

Skills-based pay is on the rise - should you consider it?

With the EU's Pay Transparency Directive due to land in 2026, companies face a key challenge: to be able to clearly and objectively explain to employees why they are paid what they're paid.

The Directive mandates pay decisions must be based on measurable criteria, such as skills. Forcing many businesses to rethink their role and title-based approach to jobs and pay. Combined with the issue of skills gaps across many sectors, there's renewed interest in skills-based pay as a potential compensation approach.

Interestingly, skills-based pay is not a new concept. It gained traction in the 1970s and 1980s within manufacturing plants, like auto-manufacturers, where pay systems rewarded employees for developing the capabilities critical to continuous improvement.

Today, a similar trend is emerging, powered by advancements in technology, automation, and digitisation. This shift has led companies like Walmart and IBM to rethink reward, shifting to a strategy that recognises and rewards the skills important to organisational success.

This article is designed to cover the fundamentals of skills-based pay:

- What is skills-based pay and why is it important?
- Why seek an alternative to traditional pay models?
- A potential pitfall to avoid.
- Case studies: two companies using skills-based pay
- The benefits of this approach
- How to implement it

What is Skills-Based Pay and Why Is It Important?

Skills-based pay (SBP) is a compensation model that rewards employees for their knowledge, abilities and skills rather than their job title or seniority. Unlike traditional pay structures, where compensation is linked primarily to an employee's position, SBP focuses on the individual's expertise and value to the organisation.

Over the years, there have been many different approaches to skills-based pay. In the 1990s, [competencies were used](#) to hire, assess and reward white collar workforces. Before falling off the radar in the 2000's as [market rates and performance-related pay](#) took centre stage.

However, skills-based pay is making a comeback, in part due to the growing skills gap impacting businesses across a wide range of sectors and roles:

EU

- [More than 75% of companies](#) struggle to find appropriately skilled workers.
- [25% of small- and medium-sized enterprises](#) say skilled staff and experienced manager availability is their most important problem.

UK

- [66% of large businesses](#) said they struggle to recruit employees with the skills they need.
- An estimated [20% of the UK workforce will be significantly underskilled](#) for their jobs by 2030.

As the [UK government's skills shortage list](#) shows, the UK needs skilled people in a wide range of roles, including engineers, hairdressers, marketers and HR professionals. Indicating the potential for skills-based pay to be adopted across industries well beyond the tech and manufacturing sectors.

Why Seek an Alternative to Traditional Pay Models?

Having the right skills on board is a [major contributor to a company's overall productivity](#). However, most companies do not explicitly factor skills into their compensation and performance evaluation processes. Here's how traditional pay models compare to an SBP approach.

Traditional Pay Models

Traditional pay models typically involve a performance-related base pay increase (historically around the low few-percent mark), a bonus review and a development review. Salary is based on an individual's job title and responsibilities.

Aside from gaining a degree or completing a multi-year qualification, additional training usually makes little impact on an individual's compensation. Whereas job title and seniority does. This places the focus on promotion - rather than skills development - for career advancement.

By omitting skills acquisition from employee performance assessments and rewards, organisations fail to incentivise upskilling. Which can hinder their ability to maintain a competitive edge in the market.

SBP Models

Under SBP, the reward components - pay review, bonus and a development review - remain the same. What differs is how individuals are awarded starting salaries, pay increases and bonuses and the pay ranges that are typically used.

SBP focuses on an individual's capabilities and experience on a particular topic to determine their pay. Employees are evaluated on factors including experience, certifications and skills. They're ranked according to their level of expertise rather than their job title with higher skill and certification levels which results in higher starting pay.

With less focus on job titles, pay and grading structures tend to be flatter with broad pay bands or ranges and fewer grades or levels. Future reward is linked to skills acquisition. Individuals' pay will increase on the basis of the skills they have, their complexity, how important the skill is to the company and how in-demand it is in the job market.

The Potential Pitfall with Skills-Based Pay: Reward Without Results

Simply rewarding employees for learning new skills—without considering how well they apply those skills to drive business outcomes—misses the point. It encourages skill acquisition for its own sake, which might not always benefit the organisation. **The smarter, more strategic approach is to link skill development directly to performance and business needs.** That way, employees are not just incentivized to learn; they're motivated to use their new skills to deliver tangible results.

Two Companies Using Skills-Based Pay

IBM

The emergence of new technologies and new professions were disrupting the tech industry and prompting a focus on skills. With a five-year half-life on many skills, [IBM](#) embedded a skills-based approach across the employee lifecycle.

This resulted in a fundamental shift in IBM's pay philosophy with base pay used to reflect skill levels alongside other factors, including performance, and incentive payments to reward performance alone.

As a result, manager-employee performance conversations became more regular and integrated performance, skills, career and pay. Helping employees understand and influence their career and pay progression.

