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# AN INTRODUCTION TO PERFORMANCE AND SKILL-BASED PAY SYSTEMS

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## Importance of Pay

Pay represents by far the most important and contentious element in the employment relationship, and is of equal interest to the employer, employee and government -

- to the employer because it represents a significant part of his costs, is increasingly important to his employees' performance and to competitiveness, and affects his ability to recruit and retain a labour force of quality;
- to the employee because it is fundamental to his standard of living and is a measure of the value of his services or performance;
- to the government because it affects aspects of macro-economic stability such as employment, inflation, purchasing power and socio-economic development in general.

While the basic wage or pay is the main component of compensation, fringe benefits and cash and non-cash benefits influence the level of wages or pay because the employer is concerned more about labour costs than wage rates *per se*. The tendency now is towards an increasing mix of fringe benefits, which therefore have an important impact on pay levels. In industrialized countries, and sometimes in countries with high personal tax rates, the non-pay element of executive compensation has substantially increased in recent years.

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## Objectives of Pay

Pay determination may have one or more objectives, which may often be in conflict with each other. The objectives can be classified under four broad headings.

The first is equity, which may take several forms. They include income distribution through narrowing of inequalities, increasing the wages of the lowest paid employees, protecting real wages (purchasing power), the concept of equal pay for work of equal value. Even pay differentials based on differences in skills or contribution are all related to the concept of equity.

A second objective is efficiency, which is often closely related to equity because the two concepts are not antithetic. Efficiency objectives are reflected in attempts to link a part of wages to productivity or profit, group or individual performance, acquisition and application of skills and so on. Arrangements to achieve efficiency may be seen also as being equitable (if they fairly reward performance) or inequitable (if the reward is viewed as unfair).

A third objective is macro-economic stability through high employment levels and low inflation, for instance. An inordinately high minimum wage would have an adverse impact on levels of employment, though at what level this consequence would occur is a matter of much debate. Though pay and pay policies are only one of the factors which impinge on macro-economic stability, they do contribute to (or impede) balanced and sustainable economic development.

A fourth objective is the efficient allocation of labour in the labour market. This implies that employees would move to wherever they receive a net gain; such movement may be from one geographical location to another, or from one job to another (within or outside an enterprise). Such movement is caused by the provision or availability of financial incentives. For example, workers

may move from a labour surplus or low wage area to a high wage area. They may acquire new skills to benefit from the higher wages paid for skills. When an employer's wages are below market rates employee turnover increases. When it is above market rates the employer attracts job applicants. When employees move from declining to growing industries, an efficient allocation of labour due to structural changes takes place.

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## Pay Reform: The Move To Performance Pay

"We now pay workers not for output produced, nor even for labour input provided, but simply for time spent on the job."

(Alan S. Blinder ed. *Paying For Productivity*, The Brookings Institution, Washington, 1990 at p.2.)

Traditionally wages and pay have been determined through government regulation, minimum wage determination, negotiation with unions, decisions of arbitration or labour courts and the individual contract of employment. The factors or criteria which have influenced pay and pay increases include profit (but generally unrelated to individual or group performance), job evaluation, seniority, cost of living, manpower shortage or surplus, negotiating strength of the parties and skills. Performance measures such as productivity or profit related to the performance of a group have been of less importance in determining pay increases. Though skills have been reflected in pay differentials, pay systems have been seldom geared to the encouragement of skills acquisition and application. Industrialized countries have built their competitive advantage not around low wages, but around clusters of competitive industries in which high earnings and standards of living have been sustained through improved technology, productivity and quality. Many Asian countries now recognize that high technology, productivity and low earnings cannot be combined and sustained over a long period of time. Many Asian employers are now seeking to sustain their competitiveness through pay increases which are more related to performance measures as a way of absorbing increased labour costs, while at the same time rewarding and motivating employees. Japan, Singapore and Korea, for example, have succeeded in moving to high value-added and technology-based or service activities partly because they had invested in skills development and accepted the fact that higher earnings (in Singapore partly through a flexible pay system) are an essential strategy for entry into the knowledge-based industries of the future. Increases in real earnings have been made possible because investment in education and skills contributed to productivity enhancement which, in turn, created the capacity to absorb higher earnings. In the 1980s Singapore made a deliberate shift to a high wage economy in order to encourage entry into high value-added activities. Productivity increases are necessary to sustain higher earnings; at the same time there cannot be any long term productivity growth without an increase in real wages.

