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SKILL BASED PAY

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ABSTRACT

Skill based pay systems are described and contrasted with job based pay systems. Currently, skill based pay is used most commonly in technical ladders and with production employees in new high involvement plants. Major advantages and disadvantages of skill based pay are considered. Organization conditions in which skill based pay is applicable are discussed. Skill based pay probably will be increasingly prevalent in the future.

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Pay systems typically are based on the principle that people should be paid, first and foremost, according to the worth of the jobs they do. In short, the system pays the job, not the person. In practice, this means that most pay systems use as their foundation an analysis and evaluation of the job the person does. This job evaluation allows organizations to decide how much a particular job is worth and, therefore, to decide the range of pay that an individual can receive for performing the job. This approach to pay is so common and so well accepted that it is rarely challenged. Indeed, it is fair to say that this approach is the cornerstone of every major corporation's pay plan.

There is, however, an alternative to the job-based approach, an alternative which is becoming increasingly popular. The alternative is to pay people for the skills that they have rather than for the job they do. This approach, which is commonly called skill based pay, starts from an entirely different perspective. It starts from the viewpoint that individuals should be paid for their skills. It argues that paying for skills has a number of advantages which make it superior to paying for jobs. Unfortunately, there is a paucity of data concerning the relative effectiveness of skill based pay, so many of the claimed advantages are hard to prove. Nevertheless, it is possible to identify

some of the advantages of this approach and to identify situations in which it seems to be particularly effective. But before doing this, consideration needs to be given to how skill based pay plans operate and where they are currently being used.

The Skill Based Approach

The design of skill based pay systems starts with the identification of those tasks which need to be performed in the organization. Next, the skills which are needed to perform the tasks are identified and tests or measures are developed to determine whether an individual has learned the skills. The number and kind of skills that each individual can learn are also determined. Employees are then told that they can learn skills of a certain nature given their positions in the organization. Individuals are typically paid only for those skills which are needed by the organization and which they currently can and are willing to perform.

Skill based pay is easiest to describe in the case of a production work group in a manufacturing plant. Typically, it is relatively easy to identify all the tasks that a production group needs to do, and it is possible to specify what constitutes skill acquisition. When skill based pay is in place, individuals are usually told that they can learn all of the skills which are needed to do the work of their group and that they will be paid more as they learn more skills. Thus, employees can earn pay increases at a rate commensurate with their individual ability to acquire new skills. Table 1 shows a typical pay progression system that might be in place in a production or manufacturing situation.

TABLE 1
SKILLED BASED
PAY RATES

<u>Skills Mastered</u>	<u>Pay Rate Per Hour</u>
Entry	6.00
1	6.50
2	7.00
3	7.50
4	8.00
5	8.50
6	9.00
7	9.50
8	10.00
All Plant	12.00

Note that at the highest level, or what is called "all plant level," the expectation is that at the least an individual can do all tasks that his or her work group requires. In some skill based pay plans, individuals are asked to learn all the jobs in the entire plant. They reach top pay only when they have accomplished this level of competency.

In many respects, the application of skill based pay to traditional manufacturing jobs is the most clear-cut and straightforward use of the concept. Typically, it simply means that individuals learn tasks which might be considered horizontal to the tasks which they otherwise would perform. That is, they learn jobs up and downstream in the production process. The plan usually contains a requirement that they learn a certain minimum number of skills and that they be willing and able to perform any skill they are paid for at any time they are asked.

The idea of paying for skills is not quite so easily and straightforwardly applied to other kinds of work. Skill based pay for managers and professionals in an organization raises a number of interesting issues. Managers and higher level professionals can learn skills that are horizontal to them just like a production worker can. That is, a personnel manager could learn accounting, and so forth. They also, however, can learn skills that are lower than them in the organization, that is, downwardly vertical from them. Examples here would include learning manufacturing production skills, typing skills, etc. They also can learn upwardly vertical skills, such as higher level management position skills, and finally they can learn the skills that are needed to perform their job in greater depth. That is, if they are an accountant, they can learn more about the tax code, etc.

