New Reward I: Team, Skill and Competency Based Pay

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Introduction

This report is a collection of research papers that have been written over the last year or so. They have been produced by IES as inputs to member events. We bring them together in two reports under the theme of 'new reward' because each of them covers a remuneration practice that has been seen as a component of the new reward approach. This is the first part of the two-part review. In this report we cover:

- team based pay
- skills based pay
- competency based pay.

In the next report we will look at:

- flexible benefits and total reward
- market-determined pay
- variable pay.

We begin by first putting these individual remuneration practices in the context of the 'new reward' philosophy.

So what is new reward?

The term 'new' reward continues to be used to describe a fresh approach to remuneration. As recently as 2001, a report for the CIPD on reward trends in the UK had a chapter devoted to 'new pay practices' (Thompson and Milsome, 2001). The authors wanted to see what evidence there was of a different method of compensating people. In fact, as Thompson and Milsome pointed out, 'new' reward is hardly new at all. They credit Ed Lawler with developing the idea as far back as 1986.[1] His ideas were picked by Schuster and Zingheim (1992). For these writers, new reward is characterised by a number of features. It is:

- strategic
- business aligned
- flexible
- performance driven
- distinctive
- integrative of the actions of employer and employee.

Strategic and business alignment should be the goals of all HR practices. Lawler saw the power of reward to leverage change in organisations in a way that could be recognised as genuinely strategic. This meant that an organisation's pay approach should be distinctive. It had to reflect its organisational needs, not be a standardised mechanism to remuneration management.

Behavioural change was seen as key to improving employee performance, and hence organisational performance. As Lawler succinctly put it: 'in order to be effective, a pay system must impact perceptions and beliefs in ways that produce the desired organisational behaviours' (1990). So the aim of new reward is to encourage employees to accept the organisational imperatives and be motivated to raise their contribution levels. Getting employees to take on board the connection between their actions and organisational performance is very much an HRM ambition, as is the emphasis on developing a common purpose between employees and employer.

In the view of these writers, the latter is best achieved through getting employees more involved in the running of their enterprise, so that they can better appreciate what their role adds in relation to the whole. The process of employee involvement underpins the actual practice of new reward.

Levels of performance needed to improve, claimed the new reward proponents, because of a number of business drivers. In particular, there was the anticipated increase in competition. As

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1 The New Pay, CEO Publication, Los Angeles, Center for Effective Organizations, University of Southern California.

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Lawler said in 1992 that new pay is found in 'reward programmes that reflect on understanding organisational goals, values and culture and the challenges of a more competitive global economy'. This pressure, together with the expected tighter labour markets, would require organisations to be more externally, than internally, focused in their pay systems. In addition, technological change would force organisations to be more adaptable. This links to the idea of greater flexibility in remuneration. Remuneration systems have to be able to adjust to changing business circumstances. This argues for a strong element of variable pay in the remuneration mix. Variable pay allows the paybill to rise and fall with business performance, and it conveys to employees their dependence on the success of the enterprise. Moreover, 'variable pay facilitates employee-organisation partnership by linking the fortunes of both parties' (Schuster and Zingheim, 1992). It is a further means of emphasising the unitarist message of an organisational common purpose.

It is not surprising therefore, that in their 1992 book, Schuster and Zingheim give pride of place to variable pay. It is the 'centrepiece' of the pay system. But an equal claim could surely be made about performance related pay, be it individually or team based, because according to Schuster and Zingheim (1992), 'pay programs should make excellent performance worthwhile'. Both should link the actions of employees to business goals and encourage better productivity, quality or other key organisational outcomes. More specific forms of this linkage can, according to Schuster and Zingheim, be found in skills based pay. They did not use the terms competence based pay or contribution based pay, but one would assume they would come within the ambit of new reward.

These remuneration policies have offered those who acquire skills or qualifications extra remuneration to provide better 'returns on human capital' (Beatson, 1995), and similar results for those who have contributed more to the success of their organisation.

Ensuring that the organisation responds to the market position could also be achieved through market-linked spot salaries, indexing pay scales to market mechanisms, by setting different pay levels for different occupations or locations, and so on. It allows employers to get their recruitment and retention right without overpaying on wages. It encourages the organisation to be commercial or business-like in its handling of remuneration, and allows the management to acknowledge the changing external environment — providing helpful flexibility.

Schuster and Zingheim also talk about flexible benefits as part of new reward. They argue that flexible reward fulfils the strategic aims of cost control and performance improvement. This, they claim, is because traditional benefits systems are too 'tenure' related. Such systems provide fixed entitlement, and demonstrate insufficient flexibility to changing business circumstances. The Schuster and Zingheim approach to 'indirect pay' seems to propose an employer- and cost-driven attitude to benefits provision, rather than the employee-centred flexibility that seems to characterise the present UK debate. This is despite the sellers nature of the labour market that would imply that flexible benefits would become a key part of the employment offer.

Indeed, that is what has happened in the UK. Flexible rewards have been one element in employers' armoury to attract and retain staff, to be part of its employer brand. This is because building up the benefits on offer (from concierge services to crèche facilities) and them allowing employees to flex them, has permitted choice to fit with individual needs.

Total reward can merely mean the summing together of all the terms and conditions of employment to represent the whole package on offer. Total reward statements offer the chance to be transparent and comprehensive in communication on remuneration. This approach has limited value from a new reward perspective. It seems to be more about ensuring that employees are aware of the full nature of the deal than encouraging particular forms of employee or organisational behaviour.

Total reward can, however, go further to describe the branding of remuneration as part of a wider employer offer that recognises that development, job satisfaction, and the work environment, all make their contribution to the 'deal'. In this sense, total reward is a recruitment and retention device in the same way as flexible benefits are.

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The new reward environment

What are the conditions that encourage new reward practices? There are some drivers that are generic; others are more sector specific. In private sector companies there are cost pressures, borne out of heavy competition, that encourage firms towards more contingent pay practices. In particular, where companies are operating in volatile product markets, they are likely to favour variable pay arrangements that allow them to alter the paybill in line with the degree of business success. These firms are also those likely to be attracted to market-driven pay if it means paying no more than the competition, and is therefore sufficient to attract and keep employees.

New reward, as we have suggested, can be part of a programme of internal cultural change. Developing a more performance-oriented culture was a key feature of the interest in early individual performance related pay schemes (Kessler, 2000). It may be that organisations are trying to get employees to concentrate on profitability (Corkerton and Bevan, 1998). Other organisations might want to see a greater customer focus, and use reward to signal their approbation of customer-friendly behaviours. Competence based pay recognises that output based schemes neglect the vital fact of how the task is performed, and so emphasises these softer behavioural competencies. Contribution based pay (Brown and Armstrong, 2000) argues that the 'how' and 'what' is performed, are both vital to corporate success.

As we have seen, finding ways of attracting or retaining staff has also been a feature of the tight labour markets of the late 1990s, leading to an interest in flexible benefit systems. With the dot com boom at the same time, there was also interest in employee share ownership schemes (Reilly *et al.*, 2001), which also sought to attract, retain and motivate. This was very much in the new reward manner, trying to draw the employees into giving greater commitment to the firm.

Conclusion

So, new reward is trying to meet the requirements of the 'holy trinity' (Kessler, 2000) of employee attraction, retention and motivation, but in a distinctive way. Distinctiveness, though, has less to do with specific remuneration devices (like skills or competence based pay) and more to do with an orientation of mind. Organisations pursuing new-reward approaches would seek to align their reward strategy with their business strategy in a distinctive and unique manner. They would choose remuneration practices that were responsive to the market and adaptable to changing business circumstances. Finally, in a new reward system, superior performance by individuals or groups would be properly recognised.

Under the headings of specific approaches to reward, we review the extent to which these ideas have taken off and been successful.

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1. Team Based Pay

John Cummings, Stephen Bevan, Peter Reilly

1.1 Why the interest in team based pay?

Whilst there are reasons for private sector interest in team based pay at present, much of the current discussion on this subject is to be found in the public sector. This largely stems from the publication of the HM Treasury-commissioned Makinson report in 2000, which looked at team based pay in the Civil Service. It has stimulated debate, and some action, in government departments and agencies, but it has also encouraged experimentation elsewhere. Makinson's important message was that he believed individual performance related pay was unsuitable for parts of the Civil Service. This was especially in circumstances where large numbers of employees are doing the same sort of job, working to common, not individual, goals — the so called 'processing factories'. He believed that in the public sector, team based pay has a number of advantages over individual performance related pay. It recognises collective not individual effort, an important feature of civil service culture. It is capable of being accurately measured, unlike many individual performance related pay schemes. It is more defensible in equality terms. Moreover, he felt that team incentives based on a balanced business scorecard would improve productivity to the extent that schemes would be self funding.

Some civil service departments may feel under a degree of compulsion to consider team based pay as a result of the taking up of Makinson's ideas, but there are reasons why other parts of the public sector are interested. Many of these potential advantages will be shared by the private sector:

- Non-consolidated, re-earnable pay may be attractive in terms of paybill control.
- Variable pay has this advantage, but also it concentrates employees' minds on their performance.
- Team based pay may be seen as an alternative to individual performance related pay, and gain greater staff support.
- Similarly, trade unions may take to team pay in preference to individual performance related pay.
- Team pay may provide a better fit with the drive towards focusing on key business issues — quality, customers, productivity, *etc.*

The difficulty of getting an affordable and business-aligned reward system is a continuing concern for personnel practitioners. Any approach that furthers this goal will be seriously considered. Team pay offers some attractive features. Because it is generally paid on top of base pay, and is closely related to positive business outcomes, it may both avoid making long-term financial commitments and be, to varying degrees, self funding. When the amount of money available for distribution in these low inflation times is small, then making the most of what you have got, or growing the size of the pot, are opportunities to be seized upon.

Under competitive business pressures, some private sector managers would like to cut base pay as far as is reasonably practicable and then pay incentive bonuses on top. This has the advantage of keeping the committed paybill low, and responsive to business performance. It goes beyond an argument of financial efficiency, however. Some managers believe that employees will only be motivated to perform if there are large and clear incentives. As they would put it, 'staff are paid too much merely to turn up for work'.

Moreover, in a competitive business environment and with a modernising pubic sector, the desire to get all employees focused on what will deliver success in terms of effectiveness and efficiency, is a prime goal. Reward can send signals of what is important. For example, profitable sales are wanted, sheer volume is not. Interdependence of goals (*eg* we cannot sell new products if existing ones are badly processed) encourages a team philosophy. If individuals are being encouraged to work

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together, and this seems to be a current trend, then the reward process should reinforce that behaviour. It may be easier to send these messages to teams rather than individuals. This is because it may be more acceptable to staff and their representatives to assess team performance than personal performance. However, as we will discuss below (see page 35), not all trade unions are happy with team based pay.

These are the positive reasons why team based pay is being considered, but there is a negative reason too. Team pay can be a response to disillusionment with individual performance related pay. As practitioners have discovered, trying to include both inputs and outputs of individual performance can produce complex performance management and remuneration systems. Managers are not always sufficiently skilled or knowledgeable about individual performance to make such judgements consistently well. It may be better, some may think, to use competency appraisal for development, not pay purposes, and reward outputs via team reward, especially where it is difficult to separate out individual contribution.

In this report, we will review the evidence of what seems to work well, and not so well, in team based pay. The report will look at the apparent preconditions to success, and some of the practical decisions that will need to be taken. But firstly, we begin by defining what team based pay is.

1.2 What is team based pay?

Definitions and types of team based pay

There are a number of definitions of team based pay. One wide-ranging definition of collective reward (Milkovich and Newman, 1987) describes it as:

> *'any form of variable pay scheme which rewards employees collectively on the basis of their performance'.*

Within the term 'collective pay', one then has to consider team based pay specifically. Katzenbach and Smith (1992) offer a commonly quoted definition of a 'team':

> *'a small number of people with complementary skills who are committed to a common purpose, performance goals, and approach for which they hold themselves mutually accountable'.*

Schuster and Zingheim (1992) offered a very broad team definition for pay purposes. It is interesting that they use the term *group* in their definition:

> *'a group is defined as any association of two or more people in a formal or informal organisational unit where co-operation is required to get the job done.'*

This suggests that there are many types of team: permanent and temporary; project; cross functional; aligned with products or processes, *etc*. Any of these groupings may be subject to team based pay.

Similarly collective reward appears in a number of guises. It may usefully be grouped, into four categories or levels, largely on the basis of size of the group to which it applies:

- organisation level
- business unit level
- team level
- individual.

At the organisational level, there is profit sharing or forms of bonus based on corporate performance. These will be excluded from our discussion on team pay, because they are not based on a real team — organisation-wide groups lack interdependent and common objectives, which are necessary for true teams to operate. The same point may apply at business unit level, though this does depend on the size and the nature of the unit. Individual rewards are clearly not relevant here.

A second axis for classifying reward schemes, including team based systems, is by performance measure. This may be financial (such as profits, return on equity, cost savings) or it may be operational (such as meeting/exceeding time deadlines, number of products manufactured, or quality targets, *eg* parts rejected, or customer satisfaction levels). There is also reward of the process — the inputs, or 'how' the outputs are achieved. Team based pay schemes may involve any of these types of performance measure.

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Thirdly, the form of the reward may be intrinsic (satisfaction of meeting goals, team relationships, creative challenges, responsibility, learning) or extrinsic. Extrinsic rewards may in turn be subdivided into financial (a cash bonus, shares, base pay increase, trips, time off, luxury gifts) or non-financial (praise from line manager, written commendation by senior staff, public acknowledgement on notice boards and staff newsletters, celebratory events, *etc.*). We will concentrate on extrinsic rewards in this report, although we acknowledge that teams can offer intrinsic rewards, and can be subject to non-financial recognition.

Another dimension to consider is whether one is offering an incentive or reward. Incentives are 'payments linked with the achievement of previously set targets which are designed to motivate people to achieve higher levels of performance' (Armstrong, 1999). In other words, incentives are carrots dangled in advance to encourage the response you want. Reward, conversely, is an after-the-event recognition of an activity that has been undertaken. Most team based pay schemes are incentive based, but there are examples of team reward.

