights and pointed to figures on the overhead screen. The screen read:

"QFA PAY PLAN 92"
BASE PAY = 75% of former pay – determined by internal equity
FLEXIBLE PAY = 25% of former pay – determined by:

• **Team's ability to show 5% annual improvement in 4 areas:**

- Quality: 30%
- Unit Cost to Market: 25%
- Speed to Market: 20%
- Safety and Environmental Compliance: 10%

• **Divisional financial performance: 15%**

"Very simply," Porterfield explained, "the plan is designed to give employees working on teams real incentives for constant improvement and overall excellence. It's meant to

Tom Ehrenfeld is editorial researcher at the Harvard Business Review.



"The plan will give employees working on teams real incentives for constant improvement."

recognize the real changes that have taken place in the company. New products and new processes are now the results of teams that work together solving their own problems. This system supports that philosophy.

"The premise is fundamentally very simple. Pay is divided into two parts: one fixed share of individual salary is based on internal equity—roughly, what others in and out of the company make for similar jobs. The variable aspect of the system pays employees for the performance of their group. Are they showing incremental improvements as a team in quality, unit cost, speed to market? Are they working with other divisions to raise profits for their entire division? The metrics of the equation, such as how many defects per product constitute high quality, will be determined by the ways each group works. But whatever the specifics, this new pay plan lines up squarely with the new company managerial philosophy: it's about accountability, excellence, and results.

"Any questions?"

Sid Noble, head of research and development, broke the silence. "I don't like it," he said flatly. "And I'll tell you why. I think we've gone far enough on this teamwork kick. Frankly, a lot of this is fiction—a motivational happy land that doesn't square with how my people really work. The people I hire and develop in this company are primarily sci-

"We've gone far enough on this teamwork kick. It's a motivational happy land that doesn't square with the way my people work."

tists. With scientific degrees and scientific backgrounds. They're damn good at what they do, and what they do is apply their chemical expertise to a business strategy.

"They already spend too much time explaining chem 101 to their other team members, time they could better spend in a lab. I want to free them up to work. To do what they do best and what we need them to do most.

"Most of all, I want to be able to attract and motivate the best and the brightest. But I can't recruit them if their pay depends on the performance of other members of a team. If we go this way, we're going to lose our good people and our whole R&D base. This new plan wants to make them team members first and scientists second. I consider that backwards."

"Of course you do," shot back Ruth Gibson, who worked as a chemical mixer on a packaging team and served as a team representative in the meeting. "You science guys believe your role of inventing products is much more important than those of the people out there actually mixing the chemicals, pouring them into drums, shipping them out, and selling them.

"But you don't represent the thinking of other product developers, espe-

cially those who are out there on the factory floor. My industrial packaging team now includes Tim O'Brien, who used to work all alone with the other scientists in the research laboratory. Now he works as part of our 25-person product packaging team, and he likes it. He likes knowing how customers use the materials he designs. He likes knowing what people pay for the product wholesale. He feels he does his job better because he knows how we build the products and he actually has a stake in how we – this packaging team – make the products together. Why not tie his pay to how we improve as a team? His skills are valuable only to the degree that our team succeeds in serving our customers."

"Ruth, perhaps you would like..." Noble began.

"Just wait Sid," Gibson continued. "Because I do have a problem with another part of this plan. It ties the performance of my group to that of everyone in the factory by bringing in plant performance. Now I'll tell all of you here that we know there's still a lot of people who haven't caught on yet. My group is going gangbusters.

brought the costs down, and we're developing innovations that other teams are picking up on.

"But these improvements didn't come easily. I worked weekends for close to a year. So did everyone else on my team. Why? Because we bought into the new idea of how this company should work. We like making our own decisions, and, frankly, most of us thought that if we had the power to make choices we could do it as well as upper management – maybe better. And I think we have. But there's something missing here.

"We haven't seen a raise or payout from all our hard work. Sure, our plant manager is down there every month or so telling everyone in the plant about our successes. But the fact is, we're hardly making any more money than we did two years ago.

"This pay plan will make those conditions worse. It's going to punish teams like mine for the failings of others instead of rewarding us for the work we do and have already done. What bonus will my team receive for the progress it's made or will make?" Gibson folded her arms and rested back in her chair.

doing business. We are going to face problems. And those problems are eventually going to show up on the company's bottom line. The real question is who should pay for them? Ruth may be frustrated about having her pay tied to areas beyond her control, but so what? Why should

"We never thought we'd design a perfect quality program, and I don't think a perfect pay plan exists either."

her team be any different from the others? Who is TopChem if not the employees of the entire company?