Traditional pay systems for non-executive staff have generally been characterized by standardization across and within sectors (e.g., government, particular industries) and within enterprises. So long as employers were competing mainly in domestic markets which were protected from foreign competition - in some cases leading to monopolies - the effects of standardization on considerations such as performance, recruitment and retention of good staff, etc. were less felt. Indeed, standardization, while being equitable from the point of view of employees, benefitted employers as well by reducing competition based on labour costs.

With the gradual opening up of economies to world trade and foreign investment, local employers are now compelled to compete with enterprises with sophisticated technology, more productive ways of providing goods and services, and the advantage of being global players. In many instances

these foreign enterprises are able to attract the best local talent on terms and conditions beyond the capacity of many local enterprises to pay. With the acceleration of the process of globalization, accompanied by the movement of former centrally planned economies towards market economies, governments and private enterprises have had to compete in the global market by developing competitive advantages, which are affected by costs and quality. Productivity increase as the measure of performance at the national and enterprise levels, with quality as an intrinsic part of productivity, is becoming the goal of many developing countries as well - now pushed to the forefront by the forces of globalization and the collapse of economic systems which were an alternative to a market economy. Economies which are seeking to progress from low wage cost manufacturing to highly skilled and technology-based production need pay systems which not merely recognize skill differentials (as standard pay systems do), but also provide an incentive to acquire skills and multi skills facilitated by years of careful and correct investment in education and training.

In the area of industrial relations, collective bargaining outside the enterprise is seen by employers as achieving distributive justice in the sense of equality, with outcomes often being based on the bargaining strength of the parties. It is increasingly viewed as contributing little to productivity and performance. The outcomes often leave employers with little or no capacity to make further payments on account of performance under a scheme. The movement towards decentralization of collective bargaining has been the result of the need to address efficiency and performance issues at the enterprise level. It is natural that with decentralization employers would seek ways to introduce performance criteria into wage increases.

The increase in atypical forms of employment (e.g. homework) which cannot consistently or always be supervised, has also influenced the search for alternative forms of pay.

Traditionally increased earnings were secured and performance rewarded partly through promotions. With limitations on higher positions in the context of organizations becoming less hierarchical in the future, relating part of pay increases to performance would be a way of rewarding performance other than through promotions.

In these circumstances pay systems are increasingly forming a part of human resource management initiatives to achieve enterprise level objectives and strategies, with more attention being paid to how they fit into the overall human resource management policies of enterprises.

These developments have several implications for pay systems. Employers (and some governments) see that pay increases need to be more than matched by productivity increases if competitiveness is to be achieved or maintained. The relationship between pay, productivity, skills and inflation was understood quite early in Asia by Japan as well as the newly industrialised economies. Some other South East Asian countries have also come to appreciate this relationship.

The pressure in the Asian-Pacific region for recognition of performance criteria in pay determination has not come only from employers. In Singapore the government initiated the move to flexible pay. In Malaysia the government drew attention in 1988 to the desirability of introducing a flexible pay system. In Fiji the government has been exploring the feasibility of introducing performance pay into the public service, while encouraging employers to do likewise. The Minimum Wage Board in Papua New Guinea has, since the early 1990s, been required to relate minimum wages to performance criteria in place of indexation. In recent years the wage determination system in Australia has encouraged employers and unions to negotiate a part of wage increases in the context of productivity and productivity-related improvements. The fundamental shift of industrial relations

to the enterprise level and the individualization of the employment relationship in New Zealand has provided ample scope for performance-related pay. Therefore it is increasingly recognized that performance and skills criteria need to be injected into pay determination; that it cannot be achieved through centralized or macro-level pay determination; and that changes have to be negotiated at the enterprise level.