The development of a skill based pay system for managerial and professional employees in an organization involves making a number of interesting and difficult decisions about which skills it is desirable to have people learn. That is, it must be determined whether it is useful for these employees to learn vertical skills, horizontal skills, and depth skills. The learning vertical skill is not limited to managerial and professional skills; it can come up in the case of production employees as well. In some skill based pay plans, production employees are rewarded for learning upwardly vertical skills. Similarly, they can develop greater depth in a certain type of specialty, such as machining and electrical maintenance, and this can result in increased pay. Still, developing such plans for production employees in many respects is more straightforward than developing a skill based pay system for managerial and professional employees.

In the cases of high technology employees and research and development employees, it is obvious that greater depth skilling should be rewarded. There, skill depth is a critical competitive factor if being at the forefront of technology is essential to the success of the organization. In these situations, it is usually apparent that it is to everyone's advantage to have at least some employees who develop a real depth of skill in particular areas.

Skill based systems do not necessarily need to include or exclude the idea of paying for individual performance. They are in a sense neutral on the point whether individuals should receive more pay depending upon how well they perform a particular skill. It is quite possible to do performance appraisals for individuals that assess how well they perform each of the skills for which they are being paid. In

this sense, skill based pay is identical to job based pay in that it allows for organizations to vary the amount of total compensation that an individual receives according to the individual's performance. An important difference remains, however. In skill based pay the starting point for pay is determined by the mix and depth of an individual's skills rather than the particular job that the person is assigned to.

Earlier it was mentioned that any skill based pay system needs to be based on measures of skill acquisition or competency. Although many of the systems which are currently in effect use peer group assessment of skills, there is no reason why this particular approach has to be part of a skill based system. Skill based pay merely requires some test of skill acquisition. Depending upon the situation, this test could be based on supervisor judgment, written questions and answers, or peer group appraisal, to mention some of the more obvious possibilities.

Finally, skill based pay systems face a unique issue when they try to price skills in the marketplace. The theory is that, just as with job based pay, an organization should go to the market and assess how much people with similar skills are paid in order to determine the pay for a particular skill. This can be a particularly tricky issue with skill based pay since there may be no other organizations in the area with this approach to pay. Nevertheless, skill based pay still can be market based pay and there is nothing in the concept of skill based pay which ignores or in any way contradicts the principle of paying market rates.

In summary, the concept of skill based pay simply says that individuals are paid for the number, kind, and depth of skills that they develop. These skills may be horizontal, depth, or vertical skills. As

we shall see later, the kind of skill development an organization decides to reward needs to be a function of the purpose that it hopes the skill based system will serve.

Use of Skill Based Pay

Technical ladders probably represent the most widespread use of skill based pay today in organizations. These ladders pay individuals for the depth of skill they have in a particular technical specialty. They are most commonly found in the research and development labs of large organizations, and in apprenticeship systems for skilled tradesmen. Technical ladders are also found in such diverse organizations as universities, where they are used for the payment of faculty, and corporate law departments, where they are used to recognize the development of legal skills.

The idea of a technical ladder has been around a long time and often is not identified as a form of skill based pay. In fact, rather than being called skill based pay, it is usually treated as part of a job based pay system. The technical ladder has never been seen as dramatically different from or incompatible with the traditional practice of paying for jobs. Different job descriptions are written for different positions on the technical ladder. Nevertheless, in most cases it is in fact a form of skill based pay, one that is based on depth-skilling rather than horizontal or vertical skilling. For this reason, it is probably the least "radical" approach to paying for skills.

During the last ten years, skill based pay plans have been installed in a number of new manufacturing plants. This application represents a very different use of skill based pay than the technical

ladder. Here production employees are paid for horizontal skills and in some cases, upwardly vertical skills. In a few cases, they are also paid for learning downwardly vertical skills, such as cleaning and routine production tasks. The major purpose of the plan, however, is to encourage individuals to learn horizontal skills and some upwardly vertical skills.

There is no definitive estimate at this point of how many plants have skill based pay for their production employees. It is the most common method of paying individuals in high involvement or high performance new plants. These plants have been built since the early 1970's and now are relatively common. Estimates of exactly how many there are vary from 200 upward. They have been built by such large corporations as TRW, Procter and Gamble, General Foods, General Motors, Johnson and Johnson, and Atlantic Richfield. In almost all of these high involvement plants, skill based pay is used for the production employees, however, it is not used for the managerial and other employees. Thus, the typical high involvement plant has both a skill based pay system and a traditional job based pay system.