"Let's imagine that a rise in oil prices drives up the cost of ethylene, which drives up the cost of our products. The company takes an across-the-board hit. When this happened six years ago, TopChem protected its employees because we saw pay as a fixed cost. We still do. Under this plan, less than 4% of an employee's pay is tied to overall company performance. I don't consider that too onerous. After all, upper management has far more of their pay tied to overall performance – up to 60%. Why shouldn't everybody share both the up and the downside? If you ask me, I think we should dramatically increase that aspect."

Gus Teller, corporate head of training, cleared his throat loudly and spoke. "I agree with Miles about tying pay to the performance of the company, but for different reasons. The benefit of tying a large group's performance to the pay of its members is that it encourages everybody to excel. And it ensures excellence through conflict. You see, productive teams have members who tell each other what works and what doesn't: they teach each other how to work better. The same should hold true for teams. Good teams need to raise the level of teams that haven't caught on.

"Why can't a member of Ruth's team invite somebody from plastics out for a beer after work and discuss



"Why shouldn't everyone share the downside if the company isn't doing well?"

We're shipping products in three weeks that used to take us three months. We've cut defects to one-fifth of what they used to be. We've

"If I may?" began Miles Haddock, TopChem's CFO. "I take exception to Ruth's argument. What she may see as a penalty, I see as a natural fact of

what plastics could do better? This plan has that built into it. You won't have people working together unless there's an incentive for them to do so: I see that built into this plan. In fact, I would make more pay dependent on how well teams teach other teams useful skills."

Bill Purcell, a team leader from polymers, cut in. "Please, Gus, let's be real. Do you really think any one of us has the time, let alone the *desire*, to take people out for beers and tell them how to do their jobs? Oh sure: 'Hey Al, how's your wife? Heard you traveled to Yosemite last month. And, oh yeah, I wanted to tell your team how you should start thinking about purchasing your materials.' I don't think so."

"Look, I don't have any problems with the plan put forward. But TopChem still has too many people who can't and won't get on board, and we're spending too much time and money trying to train them. You talk about cutting down on bureaucracy but we still have almost as many employees as we did four years ago. I say the alternative to a plan like this is to reduce the entire work force by 15% through voluntary severance. Those people who won't change will leave. Then maybe we can think about a pay plan like this."

"Okay, Bill, thanks," Verde said. "Thank you all for your input. Now let me share just a few thoughts in closing. Gil, I know you've spent an enormous amount of time talking to employees and peer groups throughout the company and testing out ideas before sharing this plan with us. And in principle, I like this system. It lines up with our new quality philosophy pretty squarely. It ties the payout to a source. It assumes the good work of empowered employees."

"We never thought we'd design a perfect quality program. I don't believe a perfect pay plan exists either. But I think we've come up with some great suggestions here. I am going to take Gilbert's plan, think about your input, and roll out our new system next month."

HBR's cases are derived from the experiences of real people and real companies. As written, they are hypothetical, and the names used are fictitious.

What kind of pay plan should Verde roll out?

Four experts on compensation discuss his options.



TopChem's final pay plan should belong to the workers – not upper management.

Sam Verde's commitment to "roll out our system next month" contradicts everything he espouses in the Quality For All program. Why should a compensation plan designed for a corporation that values empowered team members not include the input of those same workers? The plan on the table doesn't have the support of the members of the compensation team. How does he expect it to have rank and file support?

TopChem needs to reinforce employee participation and buy-in. Both the outcome and the design process should belong to line employees who are covered by the plan. Teamwork, the primary goal, must dictate the form of compensation: formal aspects of compensation design should follow – not lead – the process. Recently at Motorola, a team of technicians developed their own pay program and brought their plans to the compensation officials. After some review by compensation and senior management, the plan was approved. Now, though their program was viewed as imperfect by many com-

MAGGIE COIL is vice president for compensation at Motorola, Inc., in Schaumburg, Illinois.

pensation people, the process of allowing the employees to develop and maintain the plan will yield a better overall product because they own a plan linked to their business needs.