In these circumstances a major concern for employers will be to negotiate pay systems which:

- achieve a strategic business objective;
- are flexible in that their variable component could absorb downturns in business and reduce labour costs;
- are oriented towards better performance in terms of productivity, quality, profit, etc;
- are capable of enhancing workers' earnings through improved performance;
- are capable of reducing the incidence of redundancies in times of recession or poor enterprise performance through the flexible component of pay;
- are able to reward good performance without increasing labour costs, and
- are able to attract competent staff.

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## Types of Schemes

The types of schemes which fall within the description of performance pay are varied. Broadly speaking, they consist of schemes designed to share or distribute the financial results of enterprise performance with or to employees. In essence, performance pay is based on paying the worker for his or her value, rather than the value of the job. Such schemes fall into four broad categories:

- individual-based or based on individual performance, such as incentive schemes and sales commissions
- profit-sharing, which applies to all or most of the employees
- gain-sharing measured by a pre-determined performance formula, applicable to all or groups of employees. The performance measure may be profit or some other objective such as productivity
- employee share ownership schemes.

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## Problems and Issues

Whether extrinsic rewards such as performance-related pay actually motivate employees to better performance is a matter of controversy. It has been claimed that monetary rewards usually have a limited time-span in regard to their motivating effect. Therefore extrinsic rewards such as performance pay, even if they can exert a continuing impact on performance, should

- be consistent with overall management objectives, so that performance pay may not be consistent with, for example, a purely cost reduction strategy;
- only be used to reinforce a motivational system in which intrinsic (non monetary) rewards exist, such as reorganization of work processes, training, employee involvement/consultation in decision-making, two-way communication, opportunities to contribute ideas, career development plans and goal setting.

Some of the reasons for the failure of performance-related pay and some of the problems and issues facing employers flow from a variety of circumstances such as the following:

- i. Inadequate criteria to measure performance, or criteria which are not easily understood, communicated and accepted. Performance pay should therefore be negotiated.
- ii. Inappropriate performance appraisal systems in that the objectives of the appraisal system (*e.g.* where it is intended to identify training needs or suitability for promotion) do not match the objectives of the reward system.
- iii. The absence of regular feedback on performance.
- iv. The reward system is not designed to meet the objectives sought to be achieved. There could be a variety of objectives *e.g.* to satisfy distributive justice, attract and retain capable staff, match particular levels of pay in the labour market, change organizational culture (*e.g.* towards greater customer satisfaction) or to reinforce it.
- v. The absence of a right mix of extrinsic and intrinsic rewards.
- vi. The lack of an appropriate quantum of pay which should be subject to performance criteria. This occurs when the amount which depends on performance is too small, or it is too large and therefore the amount placed at risk (when performance is poor) is not acceptable to employees.
- vii. The absence of periodic evaluation of the scheme.
- viii. Non-recognition of the fact that performance, especially profit, is sometimes (even often) dependent on factors outside the control of employees *e.g.* management decisions, exchange rates, recessions.

There are many arguments in favour of performance-related pay which are theoretically attractive. However, it is not easy to find evidence which unequivocally supports or disproves these views, because of the scarcity of empirical evidence or because the introduction of the scheme has been faulty. Governments can sometimes facilitate the introduction of performance-based pay. In Britain for instance, the Finance Act of 1987 introduced tax relief for approved schemes to encourage their adoption and proliferation.

Two benefits at the macro level have been claimed for performance pay. The first relates to employment. If increases in basic pay are transferred to a profit-related scheme (*e.g.* 10% of basic pay), the employer may be more inclined to hire new employees as his wage cost is less than otherwise. If the percentage of profit to be shared remains fixed, additions to the workforce do not cost the employer more in terms of the profit-related pay. On the other hand, new recruitment would reduce the quantum existing employees will receive unless profits increase, and consequently dissatisfaction among employees could set in.

The second argument is that if basic pay is reduced as a percentage of total earnings, increased earnings will not result in inflationary tendencies as such increases are the result of increased profits/productivity.