Walmart

In 2015, [Walmart](#) reimagined its career pathways to create a more dynamic, skills-based workforce with a focus on developing its hourly-paid employees. It made significant changes to its hiring, training, compensation, scheduling programmes and store structures.

Deciding to remove the requirement for a degree required the business to identify alternative skills and competencies. Like the ability to use a specific software application, adaptability and teamwork. This detail enables managers to hire based on the appropriate skills, experience and capabilities for each job.

The business also invested in new development programmes, like bringing in external resources to provide academic and personal support and upskilling opportunities. The business also created the Walmart Academy and introduced an education benefit so employees can earn high school diplomas, skills certificates and college degrees focused on specific skills.

This skills-based strategy has helped employees build the skills they need for future jobs. As a result, 75% of store, club and supply chain managers began their careers as hourly paid associates. Reducing hiring costs and retaining valuable business knowledge.

While IBM and Walmart have successfully pioneered skills-based pay, other companies are discovering its broad benefits across industries.

The Benefits of Skills-Based Pay

According to [Deloitte survey research](#), organisations that focus on skills rather than jobs have found they are:

1. [63% more likely to achieve results](#) than companies that haven't adopted skills-based practices.
2. [98%](#) more likely to retain high-performers.
3. [98%](#) more likely have a reputation as a great place to grow and develop.
4. [79%](#) more likely to have a positive workforce experience.
5. [57%](#) more likely to anticipate change and respond effectively and efficiently.
6. [52%](#) more likely to innovate.
7. [49%](#) more likely to improve processes to maximise efficiency.
8. [47%](#) more likely to provide an inclusive environment.

Emphasising skills also helps organisations to break down barriers and prevents operational silos. Individuals with the right skills for specific projects can be identified and pulled onto

teams to solve problems, innovate and add value to the business. Moving forward with opportunities, and addressing issues, more quickly and effectively.

Companies are also finding that skills-based approaches provide [greater opportunity, fairness and equity](#). Because people are defined by their skills and abilities rather than their job history, tenure or network.

By linking skills to financial incentives, organisations can rapidly advance skill development and career progression. Creating a culture of continuous learning and professional growth which ensures the organisation has the capabilities it needs to execute its strategy and remain competitive.

Here's How to Do It Right

Think a skills-based pay strategy could be for your organisation? Follow these five key steps to get started:

1. Align Skills with Strategy

Identify the skills that directly impact your business goals—whether they're technical abilities, leadership skills, or industry-specific expertise. Use job analysis and insights into future needs to pinpoint these key skills. Update this list regularly to keep up with changes in the market.

2. Use Skills to Define Job Roles

Make skills a key part of how you structure your job framework (i.e. job families and levels). Assess the required skills for each role, along with other job-sizing factors like responsibility, effort and work conditions. This helps create a clear job framework to support a skills-based pay component.

3. Develop a Clear Compensation Plan

Set broad-grade or broad-band pay ranges for each job category in the framework using market data and benchmarking based on skills, not just job titles. You'll also need to be clear on the value of each skill to your company and the job-market so you align skills and reward appropriately.

Regularly review your pay bands to keep them competitive and fair. Establish clear, measurable criteria (like certifications or performance assessments) so employees know exactly how their skills affect their pay.

4. Position Employees Within Salary Bands Based on Skills

Within each pay band, use skills as a factor in determining where an employee starts in the band. Create clear pathways for pay growth—show employees how learning new skills will lead to higher pay, so they're motivated to keep improving. Make sure you include performance metrics to avoid paying only for skills and not outcomes.

5. Connect Skills to Learning and Development

Invest in training programs and create a culture of continuous learning. Offer resources to help track skill growth, so employees understand how their development affects their pay. This makes it easier to adjust to changing business needs and helps everyone see the value of skill-building.

While this condensed process sounds fairly straight forward, there are a few challenges to consider.

Conclusion:

The EU Pay Transparency Directive is prompting employers to revisit pay practices and ensure they're fair, objective, and explainable. This work will create a strong foundation on which a skills-based pay strategy can be built. With the goal of incentivising the skills growth and performance that drives productivity and competitiveness.

However, managing a skills-based pay system is more complex than traditional models. Success requires companies to clearly define current and future skills needs and measure the value of different skills, and employees' attainment of them, accurately. This involves tracking skills in detail, with regular assessments and constant updates. Managers must also be trained to hold effective development conversations and be confident explaining the link between skill growth, performance and compensation.

This is no mean feat. Particularly as the speed at which new skills are needed accelerates. But, as technology evolves to reduce the load, mastering skills-based pay increasingly looks like a wise investment in staying ahead.

Preparing for the EU Directive?

Check out SkillsTrust’s **Readiness Checklist for Employers**. Our checklist provides actionable steps to ensure your pay practices are fair, objective, and fully aligned with the Directive—helping you build a future-ready workforce.