

Skill-Based & Variable Pay
Demonstration Project
Development

Reference Guide

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Purpose of this Reference Guide

This reference guide is a tool for agencies to use in developing skill-based pay demonstration projects and was developed specifically for the Skill-Based Pay Consortium. This guide also addresses variable pay, which is generally used in combination with skill-based pay to help organizations reinforce the attainment of their goals.

Each section of the guide addresses a question frequently asked about skill-based or variable pay and summarizes current literature and periodicals as well as personal interviews with private sector compensation experts who have implemented skill-based pay. Examples of private sector skill-based pay design and implementation approaches are provided. In addition, there is a glossary of terms and bibliography for further reference.

Introduction

Skill-based pay is one of the fastest-growing compensation approaches in the United States today. This popularity in private sector companies is due to a strong emphasis on streamlining and reengineering business processes and on strategically aligning business with human resources management systems. This holistic approach begins with an analysis of the organizational context including business objectives, philosophies, needs, technology and work flow, management practices, and employee characteristics. Without such an analysis, meaningful decisions about skill-based pay specifics are impossible.¹ According to a recent study conducted by the American Compensation Association of 97 different skill-based pay plans, their data reinforce, time and again, that this kind of analysis and decision-making is absolutely necessary for skill-based pay plans to succeed. Another significant finding in this study was that employee and managerial involvement, participation and commitment are inherent in skill-based pay design.

What is Skill or Competency-Based Pay?

Skill or competency based pay is pay that recognizes employees for the depth, breadth, and types of skills they obtain and apply in their work.²

The foundation of skill-based pay (or pay for knowledge) is paying more as employees demonstrate that they are obtaining and using more and more skills that are valuable to the organization. Most skill-based pay organizations are organized into teams or self-managing work groups.³

A distinction is generally made between skills and competencies. There is no agreement in the literature on exactly how they are defined; it is agreed, however, that they inhere in the individual (not the job) and must be demonstrable (measurable).⁴ The distinction between skill and competency typically centers around 1) technical or "domain" skills: those skills and knowledges required to succeed in a particular job, and 2) "enabling" or "people" skills: those work behaviors and skills that people use to accomplish their work. "Skills" typically refers to technical

skills, and “competencies” refers to “enabling” or people skills. For purposes of this reference guide, we will use the term skill-based pay to encompass both skill and competency-based pay.

Skill-based pay is a component of “new pay,” a term coined by the consulting team of Jay Schuster and Patricia Zingheim. The basic idea of “new pay” is that it is business-focused and based on the person, not the job. Often, organizations combine skill-based pay with variable pay to reinforce the organization's goals. Since skill-based pay systems are customized to meet an organization's needs, there is no standard way of designing these plans. There can be three types of pay in these systems: 1) base pay, which is typically based on the person's skills, 2) variable pay or incentives, which can be “add-on,” “at risk,” or potential base pay “at risk” and is usually tied to the achievement of team, group or organizational goals, and 3) indirect pay, which includes leave and benefits. In the Federal Government, under the U.S. Code, Title 5, Chapter 47, demonstration project authority, skill-based pay and variable pay can be tested. Waivers are not permitted in the areas of leave and benefits nor in the definition of base pay for retirement reasons.

Why Should Federal Agencies Consider Testing Skill-Based Pay?

Under the pressure of budget cuts, Federal agencies are downsizing, delayering and focussing on organizational performance. The 1993 Office of Personnel Management report, “Revisiting Civil Service 2000: New Policy Direction Needed,” concluded that the fundamental issue confronting the Federal Government as it enters the 21st century is reengineering management systems to best utilize the workforce. Flatter and leaner organizations mean that fewer employees will be performing the work and that fewer employees will have opportunities for promotions to higher level jobs.