The benefits to management and employees are:

- where performance/profits increase, higher pay is an incentive to employees
- where profits reduce, the reduction in the performance-related pay can cushion employees against redundancies
- employee identification with the success of the business is enhanced
- variations in pay lead to employees becoming more familiar with the fortunes (or misfortunes) of the business. This would depend on the information-sharing practices of the management.

Several criticisms of a general nature (apart from those directed at particular types of schemes) have been made against performance-related pay. Among them are the following:

- i. where the performance earnings fall employees are less inclined to accept reductions in their guaranteed pay
- ii. positive employment effects could be negated due to opposition from employees to recruitment as it would dilute their earnings
- iii. since performance/profits depend on a variety of factors beyond the control of employees, it is not possible to link pay to the performance of employees. If it is linked to the overall performance of the enterprise, then management decisions should logically be subject to scrutiny by employees.
- iv. it is difficult to determine whether the amounts paid out under schemes are more than matched by performance gains.

Even though the evidence is not always clear whether profit-sharing, for instance, raises productivity levels, the positive link between profit-sharing and productivity is clearer in enterprises with employee participation arrangements. Where the extra payments replace a fixed wage component and is not an additional component of pay, there is a greater likelihood that the extra pay is matched by performance increases. In the case of group incentives payments are never proportionate to individual performance, as poor performers ("free riders") benefit from the efforts of others.

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## Performance Criteria Choices

The objectives of a particular performance-related pay scheme will determine the selection of the criteria to assess performance. The criteria may be based on individual, group or organizational performance, or on a mixture of them. Individual-based criteria would require individual goal-setting and an appropriate performance appraisal system; individual training to increase job knowledge and skills because training makes up the difference between abilities needed on the job and the abilities brought to the job; and the individual should have a large measure of control over his/her own performance. Individual performance criteria are not appropriate where the objective is to promote better overall performance through teamwork, cooperation, and the sharing of information and knowledge, or where individual performance is not measurable.

Team-based criteria are appropriate where individual performance is difficult to measure, or where there is a need for a corporate culture to promote team values and cooperation. The performance of the enterprise is easier to measure (*e.g.* profits). But individuals and groups would find it difficult to identify the link between their performance and that of the company.

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## Types of Performance Pay

### Merit Pay

A common method which has long been in existence is pay increases - in the form of increments, for example, for individual performance. Its workability and effectiveness depend on the existence of a suitable performance appraisal system, which has often been found to be lacking. Due to its integration into the salary, it is not lost due to poor performance later, and therefore may cease to be an incentive.

## Incentive Payments

Lump sum payments (such as sales commissions) is another traditional method. It is not added to base pay. Usually the formula and the relationship between performance and the payment of the lump sum, are known beforehand.

Sales commissions may often have little to do with performance because factors such as product quality, brand name and price may contribute more to sales than the ability of the salesman to convince the buyers. Appraisals are less significant to this category since the criteria (*e.g.* sales figures) are statistical and no further measurement is needed.

Another traditional method of rewarding performance is piece rates. Unless related to a reasonable time frame within which the production should be completed, such rates would not be related to performance.

There are several weaknesses in certain types of incentive pay such as piece rates:

- it is not often easy to agree with workers on the standard required output
- frequent changes may be needed in the standard output due to technology changes, and this invariably leads to disputes
- factors other than individual performance affect output *e.g.* new work arrangements
- where team work is an organizational goal, individual incentives can be counter-productive
- piece rates can generate conflict and be divisive. Employees often wish to lower the standard output. Conflicts between different work groups occur when one group is dependent on another. There is a potential for conflict when norms have to be revised.
- piece-rates could be a disincentive to employees developing more productive work methods.

Generally speaking, many incentive schemes are more appropriate to measurable repetitive tasks. They are not suitable for high technology and service activities requiring information-sharing, problem-solving and team work.

## Group Incentives and Productivity Gain-Sharing

Group incentive schemes are of three types. Gain-sharing refers to a compensation system which divides between the employer and employees the results of improved performance consequent upon the better use of human resources resulting in productivity gains. Sharing is according to an agreed, pre-determined formula. A second type, namely, profit-sharing, gives employees a share of the profits. A third type is employee stock ownership plans (ESOPS). Sometimes bonuses are paid to individuals based on their own performance appraisal ratings. In the case of group incentives, the criteria could be either group or enterprise performance.

