Competency-based Pay in the Manufacturing and Service Sectors

By Henry Jahja and Brian H. Kleiner

Employees are one of the most important assets that a company possesses, whether it is in the manufacturing or service sector. To keep good employees, jobs have to allow room for growth, and people have to be motivated by things other than titles. Furthermore, with the trend toward "flatter" organizations and fewer employees, companies need to motivate the remaining employees to make a profitable contribution while still holding them accountable for their work. Organizations can no longer afford to pay an employee whose performance does not support business strategies and organizational goals.

One of the responsibilities of human resource management is to devise alternative ways to link pay or rewards to performance. One way is through competency- based pay, in which employees are paid for their demonstrated competencies. The new pay philosophy and new pay system address an organization's needs to motivate employees and support business strategies.

What is competency?

Competency has been defined by E.G. Bogeley as "demonstrable characteristics of the person, including knowledge, skills, and behaviors, that enable performance." The emphasis in this definition is on the characteristics of the person. This is important because the competencies are independent of a job or position. Competencies must be demonstrable to serve as the basis of pay. If it is not possible to verify that a person has a competency, the company should not be paying based on that characteristic. Furthermore, competencies indicate the potential for performance. Therefore, an organization must have both a competency-based pay plan and a performance-based system to motivate performance.

Why do we need a competency-based pay system? Many organizations have tried to modify their traditional compensation programs—for example, by shifting and narrowing salary ranges. However, this approach does not address two important underlying issues. The first is that for many organizations, especially those changing their culture and values, traditional salary ranges no longer work, either practically or philosophically. Ranges tend to shift every year, locking employees into the same section of the range rather than allowing them to move forward. In addition, ranges often fail to differentiate top performance from just the average performance, and they tend to reward seniority rather than performance. In reality, merit increases have become merely market adjustments.

Second, traditional compensation programs focus on the job, not on the person. This approach is based on the erroneous assumption that workers do not influence their jobs. The fact of the matter is that employees do have an effect on the nature of their work. By assuming that they do not, organizations often fail to design a truly effective compensation program-a competency-based program that promotes their strategic values and goals.

Designing the pay plan

In his article "Paying for the Skills, Knowledge, and Competencies of Knowledge Workers," G.E. Ledford identified eight fundamental design dimensions of the pay plan.

1. Will competencies be narrow or generic?

Narrow competencies may be limited to particular business units, work locations, organizational levels or functions, or jobs.

Generic competencies apply to all employees in an organization. For example, the plan may ask all employees to understand the organization's business.

2. Will the plan emphasize existing or novel competencies?

Existing competencies encompass skills and knowledge that are familiar to the organization. Advocates of existing competencies believe a company should study its high performers, identify what distinguishes them from others, and pay all employees for obtaining these distinguishing competencies.

Novel competencies encompass new skills that an organization formerly did not have or did not give value.

3. Will the plan define competencies with a bottom-up or a top-down approach?

The bottom-up approach mimics a conventional job analysis in that it starts with an examination of all the competencies employees use in their work.

The top-down approach assumes that competencies should be defined by organizational needs, rather than by current work patterns.

4. Will competencies be complex and precise or elegant and nimble?

Complex and precise competencies resemble traditional compensation. HR professionals and consultants have naturally tended to create complex compensation plans encompassing many different competencies and control elements. In the process, they may replicate a basic problem with existing pay plans.

Elegant and nimble competencies are the most desirable form of competency-based pay. But to achieve this nimbleness, organizations may need to radically simplify pay systems to emphasize easy adaptability to continually changing conditions.

5. Will competencies be easily observable or abstract?

Observable competencies, such as operating machinery or conducting effective problem solving meetings, are relatively easy to describe.

Abstract competencies, such as creating new products, are much harder to define and verify. Thus, organizations will have more difficulty in defining abstract competencies when systems are based on this design.

6. Will competencies have enduring value or temporary value?

Enduring value competencies are assumed to have long lives and to be relatively stable over time. Companies

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using this approach are, therefore, willing to put considerable effort into refining competency-based pay systems in the belief that they will be in place for many years and require only minor changes.