Just as many private sector companies have done, the Federal Government has to focus on more effective ways of accomplishing its work, including establishing work teams, upgrading workforce skills, training employees in multiple skills and finding new ways to motivate employees who have limited advancement opportunities. Skill-based pay systems are increasingly becoming the tool chosen by private sector companies to facilitate this new work environment. Moving from job-based to skill-based pay systems helps organizations maximize their resources by rewarding employees for the skills they use on the job. In the Federal Government, where the General Schedule, a traditional job-based pay system, has been in operation for half a century, adopting a skill-based pay system would be a major change. The Federal pay system is based on the position a person holds, hierarchically structured career paths, and a strong value in seniority. Given the current budget constraints, agency downsizing and increasingly demanding taxpayers, the Office of Personnel Management supports implementation of skill-based pay demonstration projects to test this promising concept in the Federal sector.

Skill-based and variable pay are designed to support the new flatter, leaner, high-involvement organization. In fact, these approaches are a way to *lead* organizational change toward employee involvement. They communicate certain values about an organization, like teamwork and

employee empowerment.⁵ By paying individuals based on the depth and breadth of skills they have and apply in their work, these systems provide incentives for employees to acquire new skills and to work with others to achieve the organization's performance goals.

Is Skill-Based Pay Too Expensive for the Federal Government?

Skill-based pay is not inherently expensive. What can be expensive is a system that is designed without adequate built-in cost controls. Many private companies have taken on skill-based pay only to get out of it several years later because they could not control costs. This paper contains lessons learned from some of these experiences and highlights areas that need careful consideration and planning to ensure cost effective operation.

How Does Skill-Based Differ from the Traditional Job-Based Pay System, such as the General Schedule?

The following chart summarizes the major differences between job-based and skill-based pay systems.

DIFFERENCES BETWEEN JOB-BASED PAY & SKILL-BASED PAY SYSTEMS ⁶	
JOB-BASED PAY	SKILL-BASED PAY
General Definition: Employees paid for the job they are performing. Pay attached to the job. Focuses only on the individual, making it more likely that employees will compete with each other for resources rather than collaborate to share them.	General Definition: Employees paid for range, depth, and types of skills they are capable of using. Pay attached to skills.
Advancement: Few are able to attain top rate in pay system. Career ladders hierarchically structured with limited opportunities at the top.	Advancement: All employees may be encouraged to attain top pay rate in pay system. Employees encouraged to learn more skills and earn a higher rate than they might in a traditional system.

<p>Competency Testing: Employee receives pay that is attached to the job regardless of whether the employee ever develops all the competencies needed to perform the job effectively.</p>	<p>Competency Testing: Employee must be certified as competent in the skills and demonstrate competency to receive pay increase. Employees rewarded for their expertise, not the "value" of the job they hold.</p>
<p>Costs: Costs rise with inflation of jobs and more senior workforce.</p>	<p>Costs: Cost control measures very important. Employees can earn higher rate than in traditional system. Higher wages can be offset by reduced size of workforce and other cost reductions.</p>
<p>Design:</p> <ol style="list-style-type: none"> 1. Define jobs 2. Price jobs in the market 3. Administer the pay system 	<p>Design:</p> <ol style="list-style-type: none"> 1. Develop skill blocks 2. Define progression paths through skill blocks 3. Formulate maximum and minimum times that employees remain in any skill block 4. Determine training needs and how employees will be selected to receive training 5. Determine how employees will be certified, recertified, and decertified
<p>Effect of Job Change: Employee's pay usually changes automatically and immediately depending on the new job.</p>	<p>Effect of Job Change: Pay does not necessarily change just because job changes. Employees may change workstations and use different skills, but their pay may not change.</p>
<p>Employee Attitudes: perceived inequities in ability to advance.</p>	<p>Employee Attitudes: evidence that employees tend to like skill-based pay and prefer to traditional system, as evidenced by drop in turnover.</p>
<p>How Job is Defined: Different pay rates are tied to different jobs. To determine knowledge, skills, responsibilities, discretion, hazards associated with job, compensation analyst can observe someone doing job at work station and determine rate of pay.</p>	<p>How Skill Blocks are Defined: Since employees typically perform variety of skills, skills packaged into bundles or blocks. Pay based on these blocks.</p>