Verde can similarly empower the development team by redefining Porterfield's role: he should work as a coach who listens to a cross-functional team culled from all levels of the company as it develops meaningful criteria for changing the pay plan. Compensation experts like Porterfield should help the process along by getting out among the troops and answering questions – sharing expertise rather than enforcing it.

To keep the process going, Sam Verde could introduce the proposed plan as a test without payouts. The program model developed by Porterfield can serve as a tool in sharing compensation expertise. Porterfield can explain why he developed the model as he did. Matching how the plan would pay out against actual performance would enable the compensation team to examine whether it has developed meaningful measurement criteria and timetables. The team can factor that knowledge into a better plan.

Given my assumptions about TopChem's culture, I don't believe putting a portion of employee's base pay at risk will work initially. Like most century-old large companies, TopChem carries cultural baggage

that will be in conflict with "at-risk" pay. Entitlement mentality and paternalism still rule the roost at the company, and I would bet TopChem's upper management is uncomfortable not guaranteeing base rates while its workers are extremely suspicious of a take-away.

At-risk pay is a reasonable idea that has worked in many companies, but the fundamental principle for success relies on line of sight: Do employees see and understand the relationship between their contributions and their pay?

I think the TopChem pay plan development team will ultimately choose to keep base pay at a level comparable with the market and im-

plement some form of gainsharing program. There are a number of gainsharing plan models available that allow the gains derived from group or team performance to be shared between the corporation and the members of the team. Unlike company-wide profit-sharing plans that are tied to the health of the economy and the financials of the company, neither of which do rank and file employees have any control over, gainsharing is linked very specifically to what individual work teams do. A portion of the gains their efforts produce are returned directly to them. This successfully ties a key element of TopChem's business strategy—incremental improvement—to a meaningful payout.



Sam Verde needs to harmonize the goals of quality with the methods of his pay plan.

Like many companies moving toward total quality management, Top Chemical has discovered that its compensation and reward system no longer adequately supports its goals. The proposed plan, however, will only shift the barriers to quality from the level of individuals to the level of teams.

If quality truly is the centerpiece of TopChem's business strategy, then the compensation and rewards system should support the key prin-

DONALD BERWICK is associate professor at the Harvard Medical School and Harvard School of Public Health in Boston, Massachusetts. From 1989 to 1991, he served as a judge for the Malcolm Baldrige National Quality Award.

ples of quality management: encourage the flow of information and resources across boundaries, focus everyone's work toward understanding and meeting the needs of customers better, encourage constant learning and use of new technical skills, and give all workers meaningful participation in the improvement of work.

TopChem's existing pay system appears to do the opposite. Like many traditional plans, functional achievements take precedence over cross-functional teams. Employees are encouraged to please their superiors, at the potential expense of customers. Productivity is pegged to arbitrary numbers rather than learning, and participation in improvement is not directly rewarded.

QFA Pay Plan 92 is incomplete as a solution. It remains inconsistent with TopChem's search for quality in several critical areas. First, nowhere in the

compensation formula is the voice of the customer represented. Because TopChem's future lies in its ability to understand and meet customer needs, the customer, not old habits and beliefs, must become the paymaster. The QFA Pay Plan goals of quality, unit cost reduction, and speed are useful only if they serve as accurate surrogates for customer needs.

Additionally, the pay plan sets numerical goals that may kill real quality improvement. Where do the pay plan's numbers come from? Wouldn't 50% improvement be better than 30%? Numerical goals like these contain no information and show a basic misunderstanding of the causes of quality and the methods for improvement. By setting the numbers himself, Verde is also violating a fundamental principle: knowledge is in the work force. If he wants his work force to move forward, he has to allow them to develop meaningful targets.

TopChem should ultimately avoid tying raises to hitting rigid numerical targets. Payment by the numbers invites expensive investments in internal gaming: managers and employees will play by the numbers instead of improving their methods. The results—and not the capabilities that create these results—will be rewarded. This may feel good for a while, but the underlying organizational competence will not progress. If Verde focuses on results, he may get numbers that are temporarily satisfying; if he focuses on capabilities, he'll get results that he may have never imagined.

Also missing from the pay plan is a system for rewarding new competencies and learning. TopChem wants a system of learning and work—a continuous effort to improve products, services, and processes. It wants competencies, not specific numbers. But where in the plan does it say the people will get paid more as they learn more?