Temporary value competencies are assumed to have short lives. Competency-based pay systems that have temporary value can be much more nimble than those that assume that competencies have enduring value. This enables the pay system to keep up with new competencies needed by the organization. Technical knowledge in particular has a short shelf-life.

7. Will the plan use a permanent annuity (such as base-pay increase) or a one-time bonus to reward the acquisition of the competencies?

Annuity-like base-pay increases compound over time, and their ultimate, compounded value usually far exceeds the original amount of the increase. Base-pay increases are particularly suited to competencies that have enduring value. Base-pay systems appear to be much more common than bonus systems, in part because companies view competency-based pay as a replacement for job-based salary systems.

Bonuses are much more appropriate for acquisition of competencies that have temporary value. They also may be useful when a company must control base pay costs, such as when base-pay levels exceed market averages before adoption of the competency-based pay system.

8. Will the competencies have a marketplace value or a strategic value?

Some firms attempt to value competencies by reference to other companies' pay plans. Others use market survey data to help value the overall system, rather than each competency. Market data may indicate the worth of a few key benchmark positions in the competency ladder, such as entry, average, and highly skilled expertise.

Organizations also rely on strategic valuing, in which they estimate what a skill is worth to the business. This may involve intentional departures from market rates.

Case Studies:

Case #1 (Manufacturing)—Northern Telecom's Meridian PBX Plant.

Competency-based pay programs are most common in manufacturing environments that rely on continuous-process technologies. As a result, most of the employees covered by these plans are nonexempt workers. This has happened for two reasons. One, it's easier to identify skill sets needed by direct-labor employees than it is to identify skills needed by supervisors and knowledge workers. Two, more manufacturing companies are organizing around high-performance work teams in which employees are expected to learn each other's jobs.

At Northern Telecom's Meridian (NTM) plant, managers price each block of competency or skill equally. They do not designate one skill as more difficult than another. The single most important reason why NTM wanted its workers to possess multiple skills is so that when one worker is out sick, another can "pinch-hit."

"We know in our hearts that employees would chase after the skills that they already could perform or that they found the most agreeable," explains LeBlanc, NTM's former Assistant Vice President of Compensation. "So we said that the first three skills that an employee acquired would be worth 50 cents an hour per skill, regardless of which three skills were learned first. The next four skills were worth 65 cents more an hour per skill. And the final three skills would be worth 75 cents an hour per skill."

By doing it this way, employees judged the relative worth of each skill, rather than the company judging for them. NTM identified the skill blocks needed, based on the actual work performed at different work stations. One station, for example, involved the operation of a complicated wave solder machine, whereas another was a relatively easy manual-assembly operation.

NTM provides training to its employees so that those employees who wish to learn an extra skill are channeled properly.

Case #2 (Service)—Company X.

Company X is a relatively small service organization of about 1,000 mostly professional and technical employees. It recently modified its business strategy to reflect changes in market demands and expectations. Competition in its core business required broadening its focus to include previously ignored markets, and de-emphasizing short-term, largely one-time sales to build longer-term relationships with key customers.

Management began by identifying the organization's critical capabilities—the broad, collective abilities needed in sufficient quantity and quality to execute the revised strategy. Chief among those were: 1) pursuing new markets aggressively; 2) building and sustaining long-term relationships with customers; 3) developing the required technical knowledge to penetrate new markets; and 4) using a team approach to serve customers and help solidify strong relationships.

After analyzing its strengths and weaknesses in each of those areas, the company translated broad capabilities into seven basic areas of competency for individual employees. These individual competencies are customer focus, teamwork, leadership, accountability, business acumen, communication, and technical expertise. The following four stages were then defined in terms of expanding levels of employee contribution: 1) the learning stage; 2) the applying stage; 3) the guiding stage; and 4) the shaping stage.

After every competency was defined, several employee focus groups tested and validated the definitions. A management team then began assessing employees against the definitions and assigning them to an appropriate stage.