<p>Internal Equity: tends to be more important because the pay for each step of the progression is set in relation to the pay of all other steps, not in relation to the external market. Employees tend to focus on how other individuals in the organization are paid and on how they can improve their relative pay position.</p>	<p>Internal Equity: not important. Fairness of pay levels within the organization is in relation to external market. Employees may acquire more highly paid skill blocks by becoming certified and applying those skills on the job.</p>
<p>Managerial Flexibilities: difficult to move employees from job to job. Fewer options when budgets cut, so layoffs used frequently. Loss of highly skilled impacts productivity.</p>	<p>Managerial Flexibilities: easy to move employees from job to job. More options when budgets are cut. Greater employment stability - managers able to shift employees to different areas of the organization rather than laying them off.</p>
<p>Pay Administration: relatively simple. Usually change people's pay once a year according to merit or seniority.</p>	<p>Pay Administration: Complexity is inherent in a skill-based pay system. Keeping track of who is qualified to do what and how they get paid requires some administrative support. In addition, since individuals can move almost any time into new skill block and be certified, pay changes can occur throughout year.</p>
<p>Performance Evaluation: Performance appraisal system evaluates employee on how well he/she is doing on job. Tendency for employees to inflate their job descriptions to obtain higher level jobs and increased pay.</p>	<p>Performance Evaluation: Skill certification is primary means for evaluating employee's skills and determining pay. However, many companies have other performance appraisal systems for giving feedback, also additional reward opportunities.</p>
<p>Pricing: relatively simple. Market rate and benchmarking in local labor market and industry.</p>	<p>Pricing: more difficult. Difficult to find appropriate benchmarks in local labor market and industry since few organizations use skill-based pay. Not possible to directly compare particular pay levels.</p>
<p>Seniority and other factors: More time in job assumed to correspond to greater value in the organization and therefore higher pay.</p>	<p>Seniority and other factors: System tied to skills not seniority.</p>

Skill Certification: none.	Skill Certification: explicit certification or evaluation procedure aimed at determining whether employee actually has given set of skills before employee paid for skills. Skills have been identified as critical for accomplishment of organization's mission.
Training: often regarded as desirable luxury that can be deferred at the first sign of budget troubles or slipping production schedules.	Training: employee pay raises become dependent on employees' ability to obtain training needed to learn new skills. Employees more eager to receive training.

Who Uses Skill-Based Pay and Why?

Based on a 1990 Government Accounting Office survey of the *Fortune* 1000 companies (including the 500 largest manufacturing firms and an industry-stratified set of the 500 largest service companies in the U.S.), 51 percent used skill-based pay with at least some employees. Sixty percent of these companies said that their skill-based pay plans were successful. There were several key reasons why companies were using skill-based pay:

- Respondents overwhelmingly felt that skill-based pay systems were effective in achieving performance improvements.
- The adoption of skill-based pay was strongly associated with employee-involvement programs that resulted in improvements in organizational functioning.
- The adoption of skill-based pay was associated with employee-involvement efforts that produced improvements in product or service quality and in competitiveness.
- Respondents who had downsized and removed management layers during recent years were more likely to adopt skill-based pay practices.⁷

A common characteristic of companies implementing skill-based pay is that the work is organized around products or services rather than by the traditional method of organizing by functions. Skill-based pay works best in team settings where there is much interaction and cross-functional work.

Historically, skill-based pay has been used most in manufacturing organizations, such as TRW, General Mills, the General Motors Saturn plant, and Eaton. Because manufacturing firms are more likely than service firms to face tough foreign competition, they are more likely to adopt skill-based pay. In manufacturing settings, employees are paid for acquiring and applying multiple skills on the production line. The organizations save money by needing fewer people and with

more multi-skilled employees, they can avoid production "down" time when employees are absent.

General Mills is the classic type of skill-based pay organization; a new manufacturing plant with continuous-process technology and a high involvement organization design. The General Mills organization has self-managing work teams with high levels of training and extensive communication. Another similar type of organization, General Electric, uses skill-based pay in two aircraft development operations, both blue collar. Self-directed work teams at General Electric are facilitated by supervisors. General Electric sees two primary benefits to skill-based pay: 1) reduced overtime, and 2) the need for fewer people to do the work. In addition, General Electric believes employees are more fully utilized and management flexibilities have been greatly enhanced due to skill-based pay. Another very prominent company and a Department of Defense contractor, Honeywell, has successfully implemented skill-based pay in a new high involvement plant for their assembly technologies.