Then there is the delivery mechanism. Money can be paid through base pay or as a bonus, in addition to the basic wage or salary. Team based pay, precisely because it deals with teams as units rather than individuals, is usually paid in bonus form. This may or may not be money reckonable for a pension, or used in calculations on such things as overtime or shift pay. Generally, it is not.

To summarise then, the characteristics of team based pay are that it:

- applies at team level, rather than at individual or organisational level, but the size of the team may vary
- can be used to recognise inputs of effort or outputs of delivery, or both
- is a form of extrinsic motivation, though it may support intrinsic motivation
- is generally applied as an incentive rather than reward, though it is used as a form of post-event recognition
- is generally paid as a non-consolidated bonus.

How widespread is team based pay?

The most comprehensive of reward surveys, the government's New Earnings Survey, reported that 15 per cent of full time employees received a bonus in 2000. This definition, though, includes individual commission, payment by results, profit sharing, and a whole variety of payments, most of which fall outside the scope of team based pay.

Thompson and Milsome (2001) have summarised some of the main research into the extent of take-up within the UK of team pay and other 'new reward' schemes. They conclude that:

> *'the long-predicted explosion in new pay practices has proved ill-founded. Far from flourishing, they remain at the margins of mainstream reward practice in the UK and the USA.'*

They quote Brown (2000), who says 'Practices such as team pay are being used alongside, not instead of, individual performance pay.' Brown was also the author of the report by Towers Perrin (1999), where he found a

> *'picture of regular, incremental rather than revolutionary change . . .. What's really happening, is that HR managers are selectively using them and melding them with their tried and tested systems, in order to produce improved but not radically different approaches.'*

At least six pieces of research provide evidence for these conclusions, with estimates for the prevalence of team pay ranging between five and 24 per cent of employees in the organisations covered:

- A study by the IPD (Armstrong and Ryden, 1996) of 98 public and private sector organisations, found that nearly a quarter (24 per cent) had formal links between team performance and pay, and a further 47 per cent were considering the implementation of some form of team reward.
- A large-scale survey of 1,158 public and private sector organisations by the IPD (1998), found that eight per cent of respondents operated team based pay.
- Eleven per cent of participants report team based pay in the Gee Publishing (1998) survey of 286 organisations.

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- Twenty-two per cent of the 464 respondents to the company survey by Towers Perrin (1999) now operate team bonuses, compared with 16 per cent in 1996.
- Only five per cent of the private sector organisations responding to a recent IRS survey (2000) currently operate team based pay for at least one employee group.
- The Mercer (2000) survey for the CBI, of 829 companies, found that 19 per cent linked rewards to a formal assessment of team performance.

In summary, there are many forms of team pay. There are differences of view as to what should be included. While interest in team based incentives has increased, the evidence is that it remains a minority pursuit.

1.3 Why is team based pay attractive?

Why introduce team rewards?

Introducing team based pay should, at its core, be about using financial rewards or incentives to orient people to team goals. These may concern profitability, productivity, quality, or customer satisfaction. The team is chosen rather than the individual (or in combination with individual reward) because it is at the team level that either reward is expected to be more successful, or the goals are more group than individual related. In this regard, organisations may want to promote a cultural shift. Teamworking, supported by pay, may be seen as a means to promote co-operation, sharing of information, skills and best practice. Getting staff more involved in scheme design and operation may encourage just this sort of teamworking.

Team based pay may also be used to emphasise business goals through the target-setting process. The objective might be to encourage an emphasis on productivity or quality of output. This might apply across the organisational board, or to specific business units to highlight specific performance issues or recognise distinctive cultures (*eg* in Tesco Express and Royal Mail — IDS, 2001). Furthermore, business aims might be achieved by making pay to a greater degree contingent on business results or performance, through the use of team based pay.

It may be that team based pay is chosen for negative reasons, especially that the existing pay scheme is failing. The emphasis on individual-level reward may have encouraged competition, at the expense of the wider group, to deleterious effect on performance. Alternatively, organisations may feel that current pay arrangements are insufficient to attract or retain staff. This might encourage thoughts of some form of individual bonus scheme, but that might not be practicable. A team element may be necessary for some or all of the population, and for a part, at least, of the reward package.

These objectives are reflected in a European survey carried out by Towers Perrin (1997). They are listed roughly in order of importance and impact:

- enhance connection between pay and performance
- communicate business goals
- increase productivity and performance
- improve financial results
- encourage teamwork
- encourage employee involvement
- improve quality/customer satisfaction
- support changing culture/values
- reduce costs
- replace traditional merit regimes.

The advantages of team rewards

The advantages of team based pay perceived by users, not surprisingly, follow the objectives listed above. But there are other potential advantages. Armstrong (1996) adds the following:

- clarifying team goals and priorities
- reinforcing flatter and process based organisations
- supporting a move to self-management or self-direction.

The alignment between the employee and the organisation is a much sought-after HR goal. Team based pay may contribute to this aim by providing a vehicle through which business priorities can be communicated and reinforced. BP Grangemouth, for

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example, believes that its gainsharing scheme supports the business strategy and conveys the important aspects of site priorities to the workforce (IDS, 2001).

The emphasis Armstrong places on organisational structure is significant. Organisations that have delayered and reduced their management input may recognise that it is much harder to supervise employees than before. This is because the span of control has grown greatly. Individual based pay systems that rely on managerial assessment are problematic when there are numerous reports. Having a team basis to pay may then seem to be attractive. This may coincide with a general emphasis on the team as a critical element in work organisation. The more responsibility that is devolved to teams, the more attractive it is to connect performance and reward at that level. This analysis appears to be borne out in the aerospace industry, where delayering has been accompanied by greater teamworking and team based pay (Thompson and Buttigieg, 1999). One trial of team pay also found that the team leadership role was enhanced. Leaders felt a duty to help team colleagues reach their goals.

There are other advantages beyond those identified by Armstrong. Traditional, individual-level skills based pay, has tended to reward staff when they themselves acquire some new skill. Team based reward can encourage the sharing of skills, by offering the whole team a bonus when *everyone* has acquired a particular skill, to a required standard. Cross-functional teams, with supporting reward, can therefore promote skill acquisition, allowing individuals to become more multi-skilled and flexible. So, team based pay can encourage flexibility and improvement of individuals and teams. It can help communication and co-ordination. All this will align employees with the changing business goals.

There are also cost benefits from team based pay. These may stem from only making payments on the basis of successful performance — a virtue of all variable pay systems. But as team based pay is usually delivered through non consolidated bonuses, then it saves on pension and other on-costs. Moreover, bonuses have to be re-earned in a way that base pay increases do not.

So, on the surface, team based rewards have many attractions. But what are the ‘nuts and bolts’ of team based pay that need to be tackled when designing and implementing it?

1.4 The mechanics of team based pay

Types of scheme

Research by the IPD (1996) identified three basic approaches to setting the criteria against which performance is judged:

- **Performance related to defined criteria,** *eg* at LloydsTSB or Norwich Union, where criteria were sales and a measure of customer satisfaction; at Sun Life, the measure was a combination of customer service index and number of customer cases dealt with.
- **Bonus related to an overall criterion,** *eg* at the Benefits Agency, where team bonuses were paid if there was 'a valuable contribution to performance as determined by local unit managers'.
- **Bonus related to the achievement of predetermined team objectives,** *eg* Rank Xerox's added-value gainsharing plan.

Another way of classifying the team based pay types using their evaluative criteria, is to distinguish between:

- **hard performance criteria,** *eg* sales, productivity, output
- **soft performance measures**, *eg* rewarding the ability of different teams to co-operate with each other through covering or training
- **decisions based upon an overall judgement,** *eg* did the team make a valuable contribution to the organisation.

Gainsharing is an example of an approach using hard criteria. It is paid on the basis of a performance formula, such as the difference between selling price and employee costs. This enables the return to the company to be calculated directly. Employees then take a share in the benefit; the rest staying with the company. In this country it has tended to apply to a business unit or site, especially in manufacturing, and therefore may not be a true team based scheme.

Combinations of hard and soft measures are also possible. Indeed, IDS claims that *multi-factor* schemes are becoming increasingly popular (IDS, 2001). They are attractive where there are definable outputs (sales, production, *etc.*), but less well

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defined elements, either inputs (*eg* initiative) or outcomes (*eg* customer satisfaction or quality). They are also beneficial where there is a fear that *single-factor* approaches overly influence and distort behaviour. Sales are chased, but profitability is ignored. Volume is raised, but quality slips. Safety and quality performance, in particular, may need to be protected from the overenthusiastic attention to targets. This is especially true if, say, the production target is easy to grasp, but the quality one is unclear or vague.

Multi-factor schemes can work so that payouts are based on meeting quantifiable targets, but can be cut back if threshold safety or quality targets are not met. Another way of avoiding distortion is to reduce the size of later bonuses if problems subsequently come to light.

The above schemes operate on the basis of making an absolute judgement of whether the team has met its own objectives, what ever sort they are. Relative judgement schemes also exist. These too, come in a number of forms. Team performance is considered on the basis of the following factors:

- How do different teams in your organisation compare against each other, *eg* shift or operational teams doing the same job but at different times or in different places?
- How did your own organisational team(s) compare against other teams in other organisations, *eg* in a multi-company group?
- How did the team compare against an external benchmark, *eg* a national standard of performance?

The same measures as noted earlier can be used (cost, productivity, customer satisfaction) but on a comparative basis inter- or intra-organisationally.

Relative schemes have the advantage that they are often easy to design, explain and run, especially if there is good, comparable data available. They generate competition between teams, not within them — Something that Makinson (2000) saw as a positive feature.

Bonus schemes do not have to operate on the basis of just a team component. It is possible to introduce schemes that combine both team and individual pay or reward performance at both small team and organisational level. There is also the possibility of using an individual element in team reward. For example, Tesco Express required 80 per cent attendance, and TWR Seatbelt Systems 90 per cent attendance, before an individual was eligible for the team bonus (IDS, 2001). An unsatisfactory performance marking or poor disciplinary record, are other reasons used to exclude an employee from a team bonus. More radical are schemes that operate on the basis that team performance generates a pot of money (*eg* from a type of gainsharing arrangement) and this is then distributed according to individual contribution, based on, say, a managerial appraisal.

A similar linking of goals is seen in systems that try to combine team and organisational reward. This is achieved through having a multiplier, based on organisational performance, which operates on the team bonus. This has the effect that how much is paid out may be tied to what the company can afford, but still be influenced by the team.

Bonus size, distribution formulae, and methods of assessment

The size of the bonus depends variously upon the amount of incentive required, on the general importance of pay within the company, on the proportion of pay that is appropriate to be 'at risk', and on affordability factors, such as cost savings/self-financing aspects of the team. Some examples are given below:

- The managing director of Hay Group proposed that variable pay should be about a month's salary — a minimum of five to ten per cent of base pay (Caudron, 1994).
- The Makinson report (2000) suggested a five per cent level as the minimum necessary to be an incentive.
- The highest target payment in Rank Xerox was around £4,000 a year, averaging about £1,500 (IPD, 1996).
- LloydsTSB paid out a maximum of £400 a quarter (IPD, 1996)
- Tesco Express paid out to a maximum of 20 per cent of salary.
- Norwich Union Financial Planning Consultants used a maximum team bonus of £3,000 a year (IPD, 1996).

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Some schemes, like many of those above, are 'capped', *ie* the level of reward is limited by the scheme rules. However much productivity rises, individuals can have no more than a ten per cent bonus. This may control exposure (especially if the rules are loose or the assessment subjective), but there is the risk of good performers 'slackening off' once the target is reached. Uncapped schemes are more likely to be seen where the targets are revenue or profit based because such a scheme is self-financing.

One company took the view that the capping of reward is appropriate for new schemes, or where applied to new business areas, because it was difficult to judge the likely payout in advance. For mature schemes, however, there was no need to have a cap — the mechanism had by then been fine tuned to deliver a 'reasonable' reward. Another company, concerned about overconcentration of the sales of one product, capped the amount that could be earned on any single product.

HM Customs and Excise was one of the four civil service departments covered by the Makinson study. In an initial pilot exercise, six teams were selected, comprising an average of 80 staff (*eg* a VAT office).

The key characteristics of the scheme were:

1. Each team had a maximum of five 'stretch' incentive targets with equal weight derived from its Public Service Agreement (PSA) targets.
2. The department 'moderated' the targets across the pilot sites, and assessed the extent to which they were sufficiently stretching and adding value.
3. Each target had a potential bonus attached to it. Bonuses would only be payable, however, if all non-incentivised PSA targets were met. This was to ensure that staff did not focus on the bonus targets to the exclusion of other work.
4. A series of rules for bonus eligibility were devised. This included provisions for part-time staff, those on secondment, those on special leave *etc*.

Once the size of the bonus 'pool' has been determined, there are several methods for distributing it:

- a flat rate for each person
- a fixed percentage of base pay for each (this assumes that base pay reflects individuals' contribution to the team)

- a combination of flat rate and percentage
- a combination of team and individual performance measures.

The impact of staff turnover also has to be considered:

- how to handle joiners
- is there a minimum service qualification?
- how to handle leavers
- those that resign during the year get nothing?
- how to handle internal transfers
- a proportionate award is given for participating in each team?
- how to handle those temporarily absent, *eg* on maternity leave or career breaks
- what is the organisation legally bound to do?

Given the emerging principle in employment law that all staff, irrespective of the nature of their contract (be it temporary or fixed term), should have equivalent terms, it is best to presume that all employees in the team are included. Decisions also have to be taken over whether other staff not directly employed should participate. The situation regarding agency staff is likely to change soon with alterations in employment law, making the treatment of longer-serving agency staff closer to that of the organisation's own employees. One would not expect the employees of third party contractors to be included in any bonus arrangements because they have their own set of terms and conditions, though some organisations take a different view. This is where the emphasis is on binding together all workers to serve a common purpose, irrespective of their contractual status.

Finally, a decision needs to be made on how often to pay any bonus. Generally, shorter intervals tend to be more motivating. Frequent payouts are less at risk from employee turnover — individuals joining and leaving the team. However, deferring payment or averaging out payment can iron out any blips or distortions, especially where qualitative measures are used. Pay points may not be determined on a regular time basis, but according to milestones in the project. The decision between these options depends on the nature of the team and its targets.