The necessity for objective criteria for distribution of the performance component of pay, and a clear relationship between what is paid and the criteria, are important.

Productivity gain-sharing is practised by the larger Japanese companies. Their system is based on the premise that basic to successful productivity enhancement in the long term is sharing productivity gains with employees by linking a part of earnings to productivity to achieve such multiple goals as

- increasing labour productivity
- improving employees' living standards
- strengthening employee commitment
- improving labour-management relations
- securing flexibility in labour costs
- maintaining corporate viability

In the Japanese system a part of productivity gains is shared with the employees through the collective bargaining process on whatever criteria are applied in collective negotiations, and part through the gain-sharing system. The amount distributed in recent years through the collective bargaining process and the gain-sharing system in manufacturing establishments with more than four employees has been about 35% of value added. In the 15 years previous to about 1993, the share allotted to labour remained stable. The two mechanisms - collective bargaining and joint consultation on gain-sharing - have supplemented each other, and have contributed to establishing a consensus on criteria for pay increases.

The component linked to productivity is paid in the form of a bonus, which in years before the recession, represented approximately 3-5 months' pay. About one-third of companies employing 30 or more persons have productivity-linked schemes. The percentage has been much higher in the larger companies.

Some companies combine productivity and merit rating. For example, a part of the increase may be a fixed amount to guarantee a fixed payment, while the other part is linked to productivity but distributed on a merit rating arrived at through the joint consultation system and reviewed annually. Distribution of the productivity bonus may be direct to individuals, or first to the department or unit based on its performance level.

In Japan participation of employees in formulating and monitoring formulae has enabled them to:

- understand downturns and upswings in business cycles
- take a long-term view of growth
- be motivated through the opportunities offered them to influence the schemes
- achieve a common understanding of issues important to gain-sharing such as
  - concepts and measurement of productivity
  - the relationship between pay and productivity and past trends
  - estimates of labour costs and share
  - productivity improvement methods and targets
  - appraisal of the system

In general, gain-sharing systems are based on a participatory approach, and can be used to create or reinforce participatory practices. Evidence (*e.g.* in the U.S.A) indicates that such systems

- improve coordination, team work and knowledge-sharing
- satisfy social needs (through participation)
- focus on cost saving
- facilitate changes (*e.g.* in technology) needed to improve performance which are seen as being directly related to higher earnings
- result in expectations by employees of better management and planning
- result in contributions of ideas by employees.

## Profit Sharing

These schemes are not related to an individual's performance, but are linked to the profits of an enterprise, a part of which is paid as a bonus to the workers. It may be a cash payment, or a deferred payment kept, for instance, in a special fund for a particular period. There are numerous types of schemes in existence. It has been estimated that by 1988 about half a million American firms were operating profit sharing schemes.

## Long Term Incentives

Long term incentive plans are operated, especially for executives, both as an incentive to improved performance and in order to reduce fixed costs. Examples of such schemes are:

- share option plans to promote convergence of stockholder/executive interests
- bonus linked to long term performance (3-5 years) to encourage a focus on long term goals

In the 1980s stock ownership plans (ESOPs) in the U.S.A. normally included only executives, while in Japan they usually excluded executives. A lower rate of termination of ESOPs in Japan contrasted with a higher rate of terminations in the U.S.A.

## Performance Bonus

This type of bonus can be based on individual or group performance. Where it is individual based, the payment would depend on performance ratings. Since the 1980s there has been in the U.S.A. an increase in union agreements substituting bonuses for traditional wage increases. In many countries performance bonuses are commonest for executive staff. It is estimated that in the U.S.A. about 97% of the large and 86% of the medium sized companies pay such bonuses to their executives. In Western Europe the estimate is about 70% and in Singapore about 66%. As a percentage of base pay, the figure is highest in the U.S.A., though the variations are also large.

Some of the criteria for the success of such bonus payments are: group over individual performance, the existence of objective criteria for distribution, and the fact that such criteria are capable of measurement to ensure that what is paid is related to it.