There appear to be relatively few instances where established organizations have moved from a job based pay system to a skill based pay system. Thus, skill based pay at the production level continues to be largely applied in new plants, where it is the first pay system that employees encounter when they enter these organizations.

In summary, then, the major uses of skill based pay has been with technical ladders and with production workers in new plant start-ups. Little application has been made to most managerial and staff jobs and few efforts have been made to try it with production workers in already

established manufacturing or service situations. In short, creating skill based pay in new settings seems to be much more popular than changing from job based pay to skill based pay.

Effectiveness of Skill Based Pay

The critical question concerning any management practice is its effectiveness. In the case of skill based pay the obvious question is, how does it compare in effectiveness with job based pay? This is not an easy question to answer. First, there is a real paucity of data on how effective skill based pay systems are. Secondly, it is often difficult to separate the impact of a pay system from other organizational practices in order to reach a conclusion about its effectiveness. Pay is such an integral part of the overall management system in many organizations that it is difficult to tease out the effects of the pay system from the effects of other things. Finally, skill based pay has been tried in only a limited number of situations. Thus, the effects of different forms of skill based pay and its applicability to different types of organizations are as yet untested. Nevertheless, it is possible to consider some of the gains and losses that come from skill based pay. These are relatively well documented in the case of new plants. Enough research is available on these new plants to discuss with some confidence the effects of skill based pay versus the effects of job based pay for production workers.

Advantages of Skill Based Pay

The single most obvious advantage of skill based pay in a production situation is flexibility. When individuals can perform multiple tasks, organizations gain tremendous flexibility in utilizing their work force. There are a number of conditions which can make this

flexibility extremely desirable. These include such things as covering for absenteeism, turnover, and employees who are in training. If the organization's products frequently change, it can be desirable to have a highly trained workforce that can smoothly adapt to transitions in the production process. Flexibility can also be important if there is need for most employees to be working at a particular stage or particular point in the production process. For example, in manufacturing situations it is not uncommon to face parts shortages or a need to re-work part of the assembly process. If everybody can do all portions of the assembly process, then all employees can work on the needed products and cure the common ill. This is often far superior to a situation where only a few individuals can work on each particular phase of production process, and thus production is bottlenecked or the product shipment is held up until the relevant individuals can correct the problem with the product or install the missing part.

Traditionally, organizations have recognized the need to have some multiply-skilled individuals. Most companies that have operated assembly technologies have utility workers who are trained to do multiple assembly tasks. Usually this is limited to a small percentage of the work force, however. There is an important difference between having a few utility people and having skill based pay. In skill based pay, all individuals are flexible and can work at any point in the production or service process. This, of course, means that there is a much greater degree of flexibility in a skill based pay system.

Overall, the flexibility that comes from skill based pay may lead to a slightly leaner staffing among production employees. Because multiple individuals can fill in, problems of absenteeism and turnover

are not so severe, and as a result, there often isn't a need to have as many extra employees on the staff to cover for absenteeism and activities that would take people away from direct production activities, such as training and meetings.

Many of the flexibility advantages inherent in a skill based pay system can be gained by simply having a small percentage of the work force cross-trained in the utility worker concept. Thus, the advantages of skill based pay must extend beyond simple flexibility, if in fact they are going to offer a significant incremental advantage over what is possible with a traditional job based pay system and a few individuals trained as utility workers.

When combined with a participative approach to management, there is evidence to suggest that skill based pay can produce benefits other than those that stem from having a flexible work force. This seems to be particularly true when the system includes acquisition of some upwardly vertical skills by production level employees. When employees learn both horizontal and some vertical skills, they gain an entirely different perspective of the organization's operations. They come to understand the entirety of the organization's operations, the way in which it is managed, and the information which supports it. This allows them to do a number of things that they could not do in the absence of this breadth of understanding and perspective.

First, it allows employees to solve systemic problems more effectively. Their broader perspective helps employees be more innovative in improving operations. Thus, if they are in a quality circle or any other problem solving arena, they are more effective because of their broader perspective. Similarly, when they are working

on a particular phase of the production process, they are often more effective in solving problems because they know the entire production process. They are not limited to the perspective that comes from doing just one step in the process. They also can communicate more effectively with individuals doing other parts of the production process because they understand what others are doing.

