Design Rationale for Skill-Based Compensation

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A White Paper

Skill-based pay & multi-skilling

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The psychology of compensation

People do things for money. In its most elemental form, application of this principle is simple: If you want someone to show up, you pay them. If you want them to stay away, you don't pay them (unless, of course, you want them to leave now, in which case you pay them even more). Applied in a slightly more complex form, the principle says: If you want someone to show up at your business, you pay them a little more than the other companies around you.

Wages alone may get someone to the job site, but they may not influence what that individual does or how he or she does it unless pay is explicitly designed to do so. While other motivational elements are increasingly used to promote job satisfaction and direct work performance, pay is still a primary motivator. Given the primary role of compensation, companies can maximize employee performance by shaping compensation to explicitly direct behavior toward company objectives. And by rewarding personal development that is consistent with company objectives, compensation can increase job satisfaction and motivation.

Most companies view compensation simply as a cost rather than an opportunity

From an accounting point of view, compensation must be treated as a cost. That's the only way management can make financial projections. Companies need to know what their projected expenditures will be.

The accounting approach is not a good model for performance management because it does not consider how compensation dollars are applied. It simply assumes that X dollars get you Y bodies in a given job category which yields Z dollars in production. Accounting does not consider how that compensation achieves output. Without considering how compensation achieves its ends, the only imperative is "how cheaply can labor be acquired." And this can, in turn, lead to demoralizing wages, loss of personnel and reduced production.

Economic models focus on the benefit of low wages because they generally equate labor rate and labor cost. In fact the two elements are different because a higher rate may secure talent that can generate more than an equivalent increase in productivity. In that case, labor rate goes up while labor cost declines.[1]

Reducing labor costs is an objective of skill-based compensation, but it accomplishes that by other means than reducing labor rates. Skill-based compensation looks at the behaviors that lead to production. It modifies how those "Y bodies" perform their work. By directing individuals and groups toward more productive behaviors, the same X dollars (or less) applied to Y employees (or fewer) can result in a sum much larger than Z dollars.

Skill-based compensation provides management with the opportunity to tune and enhance productivity with not only the size of wages, but also the way in which they are applied.

Companies' investments in personnel are increasing

Employment trends are leading toward a more highly skilled workforce and leaner organizations. More skill implies more investment in each employee. Lean, often flatter organizations also mean less backup—depth—in any given position. So an employer must accept more investment in, and reliance on, each individual. The employer must also recognize that there will be more consequences and costs associated with turnover.

Increased productivity is rarely a matter of working faster or working harder

The limitations of the human machine and mental energy result in quickly diminishing returns from pushing. (In fact it may have the opposite effect.)[2] *And incremental reward systems based on production measures run into simple human limitation. Incremental production quotas or other metrics become increasingly difficult to meet.*

More money, by itself, may have little effect. Have you heard comments like the following? "They weren't doing the job right so I paid them more, hoping they'd be more careful." Or, "I thought if I gave them an extra 15 percent they'd produce more." Have you ever heard of it working? Increases in wages generally do not increase productivity—except in extreme situations or where the increases are applied with explicit expectations. (Examples would be a workforce where *an increment significantly increases morale, or where incentive is provided for a one-time, credible productivity goal).*[3]

Incentives based on production measures also can become disincentives. "Employees may view progressively harder targets as similar to the manipulative use of piece rate incentives and thus distrust them," writes Gerald Ledford in Compensation & Benefits Review.[4]

Increased productivity is the desired organizational behavior, but dollars that only look at the goals seldom address the means. Highly motivated people cannot produce more if they do not know how. Aggregate production objectives are generally beyond an employee's line of sight and control and usually do not provide motivation. So applying money to those goals to encourage employees toward them may have little effect. Gainsharing compensation can provide strong incentives, but if employees don't have the necessary tools, it drives up inefficiency and ultimately frustrates. Companies must look at the behaviors they can foster that are within the employee's domain.

According to a recent article in Harvard Business Review, the consulting firm of William M. Mercer concluded that "most individual merit or performance-based pay plans share two attributes: They absorb vast amounts of management time and resources, and they make everybody unhappy."[5]

Significant productivity improvements come from working smarter and in new ways

Real gains come from working in completely new ways, and this requires new skills:

- *skills to analyze the work and reshape it into a more efficient form;*
- *skills to decide what technology and form of personnel deployment can produce the lowest production cost;*
- *skills to interact in new ways; and*
- *skills to deploy the new technology.*

These are the strategic skills companies seek. Strategic skills are those that create best practices and deploy emerging technologies in a company's chosen competence.

Often strategic skills are interpersonal skills. One client stated the expectation that team skills and business skills would prove more important than all the technical skills the company was adding through their skill-based pay program.

