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BY HARRY HAWKES, ALBERT KENT,

AND VIKAS BHALLA

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by Harry Hawkes, Albert Kent, and Vikas Bhalla

Joe has been a machinist for 25 years at the same company, a steady and reliable worker. Although Joe is a significant asset to his firm, his wages have gone up steadily while his responsibilities have remained largely unchanged. The result is that Joe is significantly overpaid as a machinist compared with co-workers who have been doing the same job for just two years.

Struggling to ride out the worst of the recession and credit crisis intact, Joe's company has fired dozens of workers — and considering Joe's salary, he would seem to be a likely candidate for the next round of layoffs. Or maybe not. Joe's a stellar employee who knows the ins and outs of the organization, the result of his many years on the job. If management let him go, not only would the company lose his wealth of institutional knowledge, but a troubling message would be sent to the other workers — namely, loyalty goes unrewarded. At Joe's age and tenure, moreover, there could be legal implications to such a move. In short, the company would rather not fire Joe. But what's the alternative?

For many companies, this is an all-too-common quandary. Over time, compensation policies have gotten woefully out of whack, such that wages for some workers in some jobs greatly exceed what the market says those jobs are worth. Even more troubling is that there's no single reason for creeping wage disparities. Neglect is one culprit. Workers with many years of service have seen their wages grow in a steady trajectory year after year, fueled by adjustments for inflation as well as annual merit raises that often surpass the rate of inflation, without any increase in responsibilities or required skills. Repeated enough times, these compensation increases can morph into an exorbitant trend.

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Equally problematic is the typically inconsistent approach to setting salaries within different parts of the company, or even different parts of a business unit. This can result in huge differences in compensation among similar job categories (and sometimes similar positions) — because line managers, not human resources professionals, are making decisions about wages. Moreover, few companies have an identifiable formula for determining new-hire compensation or subsequent raises.

Many managers have chosen to ignore this emotionally charged issue — especially when business is booming. This attitude is no longer tenable, however, given the pressure that established companies feel today to cut costs wisely in order to keep up with intense competition from both upstarts and emerging markets. In this environment, the gap between high wages and market value must be narrowed, if not closed. To ensure the company's future as well as Joe's, it is time to address these kinds of wage disparities.

Simple broad-stroke wage reductions will not do the trick, because they fail to address the structural problems with compensation in most businesses. Companies need to take a more measured and strategic path: retooling labor costs, a multifaceted and tailored program that is less damaging to workers and less risky to companies than typical cost-cutting efforts. With proper execution, net labor savings of 15 to 20 percent are possible, because this approach goes beyond the need for immediate savings and confronts systemic and sometimes dysfunctional wage and salary practices.

After a company completes the retooling exercise, valuable workers like Joe could be trained to do jobs that better match their salaries. But because positions are scarcer in the upper reaches of the organizational pyramid, some of these employees, as well as less-proven individuals, might have to take pay cuts or perhaps a voluntary separation package.

Retooling labor costs requires a company-wide commitment to an ongoing wage strategy made up of analysis, decision making, and implementation. Although the process may be painstaking and difficult, over time the payoff will be as systemic as the problem once was, and most companies will end up with larger and more sustainable improvements in their margins.

Finding Useful Salary Data

To establish wage structures, most businesses rely on market reference points (MRPs). Usually provided by third parties, MRPs are based on regional salary surveys of a wide sample of companies within an industry, and provide a range of wage targets for a given job or category of jobs. For example, in a survey for an assembly-line job, the hourly wage would be broken down by quartile. The lowest-paid quartile might earn less than US$13.50 an hour, whereas the top quartile might earn between $15.70 and $16.25.

Although useful as a general guide, MRPs can be problematic. The data may be skewed high or low, depending on which companies are surveyed. Larger firms with more employees will influence the result more heavily than small businesses, and many larger firms have a "premium brand" strategy or possibly a large union presence that supports higher wages. What's more, in some MRPs the job categories are incorrectly defined or too general; for example, the label *data analyst* encompasses a wide range of roles and responsibilities, and thus a wide range of appropriate salary levels. As a result, MRPs are worthwhile for higher-level positions (where little data is available internally) but are often misleading when applied to assessments of large, undifferentiated segments of the workforce.