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Where schemes are tied to fixed, objective formulae, then no judgement has to be made as the payout. This actually understates the case, in that some schemes are so complex in their approach (using organisational and local factors, inputs and outputs) that a decision still has to be made. However, these can still be distinguished from schemes where judgements have to be made either about whether objectives have been met or, in schemes that have an individual element to them, on the quality of employee contribution. Usually, supervisors or more senior management make these decisions. There are, however, examples where peer evaluation of performance is used, but these can result in popularity rather than performance assessments.

All the above assumes that the bonus payout will be in cash. Some schemes (such as those in the NHS pilot on team based pay), with more of a reward than incentive emphasis, might recognise achievement through non-financial means. A combination of a bonus and payment into an improvement fund is also possible.

Team structure and dynamics

There are many and different types of team. There is a simple distinction between temporary and permanent, but also one between part time and full time. Organisations will have permanent, full-time teams that operate in a service or production unit. In addition, there may be full-time project groups working on specific topics. You could have a permanent, standing group, that only works periodically together, *eg* a health and safety committee. There are multi-disciplinary teams that operate together for part of the time, but whose members are separately part of other functional groups.

There can also be different types of objective that teams seek to meet. There is a broad choice between what are referred to as 'common fate' and 'line-of-sight' objectives. These are summarised in the table below.

Generally speaking, where line-of-sight objectives need to be met, a stronger degree of incentive will be required. This means it is more likely that:

Table 1.1: Types of team objectives

Common Fate Objectives	Line-of-Sight Objectives
Teamwork across organisation	Teamwork within units
Optimise total resource use	Reinforce results people can affect
Equity, reward	Performance, incentive
Long-term benefits	Short-term benefits
Financial improvements	Operational improvements
'What' of strategy	'How' of strategy

Source: IES

- small teams will be formed
- teams will be independent of each other
- targets set will be quantitative in nature
- financial incentives will be used.

Conversely, where 'common fate' objectives are applicable:

- bigger teams will operate successfully
- a greater degree of structural fluidity between teams will be possible
- less precisely measurable performance can be used
- non-financial recognition might be the correct form of reward.

It has been argued (Zenger and Marshall, 2000) that managers and professionals are more likely to be suitable candidates for team based pay than lower-level employees. This is on the grounds that they have 'greater control over organisational outcomes'. The latter point is true in most organisations, and may allow the designers of the scheme to use broader measures in judging their success. Lower-level employees need to have very specific objectives and measures if they are to be motivated to meet them. Line-of-sight objectives might therefore be appropriate for this group.

When judging the success of teams, it is also important to judge them against the correct set of criteria, recognising that the functions of teams change over time. The system of reward needs to be flexible to adapt in line with this. Team members, for example, may be involved in discrete activities that combine to

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produce an overall outcome. This might suggest a bonus scheme aggregated at a high level. Computer technology might change work duties, stripping out the mundane, and allowing greater homogenisation of work — bonuses then might fit with teams of a smaller size. Rewards may need to reflect the lifecycle of projects, for example. At the beginning stage, reward objectives may focus on acquiring new skills and familiarity; later, they may be used to emphasise expected achievements; at a more advanced stage, rewards may focus on improvements in results; and in the final stage, to recognise and celebrate success.

This section has looked at some of the practical aspects of how team based pay schemes work. It illustrates that there are a number of decisions to be made that should be thought through on the basis of what sort of scheme is wanted, and what sort of objectives it has. We will now turn to the research evidence on the success of the team based pay concept, and what appear to be the critical success factors.

1.5 Evidence of effectiveness and success factors

Research evidence of effectiveness

According to Brown and Armstrong (1999), there is conflicting research evidence on the effectiveness of team rewards, but on balance they find that:

> *'in appropriate circumstances, team reward plans are effective, in terms of both their "hard" results and their "soft" behavioural impact'.*

They stress the word 'appropriate', since teamwork and team reward are not suited to all. For example, accounts departments do not really have an output, and their customers are largely internal. This might make them less obvious candidates for team based pay than, say, a sales team. Armstrong (1999) maintains that the evidence differs by occupation. For shop-floor workers, where physical output or allowed and actual time is clearly definable and measurable, the value of team-pay is well established; whereas for white collar jobs, the case is 'not yet proven'.

Positive research evidence is reported by Rock and Berger (1991) from studies that found a long-term beneficial effect on team performance by linking group rewards to group goals (Pritchard and Curtis, 1973; Austin and Bobko, 1985).

Bullock and Lawler, in a 1984 look at gainsharing in manufacturing, found that half of the examples they examined failed to deliver the expected results, due to a variety of factors. These ranged from poor cultural fit, through poor design (lack of line of sight), to lack of management support and employee involvement. One particular problem was that employee ideas for change were neither generated nor, if they surfaced, were acted upon.

A large-scale study for the American Compensation Association, by McAdams and Hawk (1995), found that the average return on the cost of scheme payments was over 200 per cent, *ie* the scheme generated $2 for the company for every $1 paid to employees. Satisfaction levels among participating companies with improvements in business performance, teamwork and communications, were all positive.

An earlier study by the American Productivity Centre (1987) demonstrated improvements in teamworking, commitment, employee relations, as well as productivity, quality, and absenteeism. Towers Perrin (1990) found that 73 per cent of collective reward plans they studied had exceeded participants' own expectations.

A study by Gomez-Mejia and Balkin (1989), of 175 scientists and engineers involved in research and development work, found that team rewards were particularly effective in overcoming competition, and encouraging the sharing of results, especially since team progress in this sort of setting tends to go in leaps, and it is difficult to attribute success to the work of single individuals.

> In the Customs and Excise trials, there was one key difference between pilot and control sites, and this was in staff attitudes (obtained through surveys conducted in both trial and control sites at the beginning and the end of each of the pilots). Employees in the trial sites were significantly more motivated, focused, and positive. Indeed, their attitudes towards many aspects of their working lives improved significantly in the trial sites over the period of the pilot.

It is nonetheless important to distinguish between the effects of teamwork, and those of team pay; the second need not

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necessarily accompany the former, and it may be the teamwork and good goal setting which is having the positive effect.

The manner in which organisations encourage and structure their team systems can vary considerably, but from a broad cross sector perspective, the benefits that team work in itself can offer seem to be largely similar. According to ACAS (1996), teamwork can increase the organisation's competitive advantage by:

- improving productivity and quality
- encouraging innovation and the effective use of new technological advances
- influencing employee motivation, commitment and attitudes in general
- enabling the completion of complex tasks and facilitating multi-tasking
- enhancing information sharing
- distributing action and responsibility, making for more robust performance when problems occur.

For example, aerospace firms with team based pay, report higher profit margins and profit growth. This seems connected to the introduction of a team based work organisation and a good alignment between structure and reward (Thompson and Buttigieg, 1999).

However, not all the research evidence is so positive. For example, according to Rock and Berger (1991):

> *'In spite of the popularity of gainsharing programs in recent years, there is no convincing evidence that demonstrates the incentive effect of such plans on the work force.'*

Thompson and Buttigieg (1999) found a negative relationship between team based pay and a customer-focused strategy in their study of the aerospace industry. Research on US firms in the concrete pipe sector, found that team based pay was not particularly effective in encouraging a TQM approach. This, the researchers claimed, was because team based pay encourages member co-operation but not skill development, or what they called a 'systemic focus' (Shaw *et al.*, 2001). This, in fact, contradicts a survey undertaken in the UK (Snape *et al.*, 1996) that found 'no evidence that such incentives are necessarily incompatible with TQM'. Indeed, in their British Steel case study, they report the managers' view that their bonus scheme helped 'focus employee attention on the key quality improvement priorities'.

Just as effective teamworking can permit the success of team based pay, where team structures are failing it cannot be expected that team based pay will work.

There is also the problem of attribution. Is improvement in observed organisational performance the result of team based pay, or other related or unrelated processes? An emphasis on teamworking may itself give rise to higher productivity or improved service quality. There may be other elements in the HR 'bundle' (Huselid, 1995) that may significantly contribute to success — the very fact of increased employee involvement for example. There may be broader cultural change where team organisation and reward is but an element.

Factors leading to success

Communication and involvement

It is clear that to achieve success, it is not sufficient to concentrate just on the elements of the team; it is important to examine the whole company and the context in which the team works. The most crucial element mentioned is communication and involvement of the workforce. This is both in the specific sense of communication and employee involvement in the team based pay scheme itself, and in positioning the scheme in the context of wider organisational objectives. The worst policy is to do all the planning by managers and consultants in secrecy, for fear that the plans will be resisted if the workforce gets to hear of them in advance. Workers should be closely involved, from the design stage of the team to the conclusion. Communication of progress against targets will maintain interest and involvement. This will help team members give sustained support to the process.

> In the Customs and Excise trial communication was a key factor. Regular updates on progress against each target were provided. From the beginning demand from staff for these data was high. They really wanted to know how their team was performing.

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Consultation should therefore extend to line managers, team leaders, existing or potential members, whether by focus group, survey, or interview. They need to be asked their opinions about the issues around working in teams, and how best to reward them, as discussed in this report.

Indeed, Brown and Armstrong (1999) go so far as to state that the same target that may work well if it is devised by the team themselves, may fail if it is imposed upon them from without: 'People support what they help to create' (Armstrong, 1999). Research also points the fact that for schemes to succeed, the goals have to be accepted by the group members (Gowen, 1985).

Open, participative management

For this reason, an organisation introducing team pay needs to ensure it has an open and participative management culture, with clear support for team-working by senior managers. Related HR practices, such as training, need to be in place.

Targets

The team goals need to be clearly defined, and aligned with wider organisational business strategy or organisational purpose. 'Line-of-sight' objectives, where there is a clear link between effort and reward, are more likely to be effective as an incentive than 'common fate' objectives. This view is based on expectancy theory. This argues that motivation will occur if there is a relationship between performance and outcome. The employee has to expect that effort will lead to reward, and motivation will only come if the outcome has psychological value (or 'valence'). So targets have to be meaningful to team members. This generally means targets are more effective at work group rather than business unit or corporate level.

As research suggests, if the system is not to be demotivating, it is important that the goals be difficult enough to be challenging, but not unattainable (Forward and Zander, 1971). One retail organisation in the UK found that those teams that were asked to meet tough, stretch targets, under-performed; whereas, a team, which by mistake was offered relatively easy targets, over-performed. This line of thinking is supported by research into the Continental Airlines team bonus scheme, where a modest performance goal was set to overcome employee scepticism of the concept (Knez and Simester, 2001).

Rock and Berger (1991) claim that quantitative performance measures tend to be perceived by employees as objective, whereas individual performance measures, assessed by line managers, are seen as more subjective. This supports earlier research conducted by Porter *et al.* (1975) in the USA in the 1970s. In a survey of employees, he found that objective measures had much more credibility in the eyes of participants than did managerial ratings. Increased transparency of decision making also provided credibility. Of course, objective and verifiable measures are much easier to communicate than the subjective judgements of managers. This is why organisations often prefer targets based on productivity or operational goals.

Also relevant here is the question of equity. This emphasises that rewards need to match effort. If the reward is too small or unimportant for the effort involved, an individual 'will minimise increasing inputs' (Adams, 1965) and vice versa. Equity theorists assert that people are uncomfortable about being better rewarded than others. As Zenger and Marshall (2000) put it: 'employees reduce effort, depart or even sabotage the activities of the firm when they perceive pay differences as inequitable'. This, though, seems to depend on the social setting. Adams (1965), for example, argued that whether input and reward is in balance is determined on the basis of feelings/perceptions compared with others in relation to social norms. Tyler and Bies (1990) came up with related research evidence that suggests that it is procedural justice, the process of how the individual is treated, that is the key element in felt fairness. Distributive justice, the outcome of the reward, is relatively less important.

So, targets should be:

- stretching, but achievable
- consistent across the organisation
- not open to manipulation
- capable of transparent measurement
- so far as is possible, not subject to frequent change (or open to renegotiation).

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An inclusive means should be found for the setting of the targets, and ultimately, the reward should be commensurate with the effort to meet the targets.

Organisations also have to set the right number of targets. Makinson (2000) thought that for staff in general, five targets were ideal; managers could, he thought, cope successfully with eight. Here again, there is a balance to be struck between having focus (which argues for a few, clear and significant targets) and balance (in that you do not want employees fixated on some, albeit key issues, to the exclusion of other important matters). The number of targets set needs to reflect these twin objectives.

Team definitions and relationships

Teams work best where co-operation is required to achieve the best work outcome. Members of the team need to be interdependent in their functions, rather than a group of individuals. They also need to acknowledge that their success depends on co-operation and shared responsibility. At the same time, the team needs to be clearly defined and distinguished from others.

Smaller teams, with shorter payout periods and clear objectives, give members a greater incentive and sense of influence over output. Keeping teams small helps with monitoring, and is more likely to control free riders. Having standardised tasks facilitates monitoring and aids compliance, as does a consensus that high effort is the norm. This can be 'self fulfilling and reinforcing' (Knez and Simester, 2001). Wide employee discretion and autonomy is well suited to teams, rapid decision making or individual expertise are not. Indeed, granting greater autonomy can be a valuable intrinsic reward for team success.

Peer pressure can ensure that colleagues attend and perform. It can shame them into working hard. Employees may be reported to management for shirking. However, care needs to be taken to limit the excesses of group control. There are various ways in which the problem might or will be mitigated:

- training the manager to be aware of the potential for these issues and having strategies to intervene in an appropriate manner

- setting goals that minimise conflict
- limiting the size of the bonus so that its achievement is not a matter of life or death!
- resourcing the teams so that there is a good mix of skills and abilities
- using competency assessment in the performance management process to identify any undesirable behaviours in the group.

What sort of size team is best? Hackman (quoted in Thompson, 1995) claims 15 is the maximum number. More than that and the team starts to fragment, communication and co-ordination become difficult. Trust starts to ebb and factions start to form. It is also more difficult to establish the performance/outcome link.