Simply defining the strategic skills can often be the most valuable result of skill-based pay. Strategic analysis of skills encourages strategic analysis of the company—defining the core competencies upon which the company will grow. Explicitly defining the strategic skills that support the company's core competencies enables managers, trainers and individual employees to direct their learning toward those competencies. A programmed Strategic Training Redesign process focusing on strategic skills can greatly increase the value received for each training dollar. One client estimated that savings produced by training redesign could pay for the entire skill analysis and skill development within the first two years.

Assessing skill-based pay

The way to determine how skill-based pay will work in your organization is to define the explicit pathways by which skills will produce savings or productivity.

<u>Direct efficiency improvements in existing processes</u>

First look at the way improved skills could affect productivity without redesigning work processes. Here's how results of this analysis might be stated:

"If molders could recognize and reject overly wet sand, we could reduce scrap by 10 percent. That would produce savings of $47,500 per year."

"If clerks could recognize incorrect coding on invoices, we could save 635 hours a year that we now consume in tracking and correcting the errors. We could also eliminate a major source of customer dissatisfaction. The hours saved represent $13,970. We also estimate that we would net an additional $23,200 on lost sales from customer dissatisfaction."

<u>More efficient work allocation</u>

Another way to identify added value from skill enhancement is to examine how redeployment of skills among work groups can reduce costs. Corresponding statements of expectation look like this:

"By training one operator on each offshore platform to perform level 2

compressor diagnostics, we can save 300 helicopter flights a year. That represents a savings of $1.5mm a year. The training will cost $425K for a net of $1mm."

<u>More efficient ways of working</u>
New skills also let you rethink the corporation. They open the possibility of entirely new, more efficient ways of working. This is the performance domain many companies see as the outcome of skill-based pay. Statements evaluating new ways of working look something like this:

"We could shorten the engineering approval cycle by 42 percent and save $2.43mm on our current budget by implementing a Lotus-based tracking system. To accomplish this, all our engineers and engineering assistants would need to learn Lotus and the process. That would cost $732K."

"Training in work process analysis at the team level should result in new ways of performing routine maintenance. Those new methods should reduce maintenance time by 15 percent. That translates into a savings of $925K annually. Training across the company will cost $1.2mm."

In each case, quantifying expectations permit rational management decisions about the value of skill-based pay. And in the last case, it demonstrates that the effort would not pay out in the first year.

Behavioral definitions of work expectations

Behavioral descriptions of the tasks performed in each job position greatly assist the foregoing analysis. These descriptions state, in observable, measurable terms, all the tasks someone performs—"code invoices," or "prepare molding sand." They state or imply outcomes. With these clear descriptions, you can see and assess the work process as well as the quality of the work product.

Non-behavioral descriptions only addresses activities, "clerical work," or "casting." With non-behavioral descriptions, almost any action that fits the category appears legitimate, whether or not it is relevant. Without defined expectations of outcome, there is no measure of correct performance.

Developing behavioral descriptions is part of a process called Strategic Repertoire Analysis™ that provides a model of a company's activities.[6] Another element of this analysis is defining the repertoire of skills required for each group of tasks. Without a model that defines expectations in terms of observable, measurable outcomes, meaningful analysis is much more difficult.

Calculating ROI on skill-based pay

Assessment of the value of skill development can lead to fairly precise estimations of payout, because the behavioral analysis defines observable expectations and measurable outcomes. By comparing the expected returns (which can be weighted for probability) with the anticipated costs of both program initiation, pay and associated training, management can make straightforward investment decisions.

You can actually perform the analysis on a finite, task-by-task basis, if you have defined a complete repertoire of tasks and skills.

Even without coupling pay to performance, the process of Strategic Repertoire Analysis and Strategic Training Redesign can provide many of the same performance opportunities and cost reduction opportunities as skill-based compensation.

Retention and job satisfaction

Numerous studies detail how skill-based compensation programs have increased job satisfaction and employee retention. In industries where staff reductions and staff movement are realities, employees find significant satisfaction in programs that enhance their marketability, stimulate their intelligence and provide challenges associated with innovation and growth. A thorough analysis of skill-based pay should consider the costs associated with existing turnover rates and the potential reduction skill-based pay could produce.

[1] Frazier, Craig, "Six Dangerous Myths About Pay," *Harvard Business Review*, May-June 1998, p. 110.
[2] Ibid, p. 116.
3 Ledford, Gerald E. Jr. Designing nimble reward systems *Compensation & Benefits Review* 27 (4), 1995, pp.46-54.
4 Ibid. Ledford provides a clear review of advantages and disadvantages of different variable pay and gainsharing plans including skill-based pay
5 Op Cit. Frazier, p. 115.
6 See our White Paper, *Strategic Repertoire Analysis*.

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