Any new plan must include pay based on how well individuals learn new skills. Individuals or groups who think, like Sid Noble, that their true value lies solely in the unique function they enact in the company must be redirected through a number of ways, one of which is pay. This is much more likely to work in the long

run than paying for results. Verde has choices here: he can literally pay people for the skills they acquire—and give them the support to do so. He can pay for cross training or for taking certain courses. But if he really wants to encourage employees to work in a system, he must establish the value of learning.

This, of course, does not mean that people like Sid Noble are not valued as scientists. It means that people like Noble are more effective when they understand their roles and how they can work with others.

One final flaw in the plan is that it ignores intrinsic, nonfinancial moti-

vation. Compensation formulae can only do so much; the best quality managers understand the value of celebration, recognition, and joy in good work as powerful motivators. Total quality comes not from contingencies set up by managers but from the native curiosity, pride, and desire for craftsmanship that are likely to be widespread in the workplace.

I would recommend that TopChem benchmark intrinsic motivators in other companies to see how they recognize and reward the good work of employees. Milliken & Co., a Baldrige Award winner, has been enormously successful in using tools such as

putting employee photos on the walls, giving gifts, having celebrations, and getting top management to acknowledge how well teams are doing their jobs. Sam Verde might consider a "presidential review" to acknowledge publicly the excellence of groups.

To construct a meaningful pay program, Sam Verde should work out his own theory of motivation. He has not yet articulated or discovered what he believes motivates the employees of TopChem. Once he works out his theory of the psychology of the TopChem work force, he can then design the appropriate plan.



Until both the goals and the mechanics of TopChem's pay plan are spelled out to all employees, the plan can only fail.

I participated in a year-long process of designing an alternative reward system for a work group of 400 Monsanto employees. Based on what we learned, I can tell you that TopChem's proposed plan won't work.

Sam Verde's action plan lacks clarity. People in the organization will not support a program they don't understand. They need to know why they are getting a new system and how it will be created. Yet Verde has not designed a plan for educating and

TOM NYBERG is senior business systems specialist in the management information systems group of the Monsanto World Headquarters Site Administration in St. Louis, Missouri.

informing people about the process. The plan design should reflect the business strategy of sharing important decisions and outcomes with employees—a quality that Verde's stated goal of rolling it out in a month precludes.

In fact, his timetable is completely out of touch with the real process of pay redesign. In 1989, as part of its effort to become a high-performance organization, World Headquarters Site Administration (WHS) —the unit that handles the site needs of the 4,500 Monsanto employees at the St. Louis headquarters—set about redesigning its pay system into what it calls an alternative reward strategy. I was picked as part of a 12-member team to redesign compensation for the WHSA. Our group included members from all functions and organizational levels.

Our management established clear guidelines for our work. We were taught the business strategy and why it demanded new forms of pay. Furthermore, we learned how to think about compensation. We

went through three months of intense training where we met three times a week to read cases, study the plans of other corporations, and learn from compensation experts at Monsanto.

This learning enabled our design team to develop a realistic plan for linking WHSA's new business strategy to a custom-designed compensation program. And the design process created ownership for us. This brings us to another important missing link in the TopChem plan.

There is no ownership by either the employees or the development team. TopChem's plan was created by Gil Porterfield with some input from top and middle management. No individual groups seem to have developed meaningful targets for what they do.

Our group, on the other hand, represented each WHSA member in both culture and concern. The 12 of us on the compensation design team spent nearly half our working hours giving our peers an opportunity to participate in the design. We met with all 400 WHSA employees, listened to their concerns, shared our findings, and explored possibilities. We published a weekly newsletter to update our progress with the group.

This process transformed people with specific skills within WHSA into compensation experts on a team. Our work peers supported us in developing these new roles by taking

up some of the slack in our regular jobs. After four months of this process, our compensation team rolled out a plan that underlines the next area for Sam Verde to avoid.

The plan is too complicated. Organizations will not support what they do not understand. We learned that after we rolled out our first plan in 1990—and got slapped in the face. We had developed an ambitious plan with 6 targets that worked for our 12-member team of experts. But the other members of our 400-person department, who had not had the same intensive exposure to compensation concepts, didn't understand the formula and rejected it. We realized then that the plan would not be successful unless it was simplified and broadly understood.