In the past decade, there has been an increase in the application of skill-based pay in the services industry particularly in insurance, retailing and banking. Service companies such as Shenandoah Life, Crown Plaza, the technology service and management components of American Telephone and Telegraph, Northern Telecom, Aid Association for Lutherans and Polaroid are using skill-based pay. The fast-growing service sector may become an even more promising area for skill-based pay than manufacturing as companies hire unskilled or semi-skilled people and turn them into highly skilled employees.⁸

A closer examination of the types of service organizations implementing skill-based pay shows that:

- Northern Telecom, a telecommunications service organization of white collar professionals, established a skill-based system for their field service technicians.
- Aid Association for Lutherans, a fraternal benefit society that provides benefits and financial security for Lutherans and their families, also established a skill-based pay system. Their products include life, disability, and other insurance.

These companies provide services similar to those provided by many Federal agencies. For example, Veterans Affairs and Social Security Administration Benefits Offices provide services similar to an insurance business, whose process involves examining and rating claims and serving the customer in a timely manner.

What is the Best Strategy for Implementing Skill-Based Pay?

⁹An organization needs a strategy that includes the following. There is a:

- need for employees with breadth and depth of skills
- commitment to high-involvement work culture and system
- commitment to investing in people for success of the organization
- commitment to investing in support systems such as training, employee selection, performance management
- demand for a flexible and adaptable workforce
- strong support from management and acceptance of start-up costs and challenges
- commitment to monitor and adjust the pay system as necessary to accommodate the organization's needs
- plan that allows for additional increases in costs of employee pay levels that would not cause a labor cost disadvantage for the organization

Examples¹⁰ of the strategies used by companies include:

- General Mills' plan permitted the organization to ramp up pay levels in concert with increases in production levels. The cost savings paid for the wage increases.
- Northern Telecom's plan was part of a strategy that put all employees on the same pay system to reduce counterproductive status differences between interdependent co-workers.
- Honeywell's plan permitted the organization to pay good wages by local standards, even though rates were much higher than industry standards, because employees were highly productive compared with employees in competitor's plants.

An organization has to be ready to focus on the group or team's performance, not the individual's, to pay employees based on the skills they apply not on the job they hold, and to involve employees in improving work processes and other organizational issues.

Implementing a skill-based pay program is a major organizational undertaking because skill-based pay does not just affect pay delivery, it also creates a new paradigm for how work is accomplished.¹¹ Organizations must begin with a clear vision and strategy and then link pay to their business goals. Work teams of employees and other stakeholders should be involved throughout the design process, and the focus must be on the purpose of the skill-based pay system, not the system itself.¹²

The design process will vary depending on the organization's objectives, culture, degree of worker empowerment, business strategy, technology, and work systems. The framework, however, should include:¹³

- conducting numerous analyses, including organization, cost and work process)
- identifying critical activities
- involving employees, unions and partnership councils in the design activities (as interviewees, task force members, work group members or decision makers), especially those employees who will be affected by the new system
- spending significant time (up to one year) to design and implement the program

Based on examples from successful skill-based pay plans, organizations must consider this an evolving process and adjust course as needed.

What are the Components of Skill-Based Pay Systems and Key Issues in Each Area?

1) Skills

First, the organization must determine what it needs to achieve its mission in terms of capabilities. Second, it needs to determine what the current capabilities of the organization are. This gap analysis will show the difference between the organization's needs and the current capabilities. From that point, the capabilities required can be pulled apart and translated into personal behaviors, knowledge and skills. As previously mentioned, these skills typically fall into two categories; 1) "enabling" or "people" skills, such as leadership, communication, project management, and team building, and 2) "domain" skills, those skills and knowledges required to succeed in a particular discipline, such as engineering or claims examining.¹⁴ This process of identifying skills required to do a job is referred to in the Federal arena as a job analysis. Job analysis is a very useful tool for assessing what skills are required to do the work.

Once those skills are identified, a standard should be devised for competent performance of each skill or behavior. This enables a more objective and consistent process for certifying skills across the organization.