Along with these competency requirements, management then developed a relatively flat, team-oriented culture, with employees taking on a range of activities needed to pursue new market opportunities and manage new and developing customers.

Management firmly believes that employee attitudes have changed and reports renewed enthusiasm, with employees working smoothly in teams and focusing their efforts on customer needs. The company now has a system it can use over the long term to grow, develop, and reward employees without a traditional upward career ladder.

Case #3 (Not-for-profit)—American Chemical Society.

The American Chemical Society (ACS) is the world's largest scientific society. It is a not-for-profit educational and scientific organization with more than 150,000 chemical scientists and engineers as members. ACS is also one of the largest scientific publishers in the world and is highly regarded by professionals in industry, academia, and government.

The senior management team has made a commitment to continuous improvement in the design, development, and delivery of leading-edge products and services to the society's membership. The team looked to the future to anticipate members' needs and to determine what skills and competencies its workers would need to meet these needs. This analysis led the organization to begin to redefine the platform on which its human resources programs are based.

The call for an enhanced human resources program was an important part of the overall transition strategy. The HR team concluded that ACS should shift some of the elements in its compensation program. In this way, pay would align more closely with ACS's organizational strategy and with the values, expectations, and characteristics it will need in the future.

As a first step, the team, together with focus groups, assessed the existing compensation system to identify the direct and indirect "messages" being sent to employees about such things as job value, performance expectations, and rewards and recognition. Every employee develops an understanding of management's priorities and values by observing how it distributes rewards. For example, many pay plans send the message that employees are entitled to an annual salary increase.

Based on preliminary assessments, the HR team concluded that the compensation program should: 1) emphasize results and the value of contributions, and de-emphasize the job hierarchy as the basis for reward and recognition programs; 2) emphasize adding value, and

Design Dimensions of the Pay Plan	Northern Telecom PRX	Company X	American Chemical Society
Narrow or Generic	Narrow	Generic	Generic
Existing or Novel	Existing	Novel	Novel
Bottom-up or Top-down	Bottom-up	Top-down	Top-down
Complex or Nimble	Nimble	Nimble	Nimble
Observable or Abstract	Observable	Observable	Abstract
Enduring or Temporary	Temporary	Enduring	Enduring
Permanent annuity or Bonus	Permanent	Permanent	Permanent
Marketplace or Strategic Value	Strategic	Strategic	Strategic

Table 1. Comparison of case studies

de-emphasize the importance of job tenure as a value attribute; and 3) emphasize career development built on the acquisition and application of knowledge and skills, and de-emphasize equating career development with frequent upward movement.

The HR team also felt that the reward system should follow the organizational model for the future. Furthermore, it should reinforce attention to customers, promote innovation and teamwork, encourage the development of needed skills and competencies, and create a win/win situation for the society and its employees. ACS believes that the shift to a competency-based framework for performance management will help employees assess their own strengths and weaknesses and help them better understand the behaviors associated with high performance.

Analysis and conclusions

As the case studies indicate, the manufacturing and service sectors share several characteristics—a nimble approach, permanent annuity, and strategic value. They differ in their use of narrow competencies, existing competencies, the bottom-up approach, and enduring value (Table 1). The competency-based approach to pay offers a flexible, effective compensation alternative for most organizations. Such programs can be customized for any type of business—manufacturing or service, industrial or consumer, wholesale or retail, private or public, large or small, profit or not-for-profit. They can also be incorporated into any key pay component, including base salary, salary increases, and variable compensation. Further, competencies can apply to individuals, groups or teams, or even entire organizations.

More intensive case studies which detail the experiences of organizations that have experimented with competency-based pay systems are needed. These will help compensation professionals to fully understand the system. In the meantime, organizations must broaden their views about the range of choices available when designing competency-based plans. ■

For further reading

Bailey, S., "If the Shoe Fits: Not-for-profits Try Out New Compensation Plans," *Compensation and Benefits Review*, Vol. 28, No. 3.