Secondly, employees often gain a greater sense of commitment to seeing that the organization operates effectively when they have an overview of the entire operation. Feedback about such things as quality and production rates become more meaningful to them and thus, their intrinsic motivation to perform increases. This can result in improved performance and better operating results for the organization.

Third, skill based pay is an important reinforcer of a participative culture. It is a concrete way that organizations can back up their commitment to participative management and to such statements as, "people are our most important resource." It delivers a tangible reward in return for individuals doing just what the organization says it believes they can do: grow, learn and develop. Because of this, organizations which have skill based pay typically have cultures which are seen as valuing human development and are quite optimistic about the capability and potential of the people who work there. This effect, although sometimes difficult to quantify, is nevertheless a very real and important advantage of skill based pay.

Finally, and perhaps most importantly, when employees are broadly knowledgeable about the operations of an organization, the potential exists for them to be more self-managing. That is, they are in a better position to control their own behavior, coordinate with others, and

ultimately to participate in self-managing groups and teams that operate a particular part of the organization. To the degree that skill based pay aids in self-management, tremendous savings are possible. It can lead to fewer levels of management, and can also reduce the number of staff and support personnel. This is particularly true when upwardly vertical skills are included so that individuals learn some of the staff support roles and are able to perform them themselves. Not only is there no need in these cases for people to wait for a specialist to come solve a problem, there may be no need for the staff specialist at all because the individuals can do the work themselves.

In summary, the advantages of skill based pay are of two types. First, there are those which stem simply from flexibility and these include leaner staffing, fewer problems with absenteeism, turnover, work disruptions, and the ability of many employees to help with glitches in the production process. The second kind of advantage comes about when skill based pay is combined with a management style which pushes information, knowledge and decision-making to the lower levels. (In these situations, it is possible for the organization to operate with fewer people, to do better problem solving and also to have a more motivated and committed work force.) This comes about because individuals have the knowledge and skills to become self-managing and this, in turn, triggers intrinsic motivation which encourages individuals to do a high quality job and to be concerned about production results.

Disadvantages of Skill Based Systems

There are some obvious disadvantages to skill based pay systems that need to be considered. Probably the most obvious has to do with

the pay rates that it tends to produce. The very nature of the system is to encourage individuals to become more valuable to the organization. This means that they need to be paid more than they would under a traditional pay system which limits their growth, development and therefore, value. Thus, skill based pay systems typically have higher average hourly wages than do non-skill based pay systems.

Skill based pay systems commit to everyone having the opportunity to learn multiple skills. For this to happen, a large investment has to be made in training and, of course, training is expensive. The time of trainers is expensive as is the loss of production time that results from people trying to learn new skills. The time of trainers is often not a significant problem because much of the training that goes on in skill based pay plans is peer group training and is done as a normal part of the job. The more serious problem is that individuals are constantly learning new jobs, and thus there are production losses and problems due to inexperienced people doing the work. Because individuals are always trying to learn new skills, there is a constant need to make trade-offs between production and skill acquisition. Indeed, in the worst case scenario, it is possible to have an organization that has many people who know how to do every job but finds that at a particular point, all jobs are being done by individuals who don't know how to perform them at a high level of competence.

Skill assessment can also be a serious problem with skill based pay systems. In many respects, the problem here is no different from what it is with the performance appraisal part of a traditional pay system, but it is a more frequent problem since individuals have to be assessed on multiple skills rather than on skills for doing just one task. Thus,

it is particularly important in a skill based pay system to have good assessment procedures in place.

Skill based pay also makes market comparisons a bit more difficult. As was mentioned earlier, it is difficult to go to the market and get a pay rate for a skill, particularly when it is being looked at in the context of someone who has several other skills and will only be performing that skill part of the time. Thus, in many cases the pay rates which are developed for individuals have to be somewhat of an estimate of what it takes to attract, retain and satisfy somebody with that particular skill mix.

Skill based pay systems also have a "problem" that occurs with maturity. Even in the most ambitious skill based pay system, individuals can "top out," that is, they can learn all the skills that the program calls for them to learn. This can lead to discontent because they have become so accustomed to learning, growing and receiving higher pay. They are still better off than they would be in the typical pay system, but nevertheless, may be unhappy about topping out.