De Matteo *et al.* (1997) found team rewards worked better if there was a high level of interdependence between members, an equal allocation of workload, and prior experience of teamworking. Burgess and Metcalfe (1999) add to this point by arguing that where participants of a scheme have strong 'empathy' with each other, they are more likely to be motivated to achieve their goals. Zenger and Marshall (2000) also note that where there has been a long history of co-operation between managers and employees, the latter are more likely to believe that targets will be sensibly adjusted over time, and the former have confidence that employees will not shirk.

Armstrong (1999) stresses that team members need to reinforce each other's common purpose, over any individual agendas. Other important factors which he finds help success are where the team is:

- stable — they know each other, know what each expects of the other, know how they stand in the others' regard
- mature enough to be flexible in order to meet targets, familiar with using each other's complementary strengths, and being able to express contrary points of view and carry the day, without upsetting others
- collective and individual commitment to the purpose of the team is also an essential characteristic of an effective team.

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Introduction Process

Although it is tempting to use team pay as a method of encouraging a new team to meld together, team pay actually works much better if members are already familiar with each other. Having to cope with a new style of working at the same time as a new pay system may be too much. Lee (1996) cites various research supporting the view that team based pay should follow, rather than lead, team formation. A gap of a year is suggested (Caudron, 1994). Armstrong (1999) proposes using a pilot system, with core teams that already work well together; their success may then encourage others. This supports the views of De Matteo *et al.* (1997), reported above, that prior experience of teamworking is conducive to success.

Combining success factors

The importance of introducing a combination of these success factors is underlined by an (unspecified) 'recent study', referred to by Brown and Armstrong (1999), looking at 50 teams engaged in silicon chip manufacture. The study examined four factors: the physical environment, job design, reward structure, and performance management systems. It found not only that none of these on their own had a positive effect on performance, but that introducing teams without actions on at least two of the listed factors actually worsened productivity and quality. If action in three or more areas was taken, then performance improved.

This is consistent with much research on the effectiveness of people management practice. It seems that it is the 'bundle' of good HR practice that has a positive effect on performance, rather than a single element. Thus employee involvement, profit sharing, teamworking, *etc.* all contribute together to improved business outcomes.

Monitoring and evaluation

Once a team system is in place, it is important to monitor how it is working — how far it is meeting its objectives, how the team feels about the process, what problems there are, and how to improve the situation. It is important also that the structure is not fixed, but is flexible enough to adapt to changing circumstances within the project or organisation.

National Culture

How useful or successful team rewards are will partly depend upon national culture. Hofstede (1980) established, for instance, that the USA ranked highest in the world in the individualism of its culture, and the UK third. Other cultures are more collective.

This point is relevant if there is the suggestion that successful schemes be exported to other countries, or that a transnational team based pay scheme be introduced. It is also important if a non-UK parent organisation wishes to transfer a process that has worked well in the home setting. It cannot be assumed that success in one location guarantees success in another. Thus, results from team working in Japan might be very different if the same system were duplicated elsewhere.

This reinforces the message that *best fit* is a better guide than *best practice*. It means that organisations should take account of their own culture and their environment in designing their approach.

The only exception to this statement is that some team based pay schemes are introduced counter-culturally. In other words, management wishes to challenge the culture of the organisation. It may wish to shift from an individualist to a co-operative way of working. In these circumstances, reflecting the current culture may be an inhibitor to change. A pharmaceutical company did precisely this a few years ago. It realised its individualist culture would not deliver results in the future. It needed collaborative effort, so it reorganised itself around teams of researchers. In this situation, team based pay can reinforce broader organisational messages.

Conclusion

This section has highlighted the importance of process. The evidence is that team based pay can bring organisational rewards. In the first place, much attention has to be devoted to getting the team structure correct. But even if the environment is conducive to team pay, the process of introduction is critical, and in particular, the choice of targets. One that involves staff and

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gains their support is likely to be much more successful. As the next section shows, there are plenty of problems to overcome. Having your employees on your side gives you a better basis upon which to meet these challenges.

1.6 Problems with team based pay

The first problem with team reward schemes concerns team definition. If you cannot successfully define a team where there are mutual interdependencies and accountabilities, then the whole process will fail, irrespective of how good the design is. Bigger teams are more at risk of suffering from the effects of structural changes. Teams can get broken up and reconfigured in another way. Smaller teams are less vulnerable, as they can be slotted in to whatever overall structure applies.

Secondly, difficulties arise if the individual is unable to influence the outcome, either through the team or because of outside factors. As with individual performance schemes, this can have a demotivating effect. It should go without saying, but is sometimes overlooked, that if there is little scope for performance improvement, no scheme, however clever, will generate improvement.

Thirdly, if the performance targets are not correctly set, then wider organisational targets outside of the team can suffer. This displacement effect be seen when one target becomes too dominant. For example, if productivity is the key target without further qualification, production quality or safety might be marginalised. This is certainly the view of TQM advocates, who complain that any form of financial incentive encourages short-termism, risk avoidance and over emphasis on output maximisation. It creates a culture of compliance, not improvement. This is one reason why organisations have been attracted to the balanced business scorecard since it measures not just financial, but also customer, people, and process performance. The difficulty is that, although this gives a more rounded picture of what needs to be achieved, it can often result in a very blurred line of sight.

Target setting is particularly awkward for support staff, as they may not have so easily defined objectives, or even none at all. Some staff are forced into a team based pay scheme, even though ill-suited in terms of the nature of their work (too individualistic) or work activities (difficult to objectively measure success). The solution is to exclude such staff from your scheme, and either reward them through individual performance related pay, or link the bonus to corporate achievement.

Relative schemes, *eg* comparing the performance of one group versus another, can produce excessive competition and rivalry. If the activities differ greatly between the teams, this may matter less. If there are interdependencies between the groups, then the overall performance of the organisation may suffer. Mis-selling is a classic example of this. Customer services teams may have to suffer the consequences of overenthusiastic sales.

Another problem in some organisations is the poor quality of management information. This bedevilled one distribution company, where the employees switched off from their bonus scheme because they were being continually evaluated against false data. In a financial services company, the right information could be collated, but this took time and delayed payouts. Management information has to be robust and defensible.

There is also the question of whether managers have the skills to make team based pay work. This is both in the sense that they can deal with the sort of problems listed in this section, and in getting the best out of the teams. Managers who are poor delegators, who insist on retaining control, will make it harder for teams to succeed. Managers, conversely, who are good coaches and communicators, are likely to encourage and support teams towards achieving their goals.

Relationships between teams may become difficult, especially where teams are highly interdependent. Organisations need to avoid creating barriers between teams that affect overall organisational performance. An internal market may arise, where teams are reluctant to lend their 'best players' to other teams for *ad hoc* work; equally, the best performers may attempt to 'migrate' to the highest performing teams, or be poached by them, leaving weakened teams behind. Team pay may, thus, help teams that are already effective, but harm those which are weak. Those teams that perform more poorly than others may begin to find fault with the system, and withdraw support for the process.

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Once teams are successfully operational, they can become resistant to change, disliking being broken up. This problem is little different, though, to other organisational change, such as closing or re-siting a business unit, delayering or re-organising departmental functions, or making large numbers redundant. People used to working with each other are often reluctant to be separated or changed.

Within teams, there can be an issue of equity. Some team members may be perceived as 'free-loaders', riding on the efforts of others, whilst those who see themselves as high achievers resent others gaining equal benefits for apparently less contribution. As an HM Treasury report pithily puts it, team based pay 'penalises performers and rewards passengers' (Makinson, 2000). Whereas team bonuses are intended to encourage stronger team members to support and encourage weaker ones, if this does not succeed in raising the team's performance, the weaker performing members may become the subject of antagonism from others, for reducing the amount of bonus available. Bullying may even occur. Interpersonal relationships may thus be exacerbated rather than improved. Whilst this may suggest including an individual measure of performance, as well as team targets, there are pitfalls in rewarding team members differently, as this can also set up jealousies and resentments, and undermine the impact of building a unified team. Nevertheless, as Makinson (2000) also said: 'no incentive scheme will gain acceptance unless it forces management to address the problem of poor performance'. Scheme design may help, but this is largely a question of having the managerial skills referred to earlier.

An alternative problem which can occur is 'rate-busting', where higher-performing individuals are pressured by the rest of the team to 'slow down'; competition to drive the team rate up constantly can create undue pressure, which the majority actively resist. Therefore, group pressure may have the effect of bringing the best down, as well as bringing the weakest up.

This is more likely to happen if the employees fear that successfully meeting a target will only result in ratcheting up of the rate. Even if management promises to keep targets at the same level, this will only be believed if the workers have trust in the good intentions of management. Otherwise, employees will 'cap' their own performance because there is no short-term financial incentive to do so, and risk having to meet tougher targets next time.

Despite the arguments advanced in favour of team based pay, some public sector trade union leaders have been hostile to Makinson; others have been indifferent. Employee representatives tend to worry about the risk of bullying and the sort of resourcing issues referred to earlier. Some trade unions have sought to address these problems by increasing the size of the team as much as possible, even to the point where it becomes organisation wide.

What trade unions really dislike is rebalancing base pay and variable pay. In the public sector, trade unions fear that the financing of team bonuses will be at the expense of base pay increases. Their interest is currently focused more on improving low pay and speeding progression through pay ranges. These objectives are endangered if money is diverted to team based pay. So, the trade unions may swallow their objections if team based pay offers extra money beyond the usual inflation linked increase, and the team definition is acceptable.

In the private sector in the UK, and in some US and Australian public sector examples, there has been a different complaint. Criticisms have been made of gainsharing schemes because they have been driven by cost cutting. In other words, efficiencies have not come from increased productivity, but from reducing staff numbers. The remaining employees then share in some of the budget savings.

Some commentators note a tendency for schemes to 'peak out' after two to three years, and then become less effective. This is not an uncommon observation with reward schemes, though it is at the shorter end of the usual extent of durability.

Conclusion

The problems highlighted in this section may be overcome by a good process of introduction, perhaps including piloting your approach first, and certainly by involving employees and their representatives in the design. However, some difficulties are more fundamental. Getting the targets and teams right is critical. Making sure that the whole sequence of effort to reward is

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transparent and effective is equally so. You need to be sensitive to your culture, but yet not be so constrained by it that change is prevented. As with launching any new reward system, communication and training should not be underestimated.

1.7 Conclusions and future trends

Key points

As we said earlier, teamworking seems to be a successful concept. Yet team based pay, as a means of reinforcing team structures, is not as common as one would have thought. This may be because of the practical difficulties described in the last section — sorting out team membership and team objectives. The problem may start even earlier: how many organisations really have a team-oriented culture? To what extent are there teams that:

- form a natural grouping?
- have interdependent skills and tasks?
- have fairly well defined boundaries, distinct from other teams?
- have a set of transparent and measurable targets that relate to the work individual team members do as a group, and over which they have some control?

Until these questions are satisfactorily answered, one cannot get into the finer detail of how, in practice, they are to be rewarded. In fact, the reward system is the easier part of the problem. Determining the level and frequency of payout is much simpler than establishing that you have a stable team structure upon which team based pay can be supported. Even if teams exist in a fairly robust form, it is not always straightforward to identify the correct targets. This is because there are some conflicting pressures:

- Targets should relate to the business strategy, but bottom-up target setting tends towards greater employee commitment.
- Targets should provide a clear line of sight, yet they must balance competing pressures — *eg* production and safety.
- Targets should reflect group goals, but it is individuals who actually perform

This last point reinforces the fact that, as in any pay system, but perhaps more so in team based pay, there is the question of whether participants have the skills and behaviours to operate it:

- Is senior management committed to team based pay, and do they understand its purposes?
- Do line managers have the ability to manage their teams and to manage team rewards?
- Is there a high-trust employee relations' environment, where collaboration is the norm rather than confrontation?
- Do team members have the maturity to pursue team goals, but not to the point of generating antisocial behaviour?

As Abosch and Reidy (1996) observe:

> *'the most effective team rewards are a function of management and culture, more than remuneration'.*

Pay systems are rightly used to change organisational culture. Team pay might play an important part in such an attempt. Yet as Kessler (2000) observes:

> *'the very importance of pay to employees means that, if the organisations get it wrong, serious dysfunctional consequences may follow'.*

The chance of getting it wrong is perhaps greater, even, with team based pay than with individual performance related pay. Trying to create a team culture through team based pay is fraught with danger. It is much easier to reinforce a team culture with appropriate rewards than to lead with pay. The team structure has to be in place; the targets clear and self evident; the participants sufficiently skilled. Unfortunately, there are no 'off-the-shelf' solutions to team-working systems. Each case is different.

> *'Team pay may not always be appropriate, and it can be difficult to operate. The criteria for success are demanding, which explains why the number or organisations that have taken it up is quite small and why other forms of rewarding teams are often preferred' (Armstrong 2000).*

The future

The push towards more variable pay in the private sector has been seen more in the boardroom than on the shop floor. The tightness of the labour market is probably constraining some of the more zealous proponents of this idea. It is difficult to attract and retain good-quality staff when offering a low basic wage with the promise of more to come if the business does well. This may not go down too well with those seeking a mortgage or paying off a debt. An easing of the labour market may encourage a shift towards more variable pay. However, this may come in a number of forms. Cash based profit sharing schemes have declined in interest since tax relief was removed. Share based schemes may grow for the opposite reason, though they are vulnerable to stock market shocks, as we have recently seen. Both for affordability reasons, and to emphasise corporate performance, these sorts of schemes can play an important role in compensation. So, organisational-level methods of reward may be competing on the same ground as team based pay. With small sums to play with, only growing and successful businesses can contemplate rewarding at organisational, team, and individual level. Which one or two of these types of remuneration organisations opt for, ought to be determined by how they best fit their context, culture, and wider people-management objectives.

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2. Skills Based Pay

Peter Reilly, Stephen Bevan

2.1 Introduction and definitions

'Skills based pay' is also variously known as 'pay for knowledge' or 'multi-skilled compensation'. It has been defined by Cross (1994) as 'a person based and structured means of rewarding an individual for the acquisition, development, effective usage and upkeep of skills on a continuing basis'.