2) Creating Skill Blocks

A skill block is a set of skills acquired to perform a collection of tasks, duties, and/or responsibilities that represents an organizationally-valued package upon which to base pay decisions.¹⁵ Employees may move up, down, or parallel in relation to the employee's original job and either increase their depth or breadth of skills. How an organization constructs its skill blocks depends on: 1) the primary objective of the program, and 2) the nature of the organization's work.¹⁶

The primary objective focuses on either developing employees' competence in a specific area or developing versatile employees who can move quickly to different work areas depending on the needs, or a combination of these.

The nature of the work that an organization performs must be carefully studied, particularly

looking at:¹⁷

- flow of work (i.e. how products or services move through the organization)
- physical location of the work and the workers
- the need for backup and support systems
- the need for upstream and downstream quality checks
- the degree to which there are clear-cut differences between skill levels in a skill family and by which discrete job clusters can be distinguished.

Organizations using skill-based pay tend to have developed an average of ten skill blocks that comprise the set of tasks that are required in the work team.¹⁸ Employees usually choose to only master some of the skill blocks versus learning all ten blocks.

Creating Skill Blocks - Case Studies¹⁹			
GENERAL MILLS	NORTHERN TELECOM	AID ASSO-CIATION FOR LUTHERANS	HONEYWELL
Skill blocks created out of four critical steps in production process. In one plant, each block is further divided into three skill levels. Analogous to job-based pay, except that basic unit that is tied to pay is the set of all jobs in same work area rather than just one job.	Different approaches used in different work families. Skills in engineering skill block were more abstract than in technician job family.	Job descriptions were separated into services or skill blocks, such as an underwriting skill block, a policy support skill block, etc.	Overlap in skills on assembly line. Thus, skill blocks based on more abstract sets of skills found in different work areas.
<i>Average employee took four years to progress through system.</i>			

An organization may want to consider building into their skill blocks a sunset provision that requires them to review the need for that skill block after a certain period of time. Three years is an average period; however, the time will vary depending on the industry and nature of work.

3) Pricing and Progression through Skill Blocks

In skill-based pay, the starting point for pay is determined by the mix and depth of an individual's skills rather than a particular job. If employees have demonstrated competence in a particular skill block, they receive the pay allotment attached to it. How an organization determines this allotment is based on the value it places on that set of tasks or skills. Decisions about the

competitive pricing of skill units must follow logically from an examination of the labor and product markets and the organization's strategic niche with respect to these markets.²⁰

Case studies²¹ showed that companies approached the pricing of skills differently depending on their particular business or market niche and their organizational priorities:

- General Mills and Honeywell approached pricing from the viewpoint of being in competition with the local labor markets and set pay levels according to market data.
- At Northern Telecom, pricing was not as problematic as a typical multi-skill breadth design because vertical job levels continued to be used and recognized. Labor market data was used to set the entry hire rate. The maximum salary range was established on the basis of the average rate of pay for the senior job in the traditional benchmark ladder.
- Aid Association for Lutherans used yet another pricing method based on the Hay system. The value of individual services or skills is determined using the know-how portion of the Hay system of job evaluation.

Skill blocks can be assembled and matched with jobs in the outside market. This benchmark along with the value that a company places on that particular skill block is what the pay model is built on. Usually a pay range, with minimum and maximum rates is set for an entire skill category, or collection of skill blocks. How the employees are paid for their progression through the blocks varies and is based on what is right for the company.²²

It is not possible to directly compare any particular pay levels in skill-based pay systems to organizations using job-based pay systems. Market data is generally used to establish minimum, maximum and average pay levels, not to peg each particular step in the pay system to jobs found in outside markets. In establishing pay rates, companies need to take into account a projected progression of employees through the pay system as well as initial pay rates.

Pay progression was handled similarly by General Mills and Honeywell, which, from the beginning, guaranteed employees progression to the top of the skill categories, both by explicit conditions of employment and by the type of employees hired. Aid Association for Lutherans progression was based on their "valued services," or skill blocks, which have a salary range associated with them, from entry to market maximum. As new services are learned AND applied, the value of those services was added to the employee's ongoing compensation.²³

One of the advantages of skill-based pay is that an organization can pay employees for learning horizontally (learning a breadth of skills outside one's job) as well as vertically (learning a skill more in depth). This also tends to increase employees' career satisfaction.

