

White Paper

## **Skill-based Pay**

By WorldatWork Staff

May 2000

There have been significant changes in the operating environment that confronts all organizations during the past few years. Few companies have escaped the need to downsize their operations to meet the continual demands for production efficiency. At the same time, the increasing rate of technological change and the strategic emphasis placed on quality, customer service and continuous-improvement processes require frequent upgrading of employee skills. All this is happening at a time when cultural values in many organizations are changing from traditional management-subordinate hierarchies to more flexible forms of work organization with emphasis on employee involvement.

Current pay systems do not meet the challenges presented by these changes, and there is growing interest in alternative pay methodologies. Skill-based pay has been identified as one approach that has the potential to address the shortfalls of traditional pay systems and meet the current challenges for productivity, quality, customer service and other organizational-performance indicators in many work environments.

Skill-based pay is one of the fastest-growing compensation innovations in the United States as more and more private- and public-sector organizations seek ways to forge direct links between organization performance, individual contribution and pay. Skill-based pay systems have the potential to overcome many of the drawbacks of traditional pay systems.

### **Other Names**

Although relatively limited in application until recently, the concept of skill-based pay has been in use for many years under such names as pay for knowledge, competency pay, pay for skills and multiskilled pay. Historically, skill-based pay has been used most commonly for production workers in manufacturing and continuous-process environments, starting on average in 1985. In 1989, skill-based pay started spreading to professional and technical jobs as well as service industries such as finance, hospitality and retail, to include clerical, administrative and professional roles as a means of providing technical career ladders. Interest in the use of skill-based pay then broadened further.

On average, organizations using skill-based pay are 10 years old, and one-third are at least 20 years old. The average work force size is 474 employees, belying the argument that skill-based pay plans tend to be found in "flat" rather than "tall"

organizations. Typically, there are only two tiers between the location manager and direct labor — a total of four tiers. Traditional organizations of comparable size often have more supervisory and managerial echelons. Demographic characteristics of employees in skill-based pay locations are not markedly at variance with demographic characteristics of the working population in general. On average, 23 percent of employees are minorities, and 37 percent of employees are female.

## **Differences**

There are many ways that skill-based pay differs from other compensation systems. At the most basic level, skill-based pay is a person-based rather than a job-based system. It compensates employees for the skills they can use in the organization, rather than for the specific jobs they may be performing. Pay changes do not necessarily accompany job changes, yet there are many opportunities for advancement and higher wages. Also, there is little emphasis on seniority in pay determination.

In contrast, traditional pay structures lack the ability to meet emerging challenges in organization and work design and emphasize job status and seniority in the organization. They fail to meet the challenges of current economic and business environments, including:

- The need to develop more competitive, market-driven cultures
- The transition from centralized, hierarchical organization structures to flatter structures
- The emphasis on employee empowerment
- The focus on teamwork rather than individual performance
- The need to reduce overhead costs and develop efficient and response operating systems

## **Numerous Forms**

There are many forms of skill-based pay. To describe a "typical" or "average" skill-based pay plan is somewhat misleading. However, there are features that exist in every skill-based pay plan. Skill units, or collections of tasks, duties and responsibilities, are the foundation on which skill-based pay plans are built. A typical employee masters only two-thirds of the skill units in a skill-based pay plan in a period of approximately two years. The immediate supervisor, followed by co-workers and the employee himself/herself most often certifies mastery of a skill unit.

North American organizations have four major reasons for adopting skill-based pay systems:

- The need to develop and maintain productive efficiencies through increased output, often combined with a "leaner" work force and fewer levels of supervision
- The need to make more flexible utilization of the existing work force to cover absenteeism, turnover and production bottlenecks
- The need to support new technologies (e.g., total quality management)
- The need to build higher levels of involvement and commitment, increase teamwork, and provide more enriched jobs that provide greater reward opportunities for employees.

Skill-based plans also have several beneficial employee-related outcomes. Pay rates typically are higher in skill-based pay plans. In addition, skill-based pay is overwhelmingly seen as increasing employee satisfaction, commitment, capacity for self-management and understanding the organization's "big picture."

With respect to organizational outcomes, skill-based pay plans have the greatest impact on various aspects of organization functioning -- particularly in terms of work force flexibility, employee versatility and flexibility in job assignments. In addition, there are improvements in organizational performance measures, including increased productivity, lower absenteeism and reduced voluntary turnover. Many skill-based pay plans also achieve reduced overall compensation costs. This may seem puzzling because skill-based pay plans tend to pay employees higher wages. But the higher labor costs per employee are more than offset by reductions in the size of the work force, by increases in the flexibility and versatility of the work force, and by increases in employee productivity.

### **Not for Everyone**

There are some potential risks associated with the implementation of skill-based pay. Usually, the first impact is felt in increased training costs. An effective system requires a systematic and consistent approach to on-the-job and formal training, resulting in obvious costs in terms of training budgets. Also, there are potential risks of lower levels of production or service if training periods are not scheduled appropriately. Payroll administration costs are incurred as individual training is monitored, skills are accredited and pay comparisons are made with the marketplace. The move from job-based to skill-based pay means that compensation structure for individual skills will be unique to each enterprise.

Poorly designed skill-based pay plans also can lead to a series of issues ranging from payment for skills that are not used or not relevant to the business, to employees reaching maximum pay rates well in advance of planned expectations. Some reasons for discontinuing skill-based pay include:

- Inadequate management commitment to the plan
- Unwillingness to endure short-term implementation problems

- Poor plan designs that increase labor costs without providing offsetting organizational benefits
- Conflicts between employees included in and employees excluded from the skill-based pay plan
- Inadequate training of employees and supervisors
- Failure of management to require meaningful skill certifications prior to pay increases.

## **An Investment**

Most companies find that while there are some increased costs initially, investing time early in the plan design phases results in an effective transition to the new pay structure. An essential part of the design phase requires careful consideration of the work processes, work roles and employees who will be affected by the introduction of such a pay system. Work environments, job demands and employee expectations will differ across functions within one organization and across organizations in different industries. The essential questions are:

- Is a skill-based pay plan an appropriate answer to the issues?
- What plan design will meet organizational objectives and, at the same time, provide fair and equitable development and reward opportunities for the employees involved?

Given the right circumstances, skill-based pay can offer substantial advantages for organizations and employees. Clearly, organizations seeking "quick fixes" for system problems cannot look to skill-based pay to provide the answer. By analyzing organizational context, including business needs, technology, work flow, management practices and employee characteristics, a well-informed decision can be made regarding designing and implementing a skill-based pay plan to fit the conditions.

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