Basically, skills based pay works as follows: skill blocks or modules are defined, containing clusters of skills that workers will use. Once employees have demonstrated their ability to perform these skills, they are rewarded with extra pay. The skill blocks may cross several jobs. The skill blocks are organised hierarchically, with clearly defined break points between different levels of skill. Employees are then cross-trained and assessed on the skills they can perform effectively. The system may or may not include a performance element to pay.

Homan (2000) sets out the background context under which skills based pay has arisen. Firstly, changes in the structure and culture of organisations has led to fewer layers of hierarchy, leaner staffing, just-in-time production, team or project working, and matrix based management. Job boundaries are more fluid, and employees are expected to be more self-reliant, without referring problems to management. Firms are more quality and customer focused. Secondly, strategic HR management aims to be integrated both vertically (supporting corporate strategy) and horizontally (using recruitment and retention, development, reward, performance management, communications) to support

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each other. Thirdly, firms need to be flexible, with highly-trained, multi-skilled employees rewarded in line with their value to the organisation, and with skills constantly upgraded with a view to lifelong learning. Finally, individual career paths are less clear, with some valuable specialists not exercising responsibility for staff or financial resources.

Whereas traditional reward systems are job based, skills based pay is person based. The two may usefully be contrasted:

- Under job based pay, the rate of pay is attached to the job, regardless of who is carrying it out, and the skill needed is just one facet taken into consideration. Under skills based pay, the rate of pay is attached to skill units, and the job a person is doing at any one time is peripheral; the same job may be done by two people earning different amounts.
- In traditional systems, employees are assumed, after the appointment process, to have the necessary skills, and may be paid even if they prove not fully proficient. Skills based pay requires some system of certifying that employees are competent in specific skills.
- Traditionally, pay increases when the employee changes job. Using skills based pay, one may change jobs, but not get a rise until the necessary skills have been learnt and tested. Alternatively, a pay rise may follow the learning of a new skill, without having to change job at all.
- Seniority, or length of service, does not play a role in skills based pay, except possibly in deciding who gains first access to training when there is a waiting list.
- Advancement opportunities under job based pay tend to require moving into some form of management of people or resources. There are greater opportunities under skills based pay to become a more valued employee by doing a *wider range* of jobs, without necessarily being more senior in rank.

Three types of skill are discussed by Ledford (1991b). 'Depth' of skill concerns specialisation, whether by a craftsperson moving from apprentice to master, or an engineer becoming an expert in one particular field. 'Breadth' of skill involves doing jobs upstream, downstream or parallel to one's own, *eg* other jobs in the department or assembly line. 'Vertical skills' consist of supervisory or self-management skills, such as leading team meetings, training, communicating, scheduling, co-ordinating with other groups.

Discussion about skills based pay is sometimes combined with competency based pay, which is a similar concept. This is discussed more fully in a separate section, but here it is useful to distinguish it from the term 'skill'. According to IDS (1997a), the term 'competency' or 'competencies' tends to be used to refer to behaviour, whereas 'competence' or 'competences' refers to the standards to be achieved. Competencies are defined as 'the skills, knowledge, experience, attributes and behaviours that an individual needs to perform a job effectively' (IDS 1997a). Milkovich and Newman (1996) define 'skills' as what is needed to perform work, in contrast to the wider definition of 'competency' as what is 'required for a person and organisation to be successful'. Armstrong (1999) suggests that 'competence related pay' is similar to skills based pay, but for managerial, professional and administrative staff or knowledge workers, and refers to behaviour as well as knowledge and skills.

It should be noted that both skills and competences are widely used as a basis for appraisal and performance, or for training and development, but do not necessarily have to be used to determine pay as well.

2.2 Design issues

Skills based pay systems need to be carefully tailored and designed to fit the organisation and its goals. One difficulty is that, whilst there are many courses, textbooks and consultants available for learning to design traditional reward systems, these are very scarce with respect to skills based pay, and, as is discussed below, there is little research to confirm what works well and what does not. The sub-sections below cover most of the main issues that need to be taken into consideration in designing a skills based pay system (Ledford 1991a).

Organisational culture

Traditional job based systems fit well with a culture based on hierarchy, specialisation and seniority. Skills based systems require a different organisational culture, notably that of greater participation and involvement by all employees, and if the firm's

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culture is not compatible, skills based pay may not be appropriate. Flexibility may be gained by cross-training a group of workers, without introducing skills based pay; it is only worth introducing a new system for *all* employees if the costs can be recouped through greater productivity or performance.

For skills based pay to work, breadth skills are needed to allow flexibility and encourage problem solving. Vertical skills encourage self-management. It is not necessary for such a culture to exist already — it may be that skills based pay is being introduced to develop such a culture change, but the determination from senior managers to support the necessary changes must be there.

Technology

Skills based pay is commonly used in situations of continuous process production, or in customer service chains. Multi-skilled employees can quickly and easily be moved to any part of the line where they are needed, or can deal with any aspect of a customer's query, without having to pass them from one person to another.

Skills based pay is also particularly suited (but not restricted) to firms that are capital intensive, so can bear slightly increased labour costs, but need to use resources efficiently.

Employee involvement

It is important to involve employees in the design process for various reasons, possibly using representatives from all parts of the workforce. Not only does this allow ideas for what works well and what does not, to come from those who operate the system, but participation encourages understanding and acceptance of the necessary changes. Employees under skills based pay may well be involved in decisions previously reserved for line mangers — assessment of skills, appointment of new staff, control of resources, workflow management. It is therefore appropriate for them to be involved in the design of such things as skill evaluation procedures.

Selection of employee groups

It is not necessary to include all employees in a skills based pay system — some may be exempt, or even have a different skills based pay system. Generally, if all employees are included, there is less likelihood of complaints. Nonetheless, the decision on which groups to include should be conscious.

Skill blocks

A skill block or level is a set of skills to which pay is attached. The design of skill blocks is crucial to the effective working of a skills based pay system, for two reasons. Firstly, they form the structure to which pay, training, certification and communication methods are attached. Secondly, they determine how well the system matches the technology, the management style and business needs of the organisation. It is valuable if the language defining skill blocks is kept simple and jargon free, so that they are easily understood.

If production steps have little overlap in skills, these may be used as the basis for skill blocks. If there is overlap, however, staff would be rewarded for relearning the same skills, so more generic skill blocks need to be designed.

An order of progression through skill blocks needs to be defined. This may be sequential, but only if necessary, otherwise job rotation and advancement can become clogged. There may be 'gates' that regulate the flow to more advanced levels; in this case, these should be made explicit. Also, minimum time periods in each block need to be set to ensure that skills are properly learnt. Maximum time periods may be used to ensure job rotation. Minimum numbers of skill blocks ensure that new recruits appreciate what they will be required to learn. Maximum numbers of blocks ensure that staff do not get paid for more skills than they can maintain and use proficiently. If skill blocks are of approximately equal weight, this helps prevent some being avoided as difficult, or not worth the effort.

Figure 2.1 gives a simple example of how skills progression might function. Operators can move up the grading scheme as they gain knowledge and skills in each of the key work areas. Bars indicate that staff are not required at a particular grade, due

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Figure 2.1: Skills progression

	Work areas			
Grades	**A**	**B**	**C**	**D**
Operator 5		bar	bar	
Operator 4				
Operator 3				
Operator 2				
Operator 1				

Source: IES

to lack of need for staff at this position. The figure demonstrates that promotion could be vertical, through doing tasks of increasing complexity in the same work area, or through multi-skilling.

Models

Bunning (1992) proposes six varying models for a skills based pay system.

Stair-step model

This model works when there is a small number of distinct jobs, which may be arranged in a logical learning order from entry level to extremely complex. The 'steps' correspond to the level of difficulty of the jobs, and progression consists of mastering the jobs at each step.

Skills blocks model

This model is similar to the stair-step model, but the progression is less linear. For example, assuming three blocks A, B and C, of increasing difficulty: on completing block A, a worker would progress to one of the block B modules, but then might do another block B module, or a block C module, according to the needs of the organisation and the employee's interests and aptitude. Pay rises might consist of, say, 3 per cent for each B block, and 8 per cent for each C block module.

Job-point accrual model

Where too many jobs exist for all to be mastered by one person, each job may by be given a points rating, depending on criteria such as value added to the product, learning or performance difficulty, impact on quality, physical demand, use of judgement *etc.* The sum of points for all jobs mastered determines a person's pay.

School curriculum model

This is similar to the stair step model, except that some jobs are 'key', and mastered by most employees, whilst others are 'elective'. Each step involves a mixture of required and elective jobs. Advancement through the steps consists of progressively more key and elective jobs to be mastered at each step.

Cross-departmental model

Sometimes, organisations have a number of small departments, which perform independently and do quite different tasks. If the firm is small, it is useful to be able to move staff temporarily from one department to another. Basic steps consist of mastering jobs in one department, and more advanced steps consist of being able to 'float' to one, and then more other departments.

Skill-level/performance matrix

This model combines one of the above models with a fairly objective performance rating that can be summarised as a single mark. Pay is determined by a matrix consisting of skill levels on one axis, and performance levels on another axis.

A more detailed discussion of this combination of skill and performance pay is provided by Franklin (1988). Under the model he proposes, employees do not automatically gain increased pay for extra skills, as in a pure skills based system. Instead, acquiring extra skills increases one's *potential maximum pay.* In order to increase pay, however, it is necessary to improve performance. Maximum pay for any given skill level can be reached only through outstanding and sustained performance.

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Franklin argues that such a system is particularly suited to motivating technical staff, who are motivated more by the challenge of learning new skills and keeping up to date, and less by the desire to take on supervisory duties. Promotion to supervisor can result in the loss of a good technician in return for a poor supervisor, and consequent unhappiness for the employee as well.

Franklin also claims a number of advantages for this combined system over pure skills based pay: pay is dependent on higher performance, there is less demand for training, there is greater scope for progression, there is less administratively complicated skill-tracking to manage, and employees are encouraged to stay in their job and attain complete mastery, rather than to job hop.

Assessment and certification

Since pay depends on having skills, the process of certifying that employees are proficient is crucial to the system, and employees take a keen interest in its fairness. Attention needs to be paid to the assessment criteria, methods, personnel, timing and reassessment.

The methods may include work samples, written or oral tests, or observation by others. Each of these methods has advantages and disadvantages, affecting factors such as employee literacy, test anxiety, consistency over time, or ability to cope with unusual or dangerous circumstances. Often, a manual is provided, setting out details of what tests need to be taken and how.

Assessments may be carried out by supervisors, HR staff, fellow employees, or some combination of the three. Some firms design their own certification, others use external certifiers, such as City and Guilds, National Council for Vocational Qualifications, or the Engineering Training Authority. Some assessments record only competence or no competence. Others distinguish whether the individual can perform the task under supervision, without assistance, or well enough to support others' learning. Advanced assessment would also consider future potential and training needs.

The assessment process is time-consuming, and may be a major part of the assessor's job. Decisions need to be made on whether assessments are made upon request, or at scheduled times. If a test is failed, the process and timing of a retest needs to be made clear. If more people want testing than is possible, a priority queuing system is required. Some skills are like riding a bicycle, and never forgotten; others need periodic refreshment and retesting. It is also important to check that skills are still being used.

The administration of skills based pay is complex, and it is important to set up a reliable and accurate system for recording changes in staff skill achievements. Some form of appeals panel may need to be set up, to deal with complaints of unfairness.

Pricing — local and industrial equity

Choosing the right price for each skill can be difficult if there are no other local firms with a skills based system. A particular problem may arise where the local community is relatively highly paid, but the industry is very competitive. Paying enough to attract recruits has the potential to make the firm uncompetitive, unless corresponding savings can be made elsewhere (evidence given below suggests that this is often possible). In practice, firms often set an entry rate just high enough to attract local recruits, and a top-end rate that they can afford if a sizeable proportion of staff reach the maximum scale of the ladder.

> Insurance company Shenandoah Life priced each skill by calculating the number of weeks to learn it as a proportion of the weeks needed to learn all skills, and then taking that proportion of the range from minimum to maximum pay (Hequet, 1990).

Jenkins *et al.* (1992) found that specific pricing decisions did not affect 'success'; firms relied on the relative importance of the skill to their organisation, and that local market rates were considered slightly more than industrial rates. Skills based pay employees tend to start at a higher pay rate than local workers in other firms, and the gap widens further with time. It is the number of skill units learned, rather than proficiency or retention, that determines an individual's pay. Most workers do not reach the maximum possible, but stabilise at the number of units at which they can remain proficient.

When skills become redundant to the firm, employees are not usually penalised financially, but may be required to acquire some compensating skill.

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Training plan

Training plans need to be much more systematic under skills based pay than under other systems. The content of training is obviously closely linked to skill blocks. A schedule should lay down what training is available and when, and from whom. Providers may be internal or external experts, peers or managers, or just on the job. The plan should specify whether training is in company or employees' own time, on or off site. The necessary trainers' skills need to be provided.

One of the main reasons for multi-skilling is to facilitate job rotation. This may occur according to a fixed timetable, or be decided upon *ad hoc* by employees themselves, or by managers. There is a certain conflict between short-term production needs, which will militate against training taking place, and the longer-term needs for a multi-skilled and highly-trained workforce.

One firm in USA, Northern Telecom, based part of managers' pay increases on subordinates' training and development (Ledford, 1991b).

A policy needs to be in place to handle those who are reluctant to learn and rotate, or who find learning difficult.

Plan for review and renewal

Most skills based pay systems tend to be changed with time, for several reasons. Firstly, the design is sufficiently complex that errors need to be corrected, or improvements made. Secondly, changes in technology or the market make some skills obsolete, and new skills necessary. Thirdly, business objectives may change with time. It is as well, when designing skill blocks, to give some consideration in advance to what skills are likely to become redundant, and what skills are likely to become more useful in the future.

It is important, therefore, to prepare employees for the notion that the scheme is not fixed, and to invite their contributions to improving it. In order that changes are soundly based, it is important to plan what data needs to be kept to monitor the working of the system, and who will collect, store, and analyse it. A timetable for review needs to be in place.