Bogeley, E. G., "Link Employee Pay to Competencies and Objectives," *HRMagazine*, Vol. 40, No.10.

Cofsky, K. M., "Critical Keys to Competency Based Pay," *Compensation and Benefits Review*, Vol. 25, No. 6.

Grib, G., "Pay Plans That Reward Employee Achievement," *HRMagazine*, Vol. 40, No. 7.

Ledford, G. E., "Paying for the Skills, Knowledge, and Competencies of Knowledge Workers," *Compensation and Benefits Review*, Vol. 27, No. 4.

Morris, J. L., "Lessons Learned in Skill-based Pay," *HRMagazine*, Vol. 41, No. 6.

Shari, C., "Master the Compensation Maze," *Personnel Journal, Vol. 72*, No. 6.

Sparrow, P., "Too Good to be True?", *People Management*, Vol. 2, No 24.

Stark, M., "Jaguar Cars Drives Toward Competency-based Pay," *Compensation and Benefits Review*, Vol. 28, No. 6.

Tucker, S.A., "Competency-Based Pay on a Banding Platform," *ACA Journal*, Vol. 3, No.1.

cated permanent teams, but it continued to deliver base pay according to individual job classifications with across-the-board adjustments and step-rate increases based on time on the job. Employees had no performance stake in their regular paychecks and no links between pay, teamwork, and individual contributions to team success. The real message? All that employees really needed to do to get a pay raise was just show up.

When is it worth changing the base pay system to support teams? Because of the time, expense, and potential for disruption, usually only those companies with dedicated permanent teams change the base pay system to support them. However, if teams do much of an organization's work, it should consider changing its base pay system to support those teams, or at least moderating potentially dysfunctional aspects of its traditional base pay structure.

Dedicated Permanent Teams

Dedicated permanent teams are well suited to such functions as order entry, customer service, long-term product design, and core manufacturing, for example. (See Exhibit 2.) Companies that rely heavily on such teams are the best candidates for restructuring base pay and related systems, including job evaluation. Traditional job evaluation doesn't work in a team-based environment because it deals in narrow, individually focused jobs. Effective team-based jobs require more breadth to allow team members to concentrate their efforts on team productivity and performance, not just on their individual efforts.

At the same time, it is difficult to evaluate team-based jobs against the external market because of their unique design and the scarcity of compensation data for comparable team-based jobs. So when companies do price team positions against the market, the results are based on narrowly defined jobs. One way to estimate market pay for a team-based position is to evaluate several jobs that represent the mix of work the team member does and weight the results for these narrowly defined jobs according to the mix of responsibilities in the position.

Another creative and effective approach is to price individual jobs and cluster them before the transition to teams. Then use these clusters to structure a more flexible, broader banded pay system. For example, one company clustered its R&D team-based jobs into four broad bands to ensure market competitiveness while allowing room to maneuver within the bands. The company thus gained flexibility in market pricing against jobs that require similar skills and abilities. It also refocused its job evaluation process to emphasize the broader nature of its jobs. Finally, it made a conscious decision to pay a premium to employees with experience in or knowledge of team-based work. Its rationale is that individuals with team experience offer greater value to the organization and would represent a greater loss if lured away.

A company's pay structure also must be more flexible if the company elects to price team-based jobs on the basis of internal equity rather than the market. The typical multilevel pay structure has many levels, with perhaps only 5% to 10% between midpoints. This typically creates a need for drawing a myriad of minor distinctions among jobs, which can disrupt teamwork. Broad banding is a natural solution. Companies also should consider tying growth in base pay to growth in employee skills, rather than to the dictates of the external market.

In addition, by replacing traditional merit pay with a skill-based approach, companies can be sure they are rewarding employees for the acquisition of the skills that will help the teams and the company succeed. For further treatment of this idea, see Gary Bergel's "Choosing the Right Pay Delivery System to Fit Banding."

Another consideration when developing a pay structure for dedicated permanent teams is how to handle transfers back to jobs in a traditional structure. If the teams are in a banded pay structure and the rest of the organization is not, the company can align the team-based banded pay structure with the organization's pay structure using a translation table to slot jobs in either structure. If both are in a banded structure, this is not necessary.