There is a certain level of administrative complexity that accompanies skill based pay systems. Keeping track of exactly who is qualified on all the different jobs and of the different pay rates certainly requires some bookkeeping support. In addition, since individuals can move at almost any time into a new skill and master it, it means that pay changes are occurring throughout the year and thus is not a simple matter of once a year changing peoples' pay based on merit or seniority.

The desire of individuals to move from job to job can be counterproductive if it means that they are unwilling to stay and produce for a while in the job that they have just mastered. For this very reason, many organizations with skill based pay have gone to payback periods. This is a period of time during which an individual has to perform the job that has already been mastered in order to pay back the organization for the investment it has made in his or her learning and development.

It can be hard for an individual to remain current in a large set of skills. Thus, although an individual may be paid for having multiple skills, he or she may not be able to perform all of them as well as when they originally learned to perform the skills. Most skill based pay systems require that an individual regularly performs the skill in order for it to be something that the individual is paid for. This is a good principle, but it can often get lost in the desire of an organization to get production out and to operate effectively. It is all too easy to forget the importance of rotating people to be sure that they still have skills when there is a need to use the individual somewhere else.

Finally, there can be sticky issues when technology changes occur. Major technological changes can mean that certain skills are no longer needed. This raises the question of what happens to the individuals who are being paid for skills which are now obsolete. There is no simple solution to this, but one approach is to have a red circle period during which an individual has to learn a new skill to replace the one which is now obsolete. This can have the positive advantage of emphasizing to people that learning is not something that ever stops in an organization.

Where it is Applicable

Now that advantages and disadvantages of skill based pay have been considered, it is possible to talk in more depth about where it is likely to be effective. Not surprisingly, it seems to be ideally suited to exactly the place where it has been used the most, participative new plants. It fits particularly well with the participative management style and seems to be relatively easy to install in a new plant start-up. In new situations there is no job ownership to overcome on the part of established workers who have progressed to the most desirable jobs and want to hold onto them. In addition, skill based pay reinforces just what a new organization needs at start up--learning.

Many established organizations are trying to make the move from traditional to a more participative form of management. Although it has rarely been tried in established organizations, skill based pay seems to be highly applicable here as well. It can be an incentive for veteran employees to acquire new skills and to allow others to obtain their skills. With skill based pay, a reason is created to learn new jobs and to allow others to learn their jobs. The reason, of course, is that both of them can now earn higher pay and thus a refusal to let others learn becomes a negative for both themselves and for the person who would like to learn the task.

Finally, it is important to note that the nature of the work technology probably determines the applicability of skill based pay and the nature of the advantages it offers.

Two especially relevant aspects of technology are the level of coordination that is required and the level of employee skill and flexibility that is required. Skill based pay may have different

advantages depending on whether one or both of these characteristics is present. Skill based pay is probably most applicable in those situations where organizational performance depends upon good coordination and team work among individuals. In manufacturing environments, it's not surprising that it has been particularly successful in such process production plants as chemical, food and paper operations. All of these technologies require that employees jointly control and manage the production process. Thus, they can perform best when they understand the entire production process.

Organizations with process technologies, then, often can realize large gains hour skilled based pay and a participative management culture. Their level of effectiveness depends on the degree to which employees maintain high levels of coordination and teamwork, continually engage in diagnosis and problem solving, and understand the "big picture" concerning the production process.

Organizations with more traditional batch or mass production technologies may benefit more from the employee skill and flexibility associated with skill based pay. Covering for absenteeism and turnover, the ability to shift employees when production bottlenecks arise, the ability of workers to set up and make repairs on their machinery, and the adaptability of employees to shifts in product mix or the production process are often important to the effectiveness of these organizations. Skill based pay can help address these issues even in the absence of a participative management culture. If the culture is or is becoming participative, skill based pay may have additional benefits.

Although skill based pay has rarely been attempted in nonmanufacturing organizations, it is potentially applicable in many of

these organizations as well. If a high level of coordination and teamwork and/or a high level of employee skill and flexibility is needed, skill based pay may be advantageous. For example, some banks have considered developing skill based pay for branch banking employees as a way of improving customer service. Tellers might be skilled enough to respond effectively to customer inquiries about the rapidly growing mix of products offered by these organizations, and personnel might be moved throughout the workday in response to shifting patterns of customer traffic.