Communications

Employees need to understand a much more complex system than under job based pay. They need to understand several jobs, a ladder of skills, the training and certification process, and the pay attached to these. A change in a technology will affect everyone eligible to acquire that skill, not just one person doing one job. As well as a manual setting out skills, tests and pay, an intensive, multi-channel communication system needs to be in place, informing employees about many aspects of the business, as part of the participative culture. A mixture of written memos, notice boards, staff newsletters, team briefings, emails and intranet information needs to be tested. Some organisations found that team managers did not always have the skills to conduct efficient meetings, or to interpret written briefings consistently, whilst written memos and notice boards are ignored by those less literate. A variety of methods have to be tried, therefore, and training in communications given to team leaders.

Transitions

There are particular issues that relate to the setting up of a new scheme, or transition from an older, different one. Firstly, there is an unavoidable, time-consuming and costly crush of certification requirements, and demands for training. Combined with other new aspects of the system, this may mean that production falls, just as costs are rising. One solution is to spread the certification process, *eg* by assessing people on the anniversary of their hire date. Decisions need to be made on accrediting prior training. The local labour market may make recruiting rare staff more expensive than the relevant skills warrant. Some staff may need to have wages frozen at current or market levels, until the necessary certification process has taken place. Resistance from staff who benefited from a system of seniority, long service, or job status, will need to be overcome. In some cases, this may mean offering early retirement, or exempting certain staff from the scheme.

New and old sites

Whilst early pioneers of skills based pay tended to be in new plants, there are now many examples of successful schemes operating in firms that previously used job based systems. There is no evidence that the presence of trade unions is an obstacle. It typically takes about 9-12 months to install skills based pay in a new plant (Ledford, 1991a). The issues are slightly different in the two situations. New sites face chaotic start-up conditions, new technology, long working hours, and lack of an established training system. They can, and need to complete the transition quickly. By contrast, longer-established firms can afford to take more time to plan, or to set up appropriate training courses and communications systems, but face more resistance from established systems. New sites can often offer a wider spread of pay by taking new recruits in at lower rates than established firms, which need to maintain existing pay rates.

2.3 An example of skills based pay

Introduction

A manufacturing company introduced skills based pay a few years ago. This is a brief account of the approach this company adopted. The scheme applied only to manual workers, and was site specific. The drivers for the scheme were:

- global industry changes
- supply chain pressures
- customer emphasis on standards
- inadequacy of existing working practices
- a need for multi-skilling among manual and semi-skilled workers.

Its aim was to provide 'a more coherent and explicit approach' to pay progression for manual employees, removing traditional barriers and elements of subjectivity in allocating staff to grades. The idea was to encourage higher-quality work levels and more flexibility in utilisation, given greater market competitiveness and the increasing use of fixed-price contracts. Continuous skill development would be encouraged, and the rate for the job paid.

Design of the model

The company, after a joint management/trade union exercise, concluded that there should be a single manual grade with five bands, each with a single pay rate. Each band would specify a number of requirements in terms of 'skills, competences and standards'. Every department would develop their own skill matrix that would use a mixture of common and department-specific skills and competences. The content of skill matrices would be designed, implemented and reviewed through a joint union/management process. The personnel and training departments would act to ensure consistency and compatibility across the site. They would work to accredit the standards required in the matrices in a way that is consistent with company policy.

Existing employees would be allocated to a band on the basis of their previous grade through a read-across mechanism. New starters would be assigned on the basis of their previous experience. Vertical movement between bands would be possible, depending upon the job needs of each department. Horizontal movement would also be possible. Job vacancies would be advertised site-wide in terms of the skills matrix for that department. Anyone in that department or another department could apply, either on promotion or for lateral transfer.

Monitoring and evaluating the scheme

A key element in the scheme is that progress is monitored and evaluated as to whether the objectives of the changes are realised. As the company said: 'unless a mechanism exists to assess the extent to which the aims of the scheme are being satisfactorily achieved, much of the effort which has and will go into its operation may be wasted'.

A joint union/management review group was set up to carry out periodic reviews of the scheme's operation.

2.4 Extent of usage

The first manufacturing system to reward employees for their breadth of skills, rather than for depth, was implemented by Proctor and Gamble in the 1960s; they have now implemented

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skills based pay systems in some 30 plants. Whilst it was used initially with blue-collar workers within the manufacturing sector, it has now spread to service organisations such as telecommunications, insurance, hotels, retailing, and information based professionals. Polaroid in USA was the first large corporation to attempt to pay virtually all employees on a skills based pay system. In hotels, for example, staff may be moved at different times of the day from checkouts in the morning, to room cleaning, to kitchen or dining room duties, to administration, to bar work in the evening (Hequet, 1990).

Estimates vary considerably as to the extent of skills based pay. Two fairly recent studies have reviewed the current state of usage in the UK and Europe. Perrin (1997) looked at 300 multinational companies operating in Europe, and reported that 20 per cent were linking skills and competencies to pay, whilst a further 50 per cent saw it as one of their top three reward priorities over the next three years. IRS (1998) reported that ten per cent of respondents were using skills based pay, and that 8.7 per cent were considering its introduction. IRS (2000) found that fewer than 14 per cent of its 160-company survey used skills based pay, whilst Mercer and the CBI (2000) found that nearly one-third of its 829 respondents did so.

Within the USA, one of the larger surveys of skills based pay systems is that undertaken by Jenkins *et al.* (1992), covering 97 plans in 70 different companies. They found that organisations using skills based pay resemble other firms in most respects. Skills based pay is most common in manufacturing, but is growing in the service sector. It is found in both large and small, old and new firms. It is more common in firms with continuous process technologies than unit, small batch or mass production, and firms tend to have flat organisational structures, with few managerial layers. Skilled manual labour is most likely to be involved, rather than managers, but there is growth among clerical workers. A major difference between companies with skills based pay and others, is in the levels of employee empowerment, alternative reward systems used, and information-sharing practices accompanying skills based pay. The median number of skill units was ten, although the range was from two to 550. Notably, the median number of units in which employees could stay proficient was only five, with a maximum of 20. The average learning time for each skill was 20 weeks, with a median time to 'top out' (reach the maximum pay) of 143 weeks. Seventy per cent allowed skills to be learned in any order. Whilst two-thirds provided refresher training, only a quarter required refresher exams.

Examples of further case studies may be found in various reports from Incomes data Services (IDS, 1995a; 1995b; 1996).

2.5 Benefits and difficulties — evidence

Benefits

Because skills based pay is a relatively recent phenomenon, there has been very little research into it. Much of what there is consists of subjective assessments by those using it, rather than controlled experiments. Nonetheless, what evidence there is seems to be consistent, and mostly positive. For example, Hequet (1990) quotes a 1987 survey in the USA, 'People, Performance, Pay', conducted by the American Compensation Association: nine out of ten managers thought pay for knowledge was an effective reward system — the highest approval rate for any of the nine systems respondents were asked about.

The most obvious benefit to a firm of having multi-skilled employees, is their flexibility. Some personnel may be moved quickly to deal with bottlenecks in production or service, and remaining staff can cope without them. Staff can cover for vacancies due to illness or training. The need to hire less well-trained temporary staff during business peaks, or to leave staff idle during hold-ups or troughs in demand, is greatly reduced. Staff who are skilled in all processes and given a greater level of autonomy have a better grasp of the impact of one process upon the whole system, and they can be more creative at solving problems. For the firm, this can lead to higher performance, lower staffing, better productivity, improved quality, faster response to customers, more effective problem solving, and lower absenteeism and turnover costs. For the employee, this can mean higher job satisfaction, as well as greater pay.

Jenkins *et al.* (1992) found no design features that distinguished 'more successful' from 'less successful' plans, and the researchers suggest that: 'The success of skill based pay plans probably depends more on the context within which they are

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implemented and on how well the plans are custom tailored to local conditions than on whether the plan follows specific design prescriptions.' (p. 27). The factors seen by respondents as key to success were the plan's emphasis on employee growth and development, local management's commitment to the plan, the plan's emphasis on employee training, the overall management philosophy, and the ability to move employees among jobs.

Although Jenkins *et al.* (1992) did not obtain evidence to confirm respondents' impressions, the majority of firms using skills based pay saw themselves as performing better than traditional firms on a long list of factors: employee motivation and performance, productivity and quality of service, staffing levels, labour and non-labour costs per unit of production, grievance, absence and layoff rates, and supervisor-employee relationships.

Murray and Gerhart (1998) provide one study that looks only at two firms in USA, but does rely on objective measures. Using time series data over three years to study a firm before and after the introduction of skills based pay, and using a matched company as a control, they found that productivity improved by 58 per cent, labour costs per part fell by 16 per cent, and there was an 82 per cent reduction in scrap waste.

A survey by Incomes Data Services (1992) found that all the companies they contacted were able to function with a leaner, more efficient workforce than would have been possible under more traditional, job based systems.

Sun Alliance (Olorenshaw, 1994) reports improvements and target achievement in the areas of productivity, skills acquisition and cost reduction. Parent and Weber (1994) studied two Canadian plants over a period of ten months, and found that the plant operating skills based pay showed significantly better skills acquisition, quality, employee involvement, staff turnover, accident rates, and cost reduction.

Hequet (1990) quotes the example of USA insurance provider AAL, that combines skill based pay with performance incentives linked to customer satisfaction and the costs of doing business. Despite a 15 per cent reduction in staff, the unit is handling a greater volume of work, and customer satisfaction has risen from 4.12 to 4.85, on a 5-point scale.

Hequet (1990) also reports that insurance company Shenandoah Life reduced their average time to process service requests from 4.97 days in 1984, to 3.15 days in 1989, following the introduction of skills based pay. In spite of reducing staff by one-third, they handled 40 per cent more service requests. A more detailed case study of Shenandoah Life is given by Myers (1985), concentrating on the ways in which skills based pay eliminated the restrictive influence of hierarchical bureaucracy. Conservative rules gave way to self-management and creative problem solving, and the supervisor/employee ratio improved from 1:7 to 1:37.

Other examples of case studies which report positive results from skills based pay are Ledford (1991b), Shafer and Jones (1989) on secretarial pay, IDS (1997a) on manufacturer SKF, IRS (2001) on Pressweld engineering company, and IDS (2001) on Britannia Building Society's call centre.

Problems

A number of problems with skills based pay have been encountered, in addition to other issues that need to be tackled. The key ones are listed below:

- One of the first problems with setting up skills based pay is that any system needs to be much more tailor made than traditional systems, and there is less advice and experience to draw upon.
- The conversion process, or initial setting up, involves considerable clash between the need to assess and certify people, and provide training, and the need to keep production going.
- The system is much more administratively complicated than job based systems.
- The system is costly because of higher individual pay, administration and training, and is not flexible to adapt to downturns in company performance.
- Pricing jobs in the marketplace can be difficult.
- Employees need to understand a lot more about their pay and progression.
- Some employees may be resistant to learning or flexibility.

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- Those who have not learnt new skills for a long time may need their fears overcome, and their confidence built up through a 'return to learning' programme. Resistance may be calmed by stating that no one will receive a cut in pay. A period for 'catching up' on skills will probably be necessary.
- Skills need to be monitored in case they become redundant, incurring unnecessary costs to the company.
- Once employees reach the top of the skills hierarchy, they become demotivated unless there is also a performance element, or a form of gainsharing.
- Employees may constantly be seeking to move job, resulting in less experienced staff in any given post.
- It is possible for bias to be unintentionally designed in at the development stage, and careful records need to be kept to monitor equality issues around access and progression (Strebler, Thompson and Heron 1997; Gupta and Jenkins, 1996).
- Long-standing practices such as overtime pay and commission, may need to be revised.

2.6 Conclusions

Skills based pay is not as widespread as traditional job based systems, but has spread from the USA to the UK, from manufacturing to service sectors, and is growing in its popularity. It is valuable in situations where cross-training and employee flexibility between jobs is important, but requires a definite culture of employee participation. Training costs and wage costs for individual employees tend to rise, but what evidence there is suggests that these extra costs can be more than offset by savings in staff levels, higher productivity, and improved quality.

Homan (2000) suggests that further research would be useful on whether skills based pay is mainly useful in firms undergoing transition, or whether it is also useful in more stable situations. She points out that skills based pay fits in well with current notions of lifelong learning and human capital theory (Milkovich and Newman, 1996). The main factor that prevents it being adopted more widely is that it is complex and costly to set up correctly, there is little expertise available, and pay systems are notoriously difficult to change successfully. Nonetheless, those firms that have adopted it find it, on the whole, to be successful.

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3. Competency Based Pay

Fiona Neathey and Peter Reilly, IES

3.1 Introduction

According to Brown (1998), competency frameworks have a role in main HR functions in as many as 70 per cent of organisations. However, competencies are used mainly in performance management, recruitment and selection, and training and development, according to the *Competency and Emotional Intelligence Benchmarking Survey* (2002). Only a minority of organisations have decided to link pay with competency. In this paper, we describe the use of competencies in reward systems, and highlight both the attractions of such an approach and the potential problems and pitfalls that may have contributed to its limited application.

Definitions of competence/competency

The term 'competency' was brought into the public arena in the USA in the early 1980s by Boyatzis (1982). Boyatzis defined competency as 'an underlying characteristic of an individual which is causally related to effective or superior performance'. This definition is quite distinct from the way the term *competence* came to be used in the new suite of vocational qualifications introduced by the UK Government in the later 1980s. These awards, National Vocational Qualifications (NVQs), are based on nationally-determined occupational standards or competences, and focus on the desired outcomes of work performance. So whilst one term (NVQ competence) was a label for the ability to perform, the other (Boyatzis's competency) described the behaviour needed to perform a role with competence.

However, this distinction is not always clear in the subsequent literature, and is certainly not clear in practice.

Armstrong (1999), for example, talks about 'hard' or work based competences, which are expectations of work performance and the standards and outputs that people carrying out a role should attain: in other words, the NVQ description of 'something which a person in a given occupational area should be able to do'. He also refers to soft competences as 'behavioural or personal characteristics which people bring to their work roles' — analogous to the Boyatzis definition of competency/cies.

Some commentary makes a distinction between three possible uses of competency and/or competence: input (the capacity within people to do a job well — knowledge, skills and personal attributes); process (the behaviour required to convert inputs into outputs), and outputs (the actual performance in the job). These are sometimes colloquially known as the 'hows' (inputs), the 'whats' (outputs) and the 'how whats' (the process of conversion). Armstrong (1999) points out that different organisations use different combinations of one, two, or all three of these definitions when employing the concept of competency in their human resource strategies.