A potential pitfall in this system is that individuals want to move from job to job to increase their pay. For this reason, many organizations use "pay-back periods": time during which individuals do jobs they already have mastered to pay back the organization for the investment it has made in their training.²⁴ This was one of the key lessons learned from a small organization within the

Motorola Corporation that did not build a structured "pay back" time into their schedule for advancing through the skill sets. Therefore, employees moved at a fast rate through the skill sets, which became increasingly costly to the company.

Another company, the Mead corporation, experienced a similar problem with employees advancing through skill sets at a fast rate. Mead had a six-month "pay back" time for each skill; however, this pay back time was not firmly enforced. Another problem was that employees were being paid for skills they were not using on the job. Mead's costs rose over a three-year period from a typical 15-20 percent employee pay increase to 30-40 percent increases in pay. Mead attributed this severe cost escalation to the design and implementation of the system.

"Rationing" training is another alternative for controlling costs in the area of skill acquisition. Given a set amount of money available for training, a company designs a method for allocating training. Rationing can be approached in a variety of ways, such as limiting each employee to one training course per quarter or a fixed amount of training money for a fiscal year. Whatever the design, it should be carefully thought out, so that employees are assured fair training opportunities.

4) Certification, Base Pay, Recertification, Obsolete Skills.

Skill certification is a critical component of any skill-based pay program. It is the process of evaluating employee skill levels and progress. Generally, team members, peers, supervisors, managers, committees, and management can all play a role in the certification process. To perform the assessment, various tools are used such as work samples, written tests, manager observation, team assessment and self assessment. The involvement of team members, peers, and committees is important in skill certification as the Motorola corporation learned. Its managers controlled the certification and recertifications of skills and job rotations, and an employee attitude survey showed that employees perceived unfairness and favoritism in this system.

Base Pay

An employee's base pay is determined through the skill certification process. Base pay represents the market value of jobs or skills and is a set salary that focuses on the strategic value of the skills an individual learns and applies in support of the organization's mission.

Recertification

Once employees have mastered a variety of skills, the organization must remember to rotate the employee so that skills can be kept current. To ensure that employees retain their skills, organizations may require requalification, periodic refresher examinations or training, and regularly scheduled performance appraisals.²⁵

Obsolete Skills

Having a mechanism for dealing with obsolete skills is essential. When the Motorola

Corporation designed its system, it did not realize obsolete skills would be a problem. It did not build such a mechanism into its design, and costs soared as employees were paid for skills they were not using on the job.

One solution to the problem of obsolete skills is to have a "red circle" period, during which an employee must replace the old skill with a new one. This solution also has the advantage of emphasizing that learning never stops in an organization.²⁶ Another solution would be to reduce base pay after a certain time period if the person does not certify on the skills needed and outlined in the skill-based pay plan.

Skill Certification- Case Studies²⁷			
GENERAL MILLS	NORTHERN TELECOM	AID ASSO- CIATION FOR LUTHERANS	HONEYWELL
Peer trainers update checklists each time employee learns new skill that is part of a skill block.	Resembles performance appraisal process with employee's supervisor, management review committee, and human resource professionals certifying skills.	Teams certify their members' skill levels.	Most evolved system. Certifications are now based on input from team supervisor, a technical resource such as an engineer, the team leader and peers. Test methods include work samples, oral questioning, and written tests. Certification is done annually, and supplemented by mid-year performance appraisals and recertifications of skills previously demonstrated.

5) Training

The wise organization does not make promises about training or how quickly employees will reach the top skill level. Some organizations tell employees that training opportunities will depend on the organization maintaining a certain level of productivity or performance.²⁸ Also, some organizations have experienced problems with employees not moving as quickly as they expected through the skill blocks because, for example, there was no current need for more employees in a higher skill block. As noted above, this may require that training be rationed among employees.

Training needs will be identified when the organization looks at the gap between the skills it needs versus the capabilities it currently has. From this point, organizations need to create a training plan that specifies things like the number of days per employee for training, realistic expectations about the availability of training and how work will be covered when people are out on training.