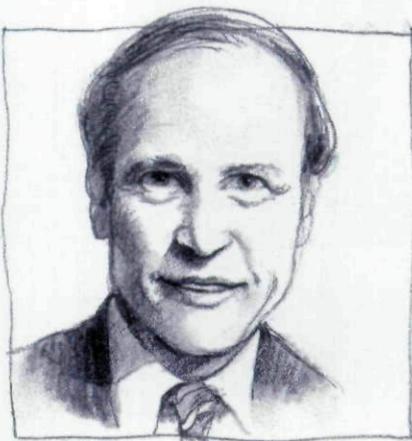
So we went back to our management and said this plan would not work. And we set out to create a plan

that would have the support of the majority of the employees. We went back into the field and listened more to what people told us. And we learned about one other crucial flaw in our first plan that Verde should note. We had used at-risk pay without thinking through the message it sent to all the people affected.

The pay plan will be viewed as a take-away. Our initial design was funded by significantly reducing the next salary-increase budget but not by reducing current base pay. We discovered that many of our people found even this step threatening—a take-away of future increases to which they felt entitled. We knew we had to approach this issue more carefully. Our team ultimately designed a simple pay plan that did not reduce the salary-increase budget in the first year but phased it in gradually in the second year.

So what should Sam Verde do? He should simplify the plan and include an upside or payout potential. He should clarify the plan's purpose by explaining the overall goals and the plan's mechanics, such as how potential payouts are calculated. He should also think about designing a plan that will change over time as conditions change. He can do this by incorporating provisions that call for the plan to be assessed continually and open to change.

But more important, Verde should throw out the one-month deadline first—and the current process altogether. He should instead establish a team to create an appropriate plan for all TopChem groups—a team that will listen to the people covered by the plan. This team should design both the process and the plan. It's worth the effort required and, frankly, it's the only way it can work.



Sam Verde doesn't want passion over compensation—but over the competition.

Sam Verde should put aside compensation and concentrate on creating an organizational and managerial context for teams to work. TopChem's teams seem to be working well, so why change the pay system? Putting the current compensation plan on the table will raise issues that are essentially unresolvable by the organization and will only undo much of the progress that has been made.

MICHAEL BEER is professor of business administration at Harvard Business School.

I have found that people either work effectively in teams or they don't: pay is usually a distraction and it rarely improves teamwork. A prevailing mythology today holds that pay can be redesigned to motivate individuals to work differently. That's simply not true. Pay is not the right tool to effect change. Telling people you are going to change the compensation system rallies them around compensation when what you want them to do is rally around making teams work.

Compensation often becomes a surrogate for issues that create ideological arguments that are not focused on the real work at hand. As the TopChem compensation committee shows, talking about pay sets off battles that have little to do with how people actually work. These ideological conversations can tear organizations apart.

Effective managers help teams succeed by addressing the performance objectives of the entire organization. They diagnose how teams operate and develop ways to improve them. Then, and only then, should compensation be examined. In this context, the only justification for tinkering with pay is that it alone creates barriers to change—a situation that does not appear to be the case at TopChem and is often not the case in other similar settings.

Sam Verde and the TopChem compensation committee should concentrate on encouraging all the employees to examine their behavior before they engage them in conversations about attitudes and ideology. Then those workers who are doing the work and know what is needed can align formal mechanisms to the extent necessary. Behavior changes first: attitudes and knowledge follow. Workers resist formal changes such as pay redesign because they are perceived as final decisions about new roles and responsibilities that haven't been accepted yet. Instead, change should be an organic process that evolves as people learn and adapt to the new work structure.