What is competency based pay?

In addition to variations in language and the ways that terms are applied, gaining an understanding of what is meant by competency based pay is also complicated by the variety of different pay arrangements that are given the label. Some of these systems are indistinguishable from skills based pay, in that they involve payment on the acquisition of knowledge or skills seen as necessary for the effective delivery of a job role. Others are basically performance related pay by another name, in that they measure and reward competency in terms of the performance that competency produces.

For the remainder of this paper, the focus will be on systems that in some way reward the *use* rather than the *acquisition* of competency. Systems that reward the acquisition of competency are best described as skills based pay, and are covered in Chapter 2, above.

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In principle, there is also a clear distinction between competency based pay and individual performance related pay. Suff (2001), citing Armstrong and Baron, gives the following as some of the distinguishing features of competency based pay:

- it is based on an agreed framework of competencies
- it is not based on the achievement of specific results, such as targets or projects completed. However, it is concerned with the attainment of agreed standards of performance.

The difficulty of getting an agreed description of competency based pay is reflected in Brown and Armstrong's (1999) definition:

> *'Competency based pay can be defined as paying for the development and application of essential skills, behaviours and actions which support high levels of individual, team and organisational performance.'*

Here we see the use of not just behaviours, but also 'skills' (akin to harder competencies?) and actions. The latter is hardly distinguishable from individual performance related pay. Also, if the performance judgement is at team or organisational level, then competency based pay becomes indistinguishable from team based pay or employee financial participation schemes.

In practice, as discussed later in this paper and illustrated by the example below, competency based pay systems are rarely used in a pure form as the only means of determining reward. Most, instead, combine the assessment of two or more of: inputs, processes, and outputs.

Aegon UK's pay system has a competency link, but performance against objectives is also recognised.

Their system has three performance zones:

- Learning (c.75% to 90% of target rate)
- Competent (c.90% to 110% of target rate)
- Advanced (c.110% plus of target rate)

Pay progression is based on: the individual's competency zone; their personal and competency development; and their salary position relative to their target rate for the job, based on market considerations. In addition, Aegon UK has an incentive scheme based on performance against objectives, using a balanced business scorecard.

Brown and Armstrong's (1999) distinction between competency based pay and competency related pay is helpful. They make the same point that many pay schemes involve competencies without these being the primary focus of reward (hence 'related'). They have also developed the concept of 'contribution related pay' to describe approaches that combine recognition for both inputs and outputs — *ie* how results are achieved as well as the results themselves. This approach is a formal combination of competency and performance related pay. Brown and Armstrong believe that contribution based pay is a desirable approach precisely because it covers both inputs and outputs in a way that is reflective of most jobs. Using the term contribution based pay is also a recognition that a number of organisations, though describing their pay system as either competency based or performance related, are actually a combination of both. Suff's research (2001) confirms that most competency based pay arrangements could equally be described as contribution related, and that systems that are entirely competency based are very much in the minority.

3.2 How are reward and competency linked?

Adams (1999a), in a survey of competency related reward, found that there are four main ways in which employers were making the link between competencies and pay:

- 76 per cent of organisations that used competency based pay used competencies in design of the grading structure
- 80 per cent used them to determine promotions
- 88 per cent used competencies to determine pay rises or pay cuts
- 56 per cent used competencies to determine how an overall pay rise should be divided into pay shares.

Brown and Armstrong (1999) summarise two main ways of linking competency and reward — a job-focussed process, which uses competencies wholly or partly as a way to evaluate jobs; and a people-focussed process that links individual pay to level of competence. The first method commonly determines where an individual role is placed in the band. The second determines the link with pay. This may be via a bonus, but through a pay increase is more common.

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A Towers Perrin European survey, cited by Brown and Armstrong, found that most companies have kept their job evaluation system, but, rather than replacing it with a system based on competencies, have modified the system — with 60 per cent considering the introduction of competencies. The typical rationale for such a change is that it will introduce greater flexibility into job evaluation, and make it easier to measure job quality as well as size. Brown and Armstrong say that competency related evaluation suits organisations with a predominantly professional workforce and a non-hierarchical structure.

Current practice in competency related pay is diverse, with almost as many different methods of linking competencies to individual reward being used as there are organisations practising them. However, approaches that make a systematic link between assessment of competency and individual pay often fall into the following categories:

- a matrix approach, where pay increases are determined by competence assessment and position in pay range
- competence assessment, which determines incremental progression within pay ranges.

In the Anglia Housing Association Group (cited by Suff, 2001), individuals and their managers rate the employee against each competency listed in the job profile, on a scale of 1 to 5. These scores are given values, and weighted according to the importance of the competency to the job role. The resulting 'personal competency score' determines the employee's position in the pay band, which is divided into increments.

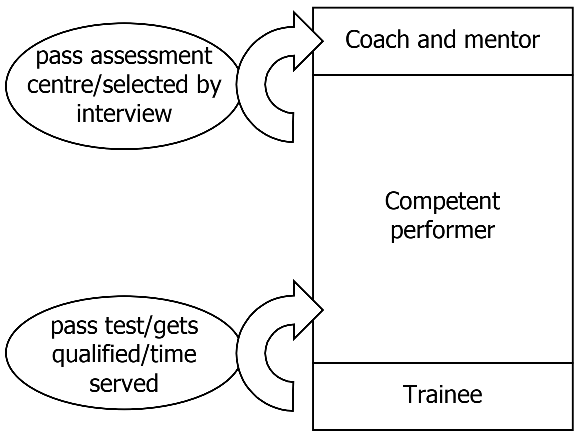
However, in a large number of organisations, the link between competency and pay is looser. Competency assessment is just one in a number of factors determining pay, with others including market, internal relativities, and performance. For example, some organisations mix competence and performance assessment, and assess staff both in terms of their performance against objectives and their competency demonstrated in doing the job. In other words, these organisations use a type of contribution based pay, even if they do not describe it as such. Often, this means that an individual will primarily be assessed against their personal objectives, or other output based factors, with a smaller proportion of their overall rating being derived from an assessment of their behavioural competencies.

Competency based role profiles have been used to help determine pay in the UK Passport Agency since 1998. Managers assess their staff on a three-point scale. Assessment of individual behaviour is against the competencies specified in the individual's role profile, plus performance against specific targets (Suff, 2001).

Brown and Armstrong (1999) describe a minority approach based on the 'life-cycle' model, that has been successful in some companies. This is based on the view that different kinds and levels of competence are required at different stages in an individual's career. Under this model, pay levels are set with reference to the market for people at a particular career stage in the occupation concerned. Pay progression is based on achievement of the competences required for a particular career stage. However, this method is appears to be a skills rather than a competency based approach.

The three figures below illustrate these different means of competency based progression. Figure 3.1 shows how in a broad banded structure, competency levels can be used to separate sections of the band.

Figure 3.1: Broad banded progression



Source: IES

Movement between bands can also be determined by achievement of competencies, as demonstrated by Figure 3.2.

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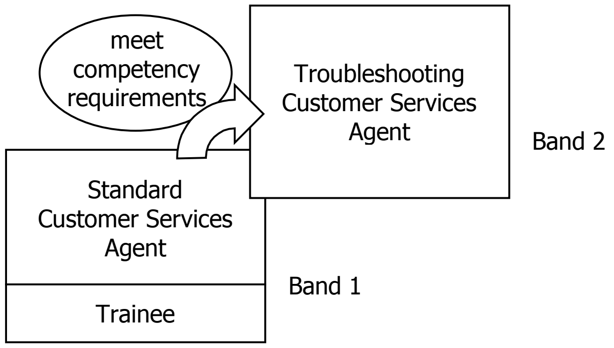
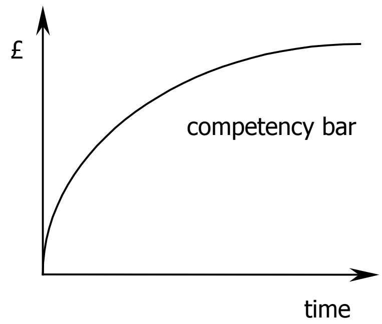
Figure 3.2: Progression between bands



Source: IES

Pay progression can be adjusted so as to offer faster progress early in the range, when competencies are being quickly added. In some schemes, there is a competency bar which determines that further progress will only achieved if a certain standard of competency is reached.

Figure 3.3: Pay progression curve



Source: IES

3.3 How extensive is the use of competency based pay?

A range of research evidence indicates that only a minority of organisations have chosen to link competency and pay. It also indicates that, whilst many organisations report considering the use of competency based pay schemes, they usually decide not to implement this approach. Overall, there is no evidence in recent years of a growth in the popularity of competency based pay schemes.

- The Towers Perrin 1997 European Survey, quoted in Brown and Armstrong (1999), found 20 per cent of participants linking skills and competencies with pay, with 70 per cent planning to introduce or extend such arrangements.
- An Industrial Society survey conducted in 1998, cited by Homan (2000), found that one-third of employers had a competency based pay system, or had plans to introduce one within the following 12 months.
- The annual review conducted by *Pay and Benefits Bulletin* (PABB) indicated that in 2002, across the UK, 17.4 per cent of companies were using competency related pay, while 19 per cent of UK employers were considering the introduction of such a scheme. These figures have remained fairly static over the several years that PABB has conducted its annual review. For example, in 1999, one in seven companies was using competency based pay (IRS, 2002).
- According to research for the 2000/01 *Competency and Emotional Intelligence Benchmarking Report*, most employers use competencies for personnel processes in recruitment and selection, and training and personal development, rather than reward. Just a quarter of organisations (24 per cent) had made a link between individual competencies and reward. By comparison, the survey found that grading and job evaluation was linked to competencies in one-third of competency users (33 per cent). Public sector employers were much less likely to use forms of competency related pay than their private sector counterparts in either services or manufacturing. The same survey repeated in 2002, included a matched sample from the previous study. Amongst this group, there had been a small decline in the use of competency based pay. However, across the survey as a whole 29, per cent linked individual competencies and pay, and 35 per cent used competencies in the grading of jobs.

3.4 Introducing competency based pay

In this section, we will describe the various steps an organisation might wish to follow in order to introduce a competency based pay scheme.

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Establishing a competency framework

It is recognised that it is better to have a successfully operating performance management system in place *before* adding a link to pay. According to most major commentators therefore, the starting point for any competency based pay system will be a well-established competency framework that has been used effectively for other HR processes. A wealth of literature exists on developing an appropriate competency framework for an organisation. A detailed consideration of this process is outside the scope of this review. However, some summary points are worth making:

- The first task in introducing a competency framework will be to conduct an analysis of what constitutes organisational success, and how individuals contribute to that success. Hence Homan (2000) describes competency based pay as a means by which 'pay and recognition are used to communicate vision and values to employees and to reinforce desired behaviour and performance'.
- A competency framework is likely to combine both core competencies that are applicable to jobs across the organisation, and competencies that are specific to particular jobs. In most organisations, competency frameworks contain both 'soft' or behavioural competencies, and technical or functional competencies, often known as 'hard' skills.
- Competency frameworks are typically developed via a process of internal research and consultation, with or without expert external assistance. Typical stages, as reported by Miller, Rankin and Neathey (2001) include:
  - individual interviews with senior managers, often at board level, to obtain their views on the current and future key issues and challenges facing the organisation
  - individual or group interviews with some other managers, to identify the characteristics associated with underperformance and high performance of individuals
  - focus groups of managers and/or other staff, again to help identify key competencies
  - benchmarking the draft competencies against the competency frameworks of relevant external comparators.

Assessment of competencies for reward purposes

The existence of a credible, tried and tested system of assessment, is also a prerequisite for effective competency based pay.

Competencies cannot be measured in quantitative terms, which makes assessment difficult. Armstrong (1999) recommends the development of profiles for roles against which individuals can be assessed. These 'do not eliminate subjectivity. However, they at least provide a framework within which more objective judgements can be made, especially when these cover the contribution and impact which can be measured by reference, not only to behaviour, but also to the results of that behaviour.'

Other approaches rely more strongly on subjective judgement A typical approach is for managers to rate employees on a scale for each competency, which is then used to produce a total score. Brown and Armstrong (1999) found that in broad-banded, devolved structures, line managers were generally required to give only a single competency score.

Introducing the competency based reward system

If an organisation has in place these structural requirements, and has decided that it would benefit from competency based pay, Armstrong (1999) suggests a series of stages for its introduction. The following list draws on the steps set out by Armstrong:

1. Communicate the purposes and potential benefits of competency based pay.
2. Obtain the views of line managers, team leaders and employees.
3. Set up a project team to develop the process. Armstrong advocates a team that is 'cross-functional and fully representational'.
4. Define the broad approach that is to be used, and decide what work needs to be done to develop it. This might include the development of a new or revised job evaluation scheme, the introduction of a broad-banded pay structure, decisions

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on how competency assessment will be linked to reward, and means of maintaining and controlling the scheme.

5. Develop the scheme whilst communicating and consulting with all stakeholders.
6. Communicate the details of the scheme to the whole workforce, and show what it will mean to them as individuals and groups.
7. Introduce the scheme and develop and implement appropriate training for managers.
8. Implement training aimed at allowing individuals to increase their levels of competency and to provide the opportunity for increased pay.
9. Monitor the introduction process.
10. Evaluate the results of the introduction.
11. Amend or improve the scheme as necessary.

All of these steps are applicable to the introduction of any reward scheme. However, some need greater attention than usual. For example, training and communication are especially important in what can be quite a complex method to operate. The design phase, number four on the list, is also trickier than in a simple performance related pay system, since the organisation has to decide how to link its competency framework to pay. Is it through a rating approach (this would be the most common decision)? If so, do all the competencies on the list have an equal value, or is there some degree of weighting? Are all the competencies in the framework to be used or only key items that are seen as particularly important for pay purposes? Finally, is there a transparent scoring system, or does the manager just make an overall judgement?

There is also the cost implication to consider. If competency based pay is treated like skills based pay, as a reward only for inputs, then payroll costs will rise. This may be justified by improved productivity, but the gains may not be clear-cut. This raises the question under item eight, above, of whether organisations will allow open access to training or whether they will control the flow to contain costs (both training and payroll).