Careers should be regarded as a multi-task acquisition track rather than as successive hierarchical moves. It is said to be advisable to "put responsibility for career management in the hands of the individual."²⁹

Case studies³⁰ showed that General Mills, Northern Telecom, Aid Association for Lutherans and Honeywell used both classroom and on-the-job training. All of them struggled to balance employee desires for more training with the need to maintain organizational performance. Advancement progressed more slowly than anticipated in all cases because of very real constraints posed by production requirements and bottlenecks in training opportunities.

Case studies also showed these unique approaches:

- Northern Telecom increased managerial incentives for providing training opportunities by basing part of managers' pay increases on subordinates' training and advancement.
- Aid Association for Lutherans' teams were responsible for training their members. The team trains one another or arranges for their own training. The lesson they learned was that you need to have adequate incentives in place to ask employees to assume new roles and duties, such as in self-managing teams. They feel that much training is required for success.

Lessons learned include:

- Make very conservative estimates regarding the pace at which employees will advance in the system.

- Skill-based pay creates a force that encourages management to meet its own training objectives.
- Employees become allies rather than bystanders in the competition for training resources.
- Costs of training must be controlled, as employees seek to acquire skills to increase their pay.

6) Communication

Employees must understand the features, benefits, and potential downside of a skill-based pay plan. As Patricia Zingheim, co-author of *The New Pay* puts it, "If you're not increasing your communication with employees about progress to results, there's really no sense in putting the plan in. New pay enables employees to better understand the challenges that the organization faces."

The Beta corporation in the late 1980's learned the hard way that communication is essential not only in informing and educating employees about a new plan, but in getting buy-in into the design of the plan. Managers and supervisors were expected to adopt and "sell" Beta's skill-based pay plan almost immediately after it was decided upon and well before they had bought into or even understood it. Furthermore, the company surveyed workers about the plan and then failed to use their feedback to make any substantive changes. The design and implementation of the plan failed due to lack of communication and involvement with employees from the beginning of the process.

Case studies³¹ of General Mills, Northern Telecom, Aid Association for Lutherans, and Honeywell showed that extensive communication about the plan is necessary. All used manuals and presentations to convey details. Northern Telecom used a full-blown multimedia campaign with the help of an ad agency. This was desirable due to the geographic dispersion of employees. It ensured that everyone got a consistent message about plan. Aid Association for Lutherans involved teams representing a cross-section of employees throughout the whole design and implementation process. The system was monitored through employee feedback sessions and surveys. Honeywell, on the other hand, had a difficult experience because it inconsistently communicated the message about the plan, later leading to implementation difficulties.

7) Performance Management, Individual Performance Appraisal, Team and Group Goals, Variable Pay

Performance management is focused in two key areas: 1) developing employees, including improving their existing skills and broadening their skills and knowledge, and 2) evaluating employees' contribution to the team's results based on organizational goals and objectives.

The Federal Government primarily uses a three- to five-level rating system for evaluating employees' performance. Employees must receive at least a mid-level (fully satisfactory) rating to

receive within-grade increases. In a skill-based pay system, skill certification, as previously discussed, is the method by which an employee is evaluated on skill levels and given a base pay increase. Skill-based pay typically uses additional performance appraisal tools with strong emphasis on measuring contributions to team and group performance while not usually assigning a rating to the employee's performance.

Performance Appraisal - the Individual

Zingheim says that "under the new pay system, performance appraisal becomes a vehicle for employee development, which is its proper role. If the performance appraisal is used to determine pay increases, it's very hard for the employee to be honest about his weaknesses."

The individual performance appraisal is typically used as a feedback tool to help the individual identify areas of excellence and areas in need of improvement in both technical and people skills. This feedback helps identify training needs and input for progression to the next skill block.

At Aid Association for Lutherans, individuals are anonymously assessed on their contributions to the team by their team members. Teams are self-managing and are accountable for processing all work for which they are responsible. In this self-managed team environment, the individual performance appraisal is focused on the individual's contributions to the team.