To analyze most wage disparities, companies should combine the data from MRPs with internal benchmarking, which calculates the average wage of workers in the company who have just achieved competency in their position. For welders, reaching that point may take five years; for bookkeeping clerks, maybe only two. This average salary can be used as a proxy for what it should cost the company to maintain these skills. This blended MRP/benchmark approach can generate target wage scales tailored to individual companies — and clearly identify the point at which the pay of long-tenured employees exceeds the value of the jobs they perform.

Putting the Data to Work

Armed with a thorough wage analysis and a better understanding of which workers' earnings are above their grade, human resources executives can bring order to the helter-skelter pay structures at their company. The "cure" will typically involve some combination of these four levers:

- **Appropriate job categorization and responsibility adjustments.** It is not uncommon for salary levels for certain workers to depart from MRP guidance or internal benchmarks by as much as 60 percent. This variance should be addressed. Some employees who are earning more than the market wage for their job can be trained and reassigned — immediately or eventually — to job categories better aligned to their wage scale. This would likely be the fate for someone like Joe, the machinist in our example. But for each job category, pay floors and pay ceilings should be established. Once employees and pay levels are in sync, this equilibrium must be sustained through rigorous policies for starting salaries and merit raises.

- **Voluntary separation.** In the case of a highly tenured workforce, asking people to leave on their own in exchange for severance packages more generous than the company typically offers could make sense. This, in turn, would allow the company to hire replacement workers at a rate much closer to market averages. A well-crafted voluntary separa-

Illustration by Michael Kirkham

tion plan will generally have an acceptance rate of 15 to 20 percent, but it could go as high as 50 percent in some business units. The outcome is directly proportional to how well the plan is communicated, to the size of the package, and to the average years to retirement of the targeted workers. To ensure high levels of participation, it is critical to tell employees that the company is determined to cut costs and smooth out salary discrepancies and that after the severance program's deadline passes, more aggressive ways to reduce wages will be considered.

- **Involuntary separation and performance management.** The company should have a disciplined program of regular reviews to remove poor performers whose salaries are too high for their jobs and to replace them with new workers making a more appropriate wage. The workforce may bristle at these actions — and morale may sink — especially if the changes are construed as a way to bring in less-expensive replacements instead of as a decision to become more disciplined about performance and salaries. This rancor can be avoided if management clearly communicates that ranking employees and letting consistently subpar employees go is now ongoing company policy.

- **Wage reduction.** Cutting salaries should be a one-time event to get the company's compensation for individual positions and responsibilities back in line with the overall job market. This lever is the quickest to implement, but it carries the most risk in terms of its effect on morale. For that reason alone, it should be attempted only after all the other options have been exhausted and the case for change has been made clear to the workforce.

Restoring Order to the Payroll

Setting the direction for the initiative, aligning it with the company's overall strategic thrust, and making sure that the commitment to the program remains strong so that wage normalization doesn't fizzle out over time are the responsibility of senior leadership. The chief financial officer or the chief operating officer, in conjunction with line management, should oversee decision making and overall planning. In addition, senior human resources managers must be closely involved in the development of this effort, because in most organizations they have the most hands-on experience and knowledge in dealing with worker skills, salaries, and concerns.

For many companies, the need to address imbalanced labor costs couldn't be more urgent: New entrants are hiring people at deeply discounted market rates, taking advantage of today's steep unemployment numbers, and widening the labor-cost gap with established businesses that have more entrenched workforces. However, any company seeking to meet this challenge must be ready to embark on a lengthy and extremely disciplined campaign — one that will determine the morale, skills, talent levels, recruitment potential, performance, productivity, and costs of its workforce for a very long time. +

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Harry Hawkes
harry.hawkes@booz.com
is a partner with Booz & Company based in Cleveland. He leads the firm's global operations and performance improvement practice for the media and entertainment industries.

Albert Kent
albert.kent@booz.com
is a principal with Booz & Company based in Florham Park, N.J. He has more than 14 years of industry and consulting experience focusing on cost transformations — specifically in field operations; manufacturing and supply chain; and sourcing for industrial, automotive, aerospace and defense, building products, and digital industries.

Vikas Bhalla
vikas.bhalla@booz.com
is a Booz & Company senior associate based in New York. He has more than 10 years of experience in developing operations and cost reduction strategies for companies in such industries as retail, media, digital, and healthcare.

Also contributing to this article was Booz & Company Associate Nicholas Buckner.

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