3.5 Why do organisations introduce competency based pay, and what are its benefits?

Homan (2000), in a review of the literature, gives reasons why employers chose to introduce competency based pay. She suggests that amongst the most frequently quoted objectives are the support of a change initiative, the pursuit of flexibility, and the need to build a broader skills base within the organisation.

A 1998 CBI Employment Trends survey found that, particularly amongst service based companies, improving employee motivation was most likely to be cited as the foremost advantage of competency related pay by service based firms (CBI, 1998). Similarly, in the 1999 *Competency & Emotional Intelligence Quarterly* survey, employers reported that the main factor influencing the introduction of competency related pay, was the desire to encourage better performance. This factor had been a consideration for 80 per cent of employers who had introduced competency based pay.

Other influential factors in decisions regarding whether or not to introduce competency related pay included:

- the need to increase flexibility amongst the workforce (72 per cent)[1]
- to change behaviour (60 per cent)
- giving employees access to job progression (52 per cent)
- to allow some form of progression within the job where no other form of promotion opportunities otherwise existed (36 per cent).

These results are similar to the slightly earlier findings of the CBI, which reported that the main benefits of using competency related pay were greater motivation, assisting with the introduction of multi-skilling, and providing greater objectivity in pay determination (CBI, 1998).

[1] The percentages given refer to the proportion of those responding who said they were using competency related pay systems.

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> The Volkswagen Group (UK) Ltd introduced competency based pay because the previous performance related pay scheme was ambiguous, and provided limited incentive to improve. This is because applying a normal distribution curve to performance means that most staff are rated as average, and there is little differentiation in pay awards. Their competency based pay scheme describes the ten critical competencies required for each job family. Staff can be placed on three or four levels of achievement. This means there is a motivation to demonstrate the competencies, and these are fully transparent. The system encourages flexibility and breadth, thereby helping the company get a broad base of experience.

As we have already established, competency based pay is commonly just one means of determining individual pay and pay progression. Competency based approaches are often introduced as a means of addressing the limitations of existing reward practices. For example, Alan Fowler (cited in Suff) has suggested that competency based pay is a more rounded or 'holistic' approach, and so avoids some of the problems associated with individual performance related pay. These include:

- difficulties in setting measurable performance targets for qualitative factors (such as teambuilding)
- difficulties in converting variable performance against a range of targets into a single assessment rating
- problems in taking into account factors outside of the individual's control in the achievement of targets
- manipulation of the system by employees to ensure that they receive high levels of performance pay
- adverse impact on team work objectives.

These issues are particularly pertinent in the Civil Service, where the setting of objectives is often problematic (Steele, 1999 and Burgess and Metcalf, 1999), where there is a high emphasis on teamworking, and there is no simple principal/agent relationship that economic theory expects. Staff often do not have the same clear goals as those in the private sector, with too many conflicting priorities through trying to serve too many masters (Marsden and French, 2002).

An example of the introduction of competency based pay as a means of addressing perceived problems with individual performance related pay, is the Government Executive Agency Registers of Scotland (Adams, 1999b). Originally, pay in the organisation was linked to the annual appraisal, but there were concerns that the system was being operated inconsistently, with attendant concerns arising from its linkage to pay. These worries led the HR department to work with consultants to draw up a competency framework and ratings system to form the basis for a new performance and development system, linked to pay.

The introduction of the scheme was supported by a series of workshops, training sessions and a telephone helpline. According to Adams, a key factor influencing uptake of the scheme was the fact that the new arrangements were negotiated with the relevant trade union, the Public and Commercial Services Union (PCS). The aim of the new scheme was to create a fairer reward system and to give better opportunities for pay progression. The company viewed the negotiations with PCS as constructive.

So, in summary, organisations contemplate competency based pay where the following are key issues:

- link to business strategy
  - competitive advantage through the way people perform
- importance of people development
  - provides incentives for development, especially where role definitions are flexible
- replacement for performance related pay
  - PRP has proved problematic and inappropriate in some settings
- organisational re-positioning
  - structurally or culturally.

Many of the above points on the reasons to introduce competency based pay are again common to many reward change projects, and similarly, the benefits tend to be the same. However, trying to change behaviours through signalling that certain competencies are important to the organisation is unique to competency based pay. These can be linked to 'core' competencies or values, emphasising what is critical to organisational success or proper management. Links can be made between reward, recruitment, development, and selection,

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so that there is an holistic approach to people management, with competencies being the unifying theme.

Competency based pay also recognises that how the job is done is as important as the end result. It considers the whole person's performance. This is particularly evident in such areas as customer services. Appraising people through competency rating frameworks has advantages compared with some other approaches. It is an absolute measure of performance. This means people can always improve — this is less true in ranking systems. In addition, there are clear measurement criteria, sometimes missing from performance ranking.

Competency based pay gives more options than other schemes, in that it can be used to determine progress up a pay band, to determine movement within or between bands. In allowing *through* progression in broad-banded structures without the need for formal job evaluation procedures, competency based pay systems may be seen as providing greater flexibility and responsiveness to changing business needs.

Other features relating to individual motivation, righting the wrongs of previous schemes, could just as easily apply to individual performance related pay or contribution based pay schemes. Improving pay progression is also a frequently found objective in renewing a remuneration structure.

3.6 When is it appropriate to introduce competency based pay?

Given that if you wish to change your approach to remuneration, there is a wide choice of different approaches, when would it be best to consider competency based pay?

Armstrong (1999) suggests that there is a set of criteria that determine whether or not the introduction of some form of competency based reward system is appropriate for an organisation. Armstrong's criteria are:

- a well-established competency framework already in use for development and recruitment
- established criteria for measurement/assessment of competencies

- the organisation has a specific objective of increasing the level of competence amongst its workforce
- the organisation plans to move to a broad-banded pay structure, or already has such a structure in place
- the organisation wants to move to a flatter structure.

Homan (2000) adds to the last point that competency based pay supports the move to more fluid job boundaries. It also provides ways of awarding those with high-level professional skills but who do not have responsibility for staff or financial resources.

It seems competency based pay might be launched together with wider structural change — delayering and broad banding. It might be appropriate as part of a wide-ranging people management initiative — integrating selection, development and reward processes. It might be used to deal with a specific population or problem. This might be to deal with a particular type of workforce (*eg* research scientists) where outputs are difficult to measure, and where previous performance related pay schemes have not been satisfactory. Another context to the introduction of competency based pay is where it is seen as an integral part of a cultural change. Especially where this is strongly values driven, performance management may be used to signal behaviours that are encouraged and the pay system reinforces them.

3.7 How effective is competency based pay?

As with so many pay schemes, systematic evaluation of the effectiveness of competency based pay is thin on the ground. However, Armstrong (1999) suggests that where a scheme is introduced for the right reasons and in the right way, organisations can reap the following benefits from the introduction of competency based pay. They can:

- promote need for greater competence
- facilitate lateral career development
- encourage staff to take responsibility for their own career development
- help to integrate role and generic competences with organisational competences.

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Suff (2001) suggests that the experience of organisations using competency based pay, and the analysis of a range of commentators, indicate other potential advantages arising from the introduction of competency based pay. It can:

- boost co-operation and teamwork
- lead to a focus on the totality of the job rather than just what is achieved
- provide a framework for salary progression where promotion opportunities are limited
- increase employee satisfaction through the provision of development opportunities
- provide a link between reward strategy and overall corporate objectives.

These are indeed *potential* advantages of competency based pay. What we lack is concrete evidence that introducing this form of remuneration will improve organisational performance. Of course, this is a tough requirement. It is hard to find true cause and effect. Even when performance has improved through greater productivity or better quality, it is difficult to attribute the gain to one single HR initiative. It is more likely to be associated with a bundle of initiatives. Competency based pay does have the advantage of linking selection, performance appraisal, and development. In that sense, it is an integrative approach. But how much more effective is competency based pay than individual performance related pay in getting employees to work harder and smarter? Is team based pay a better means of generating co-operative behaviour than rating staff on their teamwork competency and rewarding on the basis of the rating?

We do not know the answers to these questions because, unfortunately, practitioners tend to merge the answers to the questions of why introduce a scheme, what benefits does it offer and how effective is it. This is because we tend to hear more about success than failure, more about the honeymoon than the divorce!

3.8 Potential problems and pitfalls

Despite the potential advantages highlighted above, only a minority of organisations have introduced competency based pay. So, although managers surveyed by Holbeche and Glynn (1999) were broadly supportive of the use of competency frameworks, many were opposed to their use in reward systems. The survey conducted by *Competency & Emotional Intelligence Quarterly* in May 1999, indicated that there was a range of reasons for employers choosing not to link pay to competencies. These included:

- the likely impact of competency based pay on other competency initiatives (26 per cent)
- fears concerning employees' reactions (21 per cent)
- doubts in general about linking competencies to pay (21 per cent).

> Adams (1998b) has reported how, after introducing competency based pay, ICL discovered that the new system emphasised pay at the expense of development, and that in reality, the system had few differences from a traditional grading system. Therefore, despite having been one of the first companies to introduce competency based pay, ICL was now rethinking the whole basis for their involvement with competency based pay.

Concerns regarding employee reactions to such schemes are perhaps not surprising. An Industrial Society report indicated that the involvement and support of employees was key to the success of introducing competency based pay schemes (Industrial Society, 1998). The main factor determining successful introduction of the pay scheme at Registers of Scotland would appear to be the emphasis on support and communication during the implementation phase (Adams 1999b).

Some of the potential problems with competency based pay systems include the following:

- They can be time-consuming and expensive to implement. The 2000/20001 *Competency and Emotional Intelligence Benchmarking Survey* found that the time, cost and resources involved were the main problems with the use of competencies in general. Schuster and Zingheim are quoted

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as finding that too many schemes are 'complex and over designed' and 'laborious and time consuming' (Risher, 2002)

- The objective measurement of competencies is difficult to achieve. Paul Sparrow (1996) has said that managers find it difficult to make complex assessments across a range of competencies. In the survey cited above, 59 per cent of employers had experienced difficulties with assessing competencies. According to James Kochanski and Howard Risher, reported by Suff (2001), 'the assessment of results or in the case of competency based pay, competencies, is often where otherwise well-defined systems break down'. Risher (2002) says that the problem stems from the fact that competencies were designed by psychologists, primarily for selection. Managers find it hard to use competencies effectively. Suff suggests that a focus on the evidence of what the individual has achieved and how this was done, is central to effective competency assessment. Risher argues that you need to limit the number of competencies, and relate them clearly to the job done and its level in the organisation.
- If competency is linked with other means of determining reward, the link with pay may be unclear, which will reduce any motivational impact of competency based pay. This is because there may be a poor line of sight between appraisal and reward, due to multiplicity of assessment items.
- If not properly controlled, there is a risk of pay drift without performance improvement. This may happen where there is a through progression or 'soft' grading approach.
- Competency based pay systems make considerable demands on line managers, who require considerable training and support.
- One of the objectives of competency based pay schemes can be to promote enthusiasm for training and development, in order to acquire the additional competencies that bring with them the opportunity of increased pay. However, if not properly controlled this can lead to additional, unplanned, resource burdens on the organisation. Alternatively, the emphasis is too much on the pay outcome, with development given lower priority than messages on reward.

Adams (1998a) reports how the introduction of a competency based performance management system in a housing association led to greatly increased demand for training and development to assist individuals to move along newly-introduced salary bands (the salary bands being determined by levels of competency). The demand was so great that the housing association had to set up its own training and development unit in order to meet it.

- There is evidence that raters become more lenient as time goes on. There is a risk of manipulation in appraisal scores that suits both appraiser and appraisee.
- Organisations should avoid using competencies that do not discriminate between people's performance and are not highly relevant to the success of the job. Otherwise, an over-elaborate system might be created that makes it harder, not easier, to value superior performance.
- There is a risk of gender and ethnic bias. For example, research conducted by IES for the Equal Opportunities Commission, found that gender-role stereotyping is reinforced in the way that competencies, such as those for managers, are defined. The result is that women are consistently rated lower than men in terms of leadership ability. In addition, the process of competency based assessment, and so the awarding of a pay increase, is highly reliant on the role of the line manager and is therefore open to distortion by their individual views. Staff in many organisations, but particularly in the public sector, are concerned about inconsistent scoring.

These factors make it particularly important for organisations to monitor the impact of their competency based pay systems by gender and ethnicity. As Adams (1996) has pointed out, without such monitoring, organisations run the risk of:

- treating individuals unfairly
- wasting the talents of individuals and groups in the organisation
- exposing themselves to legal action, including equal pay for work of equal value claims.

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3.9 Conclusion

Competency based pay is a term used to refer to a wide range of different pay arrangements, some of which are effectively skills based pay, and others that are individual performance related pay by another name. In this paper, the focus has been on systems that link individual reward to the demonstrated use of competencies, either as the main source of pay progression, or more commonly, combined with other forms of pay determination. In many cases, the arrangements defined by the organisations that use them as competency based pay, fall within the definition of contribution related pay developed by Brown and Armstrong (1999), in that they reward both the way the job is done and the outputs of that behaviour.

Despite the popularity of linking individual competencies with, for example, recruitment and selection, and training and development, only a minority of organisations have passed the 'final frontier' (Adams, 1999a) of linking competency and reward. Even fewer have done this in a pure form, *ie* without taking into consideration performance against, for example, work objectives. This may, in part, be because commentators associate the effective use of competency based pay with particular organisational developments, including the move to flatter structures and the introduction of broad-banded pay arrangements.

In addition, employers may be wary of the potential pitfalls of competency based pay, which include escalating costs, heavy demands on management time, problems of assessment, employee resistance, and equal opportunities considerations.

Nonetheless, competency based pay has been found by some organisations to bring substantial benefits in changing organisational culture and in supporting broader HR strategies.

Competency based pay may therefore be suitable in organisations where:

- there is an over-emphasis on outputs
- how you do the job is as important as the results
- alignment is sought with other HR processes through competencies

- fit with a performance appraisal is required
- a new values system has been introduced
- cultural change towards greater flexibility is sought.

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