In situations where tasks are highly independent, it is not clear that skill based pay will in fact pay off. For example, insurance salesmen often operate very independently. It is not clear that training them to do other parts of the insurance process would necessarily make them better sales people, although it might improve to a degree their relationship with the home office and the people doing the support work for their selling. In any case, it is clearly a much different situation from that of a person operating a work station in a manufacturing plant or an office "paper factory."

In summary, the skill based pay seems particularly appropriate when combined with participative management philosophies and in organizational situations where the technology demands either a high degree of coordination among different tasks or a high level of employee skill and flexibility.

Future of Skill Based Pay

The future of skill based pay appears to be quite bright. It fits a participative management style and this approach is increasingly popular in the United States. It also fits well in organizations in

which work is highly interdependent and cooperative and/or the work is rapidly changing. These types of work seem to be increasingly common in the United States as work become more high technology-oriented and service-oriented. Finally, it fits rather well with knowledge based work particularly when it takes the form of a technical ladder and this type of work is also increasing in the United States. Thus, there is reason to believe that skill based pay will become increasingly popular in the United States.

There is one area where a question mark remains about the long term utilization of skill based pay. This is in the area of managerial work and staff support work. So far, there are virtually no applications of skill based pay to this type of work, only a few new plants have it or are considering it. It can be argued that it is important to put all employees on it because it puts everyone in the plant on the same footing and creates a homogenous culture within the plant. However, the problems in applying skill based pay to managerial and staff work are significant. First, there are a number of difficult issues around what skills to pay for in the managerial area. Secondly, there are questions about how easily these skills can be measured. With respect to which skill to pay for, there are issues about whether to pay for downwardly vertical skills and about how many of the skills that are currently done by managers should be opened up to production workers.

It is possible to imagine a situation in which all skills in the organization would be available for learning to all employees. This could create a situation where "production employees" would in fact become indistinguishable from managerial employees. It could also create a situation where somebody would be doing a production task and

in fact be the highest paid employee in the organization. At first glance, this seems a bit radical, but if that person had the most knowledge about plant operations, then in fact they would deserve the highest pay in a skill based pay system. There of course remains the issue of whether that would be the best utilization of a person's time, but it is possible that it might be in certain situations.

There is one societal trend in addition to the movement toward participative management and high technology work which may encourage organizations to use skill based pay for managerial employees. The population trends in the United States are such that there is going to be an increasingly large number of individuals in the age groups which typically occupy management positions. A large number of people are now entering the age group between 30 and 45. This means a large number of candidates for managerial jobs are present, but this cohort is running into a work situation in which organizations are trying to reduce the number of managerial employees. Thus, there is a direct conflict between an increasing number of people who are aspiring to upward mobility in an organization and a decreasing availability of these kinds of jobs because organizations are becoming flatter and leaner. Unless something changes, this means that many individuals will be dead ended in jobs with no pay progression or learning opportunities for much of their adult work life.

Skill based pay represents one potential approach to ameliorating this problem. Individuals could be paid for horizontal moves in learning as well as for vertical learning if skill based pay were in place. This would have the effect of raising their wages and giving them an opportunity to continue to grow and develop. Thus, skill based

pay represents a possible partial solution to the problem of making careers more satisfying for individuals. It also could serve to legitimate the idea that a good career move is a horizontal, not just a vertical one. Because of the way the reward structures are set up in most large U.S. corporations, the only legitimate career move for many individuals is upward. The reward system rather clearly says that it is the only kind of mobility that is valued. This makes sense if management wants large numbers of people striving for fewer and fewer positions in upper management, developing skills that only a few of them will ever get the opportunity to utilize. It doesn't make sense, however, if the concept of management is a more participative one in which a large number of individuals should be developing a broad understanding of how the organization operates and multiple skills so that they can become self-managing, so there is less need for top management to direct and control the work of others.

In summary, then, there is the possibility of widespread use of skill based pay for management and professional employees because of demographics and the changing management style in the United States. Nevertheless, broad application of skill based pay is very much in doubt at the moment. Much surer is the continued widespread use of skill based pay in new plants, and the probable increased use in traditional work situations where more participative management styles are being used for production employees. The benefits here are significant, posing a real challenge to traditional assumptions about how compensation should be administered in organizations.

undergraduate business majors and 1,300 graduate students. Full-time faculty numbers 125.

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