Dedicated Temporary Teams

Dedicated temporary teams, usually brought together to solve specific, possibly urgent problems, may engage in short-cycle product develsomewhat outside its product line. Rewarding this team on the company's annual incentive cycle went against the nature of the team's work, so the company developed a special incentive providing small payouts upon the successful completion of early milestones and a balloon payment upon the successful introduction of the product. All payouts were based on the team's performance and were split evenly among team members to reflect their relatively equal contributions to team success. In addition, the payout level was somewhat higher than typical annual incentive awards because of the project's perceived level of difficulty and risk and the potential difficulty of reintegrating team members into the organization after the project's completion.

If a dedicated permanent team or a dedicated temporary team stands alone (little interaction with the rest of the organization), its incentive plan can be unique. However, if it is interdependent with the rest of the organization, its incentive plan must be designed to be integrated with other organizational incentive plans—but with goals that are specific to the team. Integration should avoid equity problems between team members and other employees.

Nondedicated Permanent and Temporary Teams

Members of nondedicated teams may also do substantial other work in the organization and may be eligible for other incentive plans. Should such teams be offered team-based incentives? The first issue to consider is the nature and importance of the team's work. If a team is created simply because a team is the best organizational form to complete the work, that is not a compelling enough reason to separately reward the team's work. Similarly, if the team's work is not central to the organization's immediate success or is not strategically important, the team also may not be a candidate for team-based incentives.

However, if the work of a nondedicated team is absolutely critical, team-based incentives are important in emphasizing the work's value. Since team members sometimes are eligible for nonteam incentives as well, the company needs to balance incentives for both team and nonteam work. The design solution may be as simple as reducing the target amount for the traditional incentives and shifting the remaining potential payout into a team-based program.

The challenge gets considerably more difficult if team members serve on a number of teams. In these cases, the designer must provide a way to track each team's payout and balance payouts for each team member. At the same time, award sizes must be meaningful. An information systems organization in this situation ranked each team project on cost savings and strategic importance. The overall funding of the plan was based on the success of each team according to the rankings, with those teams with larger potential cost savings and higher strategic importance determining more of the funding. Individuals' payouts were given as a percent of base salary but with no individual performance criteria. This design clearly communicated which teams were most critical to the organization's success and provided all teams with an incentive to invest in the success of those critical teams. This approach provided the organization with the flexibility to shift resources to critical projects while rewarding team success. Although payouts were individual-based, the emphasis was on funding, which was based on collective team results.

Companies also can provide nondedicated temporary teams with discretionary spot awards for superior team performance and results.

PERFORMANCE MANAGEMENT

Recognizing that performance management systems need to be altered for teams, a company's first impulse usually is simply to modify its existing individual-based performance management system. This is the wrong way to begin. Performance management for any critical team should be based, above all, on evaluation of the outputs of the team and its overall effectiveness. Evaluation of individual contributions—both technical and behavioral—should be secondary.

A team performance management system requires a five-step process:

• *Create the team.* For performance management to be successful, each team must be created

CONCLUSION

As companies embrace team-based work design to improve customer focus, productivity, and quality, among other key factors, they also must be prepared to reinforce those changes through their reward systems. Organizations have adopted team-based work systems, at least in part, because of the flexibility they offer. This flexibility presents the greatest challenge to reward system designers, as organizations seek to develop customized reward programs that carefully integrate with the team's work system.

Just as they determine what type of team is most appropriate for the work being done, companies also must examine their current reward systems to make sure they are appropriate for the work system being used. Unless the company addresses gaps or contradictions that might limit team or organizational success, it risks losing any gains resulting from the team-based work system.

Designing rewards that align with and support the work of a team-based organization is well worth the investment in time and resources —despite the difficulties and challenge. After all, implementing a reward program that supports the organization's objectives and work system sends a powerful signal about what is important to the company and what it takes for it to achieve success.

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