Team and Group Goals

The primary focus of performance appraisal in skill-based pay organizations is at the team or group level and is tied directly to the goals and mission of the organization. Team and group goals are easier to measure than individual goals, are also more limited in number, and are easier to identify because they are closer to the basic goals of the organization.³² Team performance is measured using a variety of sources including monthly/quarterly reports (these could include number of customers served, costs, work products, etc.), peers, team leaders, supervisors and customer feedback.

At Aid Association for Lutherans, the team meets regularly to discuss goals, to identify, analyze and solve work-related problems and/or improvement ideas. The team is responsible for motivating, training, coaching and developing its members. The team trains one another or arranges for their own training. The team's actual behavior as a team, e.g. cooperating, encouraging, training, disciplining, goal setting, etc., is appraised by the manager. Teams assess their own progress against standards and goals that contribute to bonus results. The Association's recent survey of employees indicated that a problem area was "employee's inability to measure how well they were doing in their new roles." The Association feels that this is a difficult change for some to accept in a culture where "individuality" has been lauded and many prefer to be "fully" in control of their own destinies.³³

The foundation for this team approach is that employees must be immersed in making the

organization's goals a reality.³⁴ This means that employees must be involved in setting team goals, tracking progress toward achieving goals, and providing input into improving work processes.

Variable Pay

Variable pay focuses on the quality or quantity of performance and rewards teams, groups, or individuals. It includes incentives, bonuses, gainsharing and goal plans and is "any form of direct pay that is not folded into base pay and that varies according to performance."³⁵

"In designing a new pay program, employees may want to define outstanding performance and agree to set aside a certain percentage of the pool to recognize it. But the people companies really have to motivate are the middle group of solid performers. If they can increase performance at that level, they're going to get more leverage overall."³⁶ This pool of money is variable pay, and must be re-earned each performance period.

It is important when designing the variable pay to have no more than three to five performance measures on which employees/teams/groups must focus on to earn their reward. Examples of these measures are customer satisfaction, cost savings, accuracy and timeliness. Once the measures have been established, they must be clearly and frequently communicated to employees. Establishing benchmarks and performance targets is a must. It is also important that the measures to which employees are being held accountable are in their line of sight. Employees need to see how the measures of productivity result in cost savings. A key to having effective variable pay is credible measurement. If you are asking an employee or team to put some pay at risk, then the employee or team needs a good line of sight to see that if they change their behavior, it will translate into a particular measurable result.

If employee pay is to be linked to quality and customer value outcomes, it must reward smaller teams and larger groups of employees working together to attain shared goals.³⁷ For example, at Aid Association for Lutherans, reward systems are set up so that both teams and individuals are rewarded for their performance. The team's results may determine the size of the compensation resource pool available to them. Team members determine the distribution of awards to the members. Developing self-managing teams takes a long time as teams mature and are able to learn and apply all the new skills incumbent in making it work.

Gainsharing and goalsharing are types of variable pay that organizations may also want to consider. These plans directly tie a part of the employee's variable pay into the performance of the entire organization, either based on the financial performance (gainsharing) or the goals achieved (goalsharing).

What are the Major Benefits of Skill-Based Pay and What Issues Need to be Addressed to Achieve Those Benefits?

Below is a chart that illustrates the critical issues that need to be addressed to realize success in a skill-based pay system. The benefits and issues below represent a brief summary of the information found in this guide.

Benefits	Issues
Organizations can do more with less: maximize human resources & increase managerial flexibilities.	Training is key to making better use of the workforce. Issues such as cost, training availability, training distribution, and pay back periods need careful attention.
Employees are more satisfied, have the potential to earn more money than under job-based system and enjoy greater variety on job.	Cost control mechanisms must be in place, and cost savings and other organizational performance measures must be tracked and tied into pay system.
Organizations can break down functional "stovepipe" structure.	Communication across the organization at all levels and all directions is critical. Employees have to know where they, their team, and the whole organization stand and what the strategic direction is.
Organizational performance improves.	<p>Must have a strategic plan and follow it - progress on organizational measures tracked and shared with employees, results linked to their pay.</p> <p>Design of pay system must be detailed and easily explained to employees, relatively easy to administer, and flexible.</p>

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