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## Some Concluding Remarks

The success or failure of performance pay is affected by a variety of circumstances which vary from country to country. That is why transplanting such systems without necessary modifications is unlikely to meet the objectives. Success or failure will generally be influenced by circumstances such as the following:

- the tradition of collective bargaining
- attitudes of unions. For example, the negative attitude of unions in Malaysia has hindered its introduction in that country, while the opposite attitude of the union in Singapore considerably facilitated it.
- cultural factors. For instance, group incentives may be more appropriate in some cultures.

- a human resource management strategy which uses pay to reinforce larger business strategies. Thus organizations which are in low cost manufacturing, promote innovation, skills and higher performance, or which are in service industries need to consider different forms of performance pay. Their human resource management strategies will differ, and pay objectives should be consistent with them.
- whether the overall climate in the enterprise is favourable to performance and productivity. For instance, enterprises which encourage employee involvement policies and practices have experienced better results with performance pay.

It is necessary to bear in mind that performance is affected by a variety of factors such as

- knowledge or skills which determine the potential to perform, and which need to be developed through training
- work attitudes which determine willingness to perform, and which therefore have to be matched by appropriate motivational systems with intrinsic rewards
- the ability to match the above factors is what secures performance, and is consequently a central task of human resource management.

On the controversial issue of whether reward systems do motivate, it is essential to pay attention to aspects which are equally - perhaps even more - important than the rewards themselves, such as:

- reorganization of work processes
- training
- employee involvement and participative decision-making
- opportunities to contribute ideas and knowledge
- non-monetary recognition
- career development
- goal setting

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## Guidelines

The following tentative guidelines are suggested:

1. A performance pay system should be designed to promote the kind of performance an organization needs. In order to do so
  - an analysis should first be made of the objectives and results sought
  - the principles/policies and practices needed to obtain the results (*e.g.* team work) should be established
  - these policies and practices should form part of an overall human resource management strategy.
2. Employees should be consulted in the formulation of the plan (to ascertain the type of rewards most likely to have motivational effect), in regard to its operation and distribution of rewards, and in monitoring the scheme.
3. The criteria for the determination of performance pay should be
  - objective
  - measurable and measure only what is important
  - that it is operated along with an appraisal system which measures performance appropriately

- designed to feed back information to employees, and not only to management
  - easily understood
  - related to what is controllable, so as to exclude what is beyond the control of employees.
4. The intrinsic reward system should be strengthened if need be, *e.g.* through
    - consultation, communication, participatory systems
    - training
    - job satisfaction and responsibility
    - reorganization of work processes
  5. How the performance pay is shared is as important as the quantum, because the manner of sharing affects employees' perceptions as to whether the scheme is equitable.
  6. The impact of the scheme also depends on the frequency of the payment. Therefore the reward should follow the performance as soon as possible.
  7. The scheme should be given wide publicity within the enterprise.
  8. The performance level should be achievable or else the scheme will have no motivational impact.
  9. The quantum of pay on account of performance which is placed at risk (*i.e.* the amount that can be lost due to poor performance) should be carefully determined. At the same time the scheme should be sufficiently flexible to absorb downturns and adequately reward when performance is good.

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### **What Is Skill-Based Pay?**

Skill-based pay refers to a pay system in which pay increases are linked to the number or depth of skills an employee acquires and applies and it is a means of developing broader and deeper skills among the workforce. Such increases are in addition to, and not in lieu of, general pay increases employees may receive. The pay increases are usually tied to three types of skills:

- horizontal skills, which involve a broadening of skills in terms of the range of tasks
- vertical skills, which involve acquiring skills of a higher level
- depth skills, which involve a high level of skills in specialised areas relating to the same job.