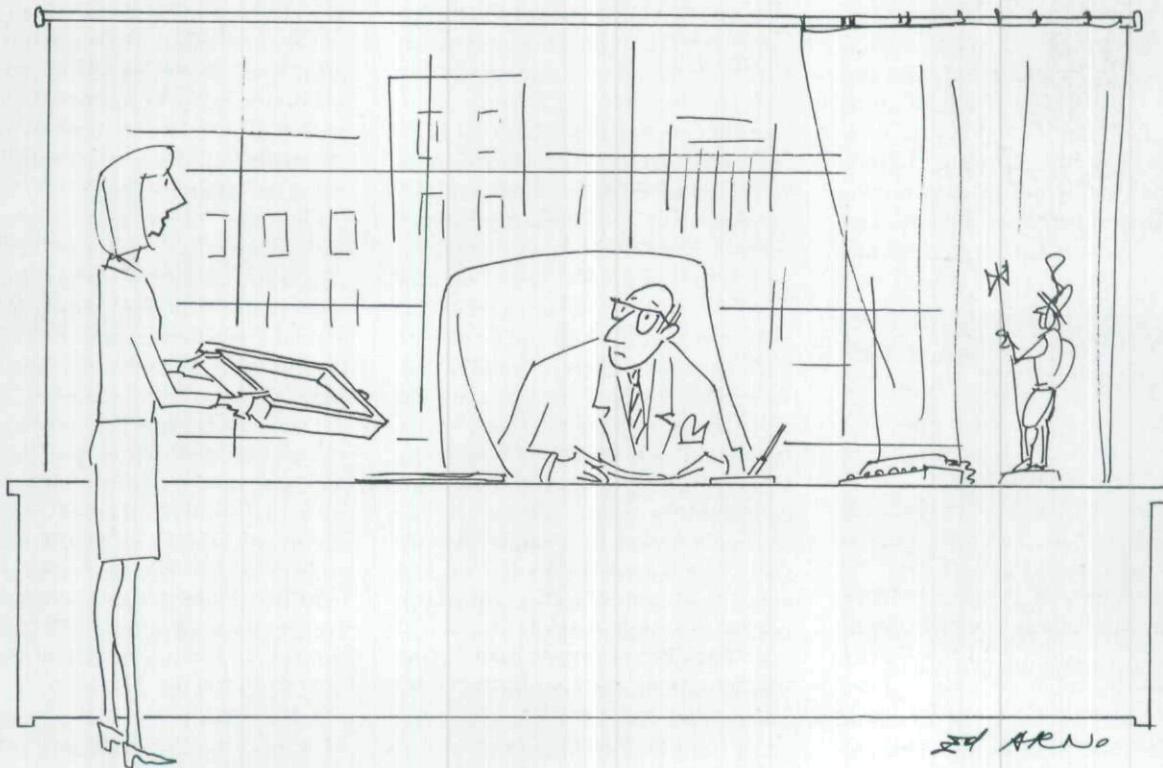
Pay's function is to create equity and fairness. It should attract people to an organization and keep them there. Pay should not be an active ingredient in promoting teamwork and motivating performance. There is no evidence that TopChem's current pay plan is the problem. Organizations should change how they work before changing how they pay, and they should defer changes in pay until they are strongly needed. Formal aspects such as pay or information systems change after more important restructurings take place: new roles, responsibilities, and relationships that seem, in fact, to be already under way at TopChem.

My advice is to let the pay plan atrophy. Sam Verde doesn't really want to generate passion around compensation. He wants it over whether TopChem is beating the competition or serving the customer. So he should try to commit the compensation issue to a committee where it will die a quiet death. If eventually forced to take action, Verde should take the least amount of action possible. If Sid Noble really believes what he says, then give scientists a choice between traditional pay or some manner of team-based pay. No overall system should force everybody into one plan. Instead, there should be a voluntary system that is organic,

incremental, and based on the processes in place.

Most organizational change is done without an effective diagnosis. People change the wrong things because they fail to identify the root causes of the problem at hand. Verde should really be asking how well teams are working. If they are not working, he should identify why and be prepared to examine his role and the roles of TopChem's teams in creating the barriers. Is there even consensus at the top on the need for teams? Have managers identified how their roles will change if teams are to function effectively? Are they really prepared to change to teams? □

Reprint 92102



"It's from the desk of William J. Strout."

Harvard Business Review Notice of Use Restrictions, May 2009

Harvard Business Review and Harvard Business Publishing Newsletter content on EBSCOhost is licensed for the private individual use of authorized EBSCOhost users. It is not intended for use as assigned course material in academic institutions nor as corporate learning or training materials in businesses. Academic licensees may not use this content in electronic reserves, electronic course packs, persistent linking from syllabi or by any other means of incorporating the content into course resources. Business licensees may not host this content on learning management systems or use persistent linking or other means to incorporate the content into learning management systems. Harvard Business Publishing will be pleased to grant permission to make this content available through such means. For rates and permission, contact permissions@harvardbusiness.org.