Skill-based pay differs in the following respects from traditional pay systems which reflect skills differences in a structure consisting of rates of pay for unskilled, semi-skilled and skilled workers:

- Skill-based pay is a person-based and not a job-based, system. It rewards a person for what he/she, rather than the job, is worth. Job worth is reflected in a basic rate of pay for minimum skills, but pay progression is directly linked to skills acquisition (rather than to general pay increases applicable to all) .
- It rewards (and therefore emphasizes) a broad range of skills which makes the employee multi-skilled and therefore flexible.
- It positively encourages skills development.
- A skill-based pay system may not necessarily reflect how well the skill is used, as this falls within the performance component of pay. But there is nothing to prevent injecting performance criteria into the system. In such cases the system will be more performance-oriented than a structure which merely recognizes different rates of pay for skills.
- The system needs to be underpinned by opportunities for training which is critical to the success of the system. The traditional structure is not dependent on such opportunities.

## **Reasons For Skill-Based Pay**

More than ever before in industrial relations history a commonality of interests in the skills of employees has developed between employers and employees. Skills provide employees with a measure of protection against unemployment, as well as opportunities for higher earnings. At the same time, skills provide employers with an important means of achieving competitiveness.

Many countries today are seeking to advance to more technology and skill-based industries, while others have become (or are becoming) 'post industrial' societies, in which the application of knowledge determines productivity, performance and competitiveness. Comparative advantage based on, for instance, cheap labour or raw materials, has declined in importance relative to competitive advantage based on the ability to add value to a particular resource or advantage. Such comparative advantage partly (often largely) depends on people - their standards of literacy and education, work attitudes, value systems, skills and motivation. Critical today is the ability to innovate and develop clusters of competitive enterprises in particular industries. For the more industrialized countries this means 'capturing' some of the key industries of the next century - micro-electronics, biotechnology, new materials science industries, telecommunications, civil aviation, computers and software, robotics and machine tools and entertainment. An employee with skills is most flexible and productive when he develops a broad range of skills, is able to learn the next higher skill, develop analytical skills and is also able to work in a team. Important aspects of today's skills package include multi-skills, cognitive skills, interpersonal and communication skills, positive work attitudes and quality consciousness. Training is no longer only for current competence, but is also to prepare for the next stage of skills. Thus pay systems which promote current and future skills needs are increasing in importance among employers.

The impact of rapid technological change, the increasing globalization of product markets, greater customer choice and the emphasis on quality necessitate a frequent updating of skills, and flexibility to respond to rapid changes in the requirements of markets. A flexible workforce, which is one that is multi-skilled, ensures that production is not interrupted due to the narrow skills of workers, and that workers are themselves responsible for the quality of products.

## **Introducing The System**

Introducing a skill-based pay system requires several steps to be taken and several issues to be addressed:

- The skills requirements of the enterprise should be analysed
- The availability of resources for training should be ascertained
- The jobs to be covered by the scheme should be identified
- The individual jobs have to be grouped into 'job families' on the basis that in each 'family' the skills needs are similar. The skills within each job family and the tasks needed to perform the job should be analysed
- The above will lead to an identification of the skill blocks or levels. The skill level is the pay grade relative to the competence to use particular skills, and the skill block is the training input which has to be completed to the satisfaction of the certifying authority in order to gain

entitlement to the extra pay. It is not unusual for skill levels to consist of several skill blocks, each to be acquired through training.

- Training modules have to be formulated
- The way in which certification is obtained that the skill has been acquired should be agreed upon.
- The base rates for 'job families' have to be set, as well as the payments that will be made thereafter when an employee moves upwards through the skills route.
- The criterion for extra payment is not acquisition of the skill, but its application.
- The period during which the skill should be applied before a new one is acquired should normally be decided on, as the skill should benefit the employer who should receive a return on the investment made.
- A difficult question is how obsolete skills should be dealt with *e.g.* through retraining or redundancy.

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### Problems In Skill-Based Pay

There are several problems associated with the introduction of skill-based pay which should not be underestimated. They can be extremely costly having regard to

- the extra payment involved
- training costs
- the fact that some skills may be paid for but used infrequently
- the possibility that unusable skills may be acquired unless the system is properly administered
- the fact that it is not always easy for an employer to anticipate accurately what skills will be needed in a few years' time

The administration of the system is complex, both in regard to certification of skills acquisition and payment. Therefore, unless administered properly, the costs can outweigh the productivity and flexibility gains. Further, the employees who reach the maximum of the skill levels can be demotivated when extra payments, as distinct from general pay increases, cease. Therefore the gains from flexibility, improved quality, the elimination of some jobs and so on depend on the employer's ability to administer the system properly, making clear also that it is not the acquisition of **any** skills, but agreed skills, that fall within the scope of the scheme. Hence the need to negotiate the system. It is easier to introduce skill-based pay in an entirely new (greenfield) site, than in an already existing one where there is in existence a pay system based on different criteria.

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### Factors For Success

Some of the circumstances which contribute to the success of skill-based pay are:

- the employer's commitment to continuous training and development
- the value attached by the employer to personal growth and encouragement of a learning orientation
- dismantling strong bureaucratic hierarchies and narrow job demarcations
- participative management practices, independent and cooperative forms of work

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## Appropriate Industries

Skill-based pay systems are most appropriate to enterprises which depend on a high level of skills, and in which labour costs represent a relatively small portion of total costs, unlike in labour intensive industries. Though such pay systems have been commonest in manufacturing organizations, they are applicable to service industries as well though the objectives may differ. In banks and airlines, for example, skill-based pay can be used to encourage people to work in areas where manpower is most needed at a given point of time due to customer flows. Skill-based pay is particularly consistent with knowledge-based work.

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## Advantages Of Skill-Based Pay

Among the advantages of skill-based pay are the following:

- It contributes to job enlargement and enrichment by breaking down narrow job classifications.
- Flexibility is increased by encouraging the performance of multiple tasks. It enables job rotation, and filling of temporary vacancies due, for instance, to absenteeism. It therefore contributes to a leaner workforce.
- It enhances productivity and quality through better use of human resources.
- It facilitates technological change, which may meet with resistance in a purely job-based system.
- The higher pay levels, continuous training, and job enlargement through the broadening of skills, tend to reduce staff turnover.
- Elimination of unnecessary jobs can result from a workplace having broad, rather than narrow, skills. It also reduces the need for supervision.
- Job satisfaction is engendered through employees having greater control over the planning and implementation of their work.
- Broadening of skills leads employees to develop a better perspective of operations as a whole.
- It is an incentive for self-development.
- It provides employment security through skills enhancement.
- It reduces the need to look to promotion to higher levels (which are always limited) as the only way to enhance earnings, and it facilitates the planning of an employee's career development path.
- Since the reward flows from the application of a skill and it does not reduce opportunities for others to similarly increase their skills and earnings, there is likely to be less competition among individuals.
- Since the pay increases on account of skills are linked to a measurable standard, the criticism of subjectivity often associated with performance appraisals and individual-based performance-related pay, is avoided

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## **Some Guidelines to the Introduction of Performance and Skill-Based Pay**

Performance and skill-based pay systems need to be negotiated and introduced at the enterprise level. Other than for very broad policy issues (*e.g.* whether such systems should be introduced), performance and skill-based pay cannot be negotiated or designed at the macro, or even at the industry, level. It follows therefore that it is not possible to recommend a particular system which could be introduced across several enterprises or even across an industry. This is evident from the following steps that need to be taken before introducing such a scheme:

- A pay expert, or the management, would have to first analyse the existing pay structure.
- The business objectives of the enterprise and its overall human resource management policies should be determined.
- The objectives of the system to be introduced should be clearly identified.
- Whether the scheme to be introduced fits with the overall corporate and human resource management objectives of the enterprise has to be ascertained, as they must all 'fit' together.
- The scheme should be negotiated, and employees consulted to ascertain whether the desired objectives are likely to be achieved.
- Mechanisms to monitor and review the scheme should be agreed upon.

The principles outlined herein could help to guard against possible pitfalls and to identify some of the procedures to be followed, as well as to assist to some extent, in the making of choices between different schemes which may be introduced to achieve the objectives. No blueprint can be provided, however, though the principles can facilitate in identifying the types of schemes suitable to particular types of businesses and tasks.

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*For further information, please contact Bureau for Employers' Activities (ACT/EMP)*

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