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Employment Cost Index:

Compensation Consultants: 1Q Wage Hikes Hold Steady Despite Uneasiness

- No Big Changes Yet on Compensation as Companies Monitor Economy
- Health Insurance Costs May Jump as Workers Rush to Use Benefits Ahead of Layoffs
- Workers Seen Paying Price of Inflation through Longer Hours, Second Jobs

By Gary Rosenberger

NEW YORK (EconoPlay) April 22 – Employers left intact budgets planned late last year that called for modest wage increases this year despite the economic fusillade that left in its path a quarter of a million job losses in the first three months alone, compensation consultants say.

Salary increases, which tend to be enacted around now, will likely stay within recent bounds of just under 4.0% on average through the first half of the year, while employers monitor the economy with an eye toward future wage freezes, wage cuts and more layoffs.

Health benefit costs might actually rise in this downturn – with insurers less worried about appearances in an election year than they are about paying for a spike in claims at a time when workers race to undergo long-neglected procedures before coverage ends with the loss of a job.

Record fuel prices, food inflation, and other cost of living increases are no bargaining chips when job insecurity is also on the rise – leaving workers to fend for themselves with longer hours or second jobs at a time when management will be looking to cut labor costs.

Compensation consultants are second-guessing the myopia that came when employers shed workers during this rough patch, noting they will only have to rehire and retrain help at a far greater cost above the savings they're getting now.

An enlightened minority might see opportunities now to hire fresh talent at a relatively low cost or to focus on non-monetary worker retention programs – say, by allowing people to work from home one day a week when gas prices rise above \$3.

Top executive pay at publicly traded companies will reflect pre-recession 2007 performances and are likely to further annoy shareholders and grandstanding politicians for the duration of the proxy season – with bonuses likely to orbit lower next year.

“I haven't seen people change plans yet on compensation,” said Steve Gross, employee compensation leader for Mercer Human Resources Consulting, at his Philadelphia office.

Companies planned their budgets in the fourth quarter for increases effective March, April, and May – and “outside of a few industries that are in the tank, like housing construction and home mortgages, it's business as usual,” he said.

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Gross recently completed a survey of 400 companies in North America and the only real change he saw was companies “trying to get more work from the same number of people.”

Reluctance to Go Overboard

If anything, he sees a greater desire to retain people than he saw in the last recession. “I’m picking up on reluctance to wholesale chop the workforce,” Gross said. “Companies learned their lesson and are afraid to get rid of people only to have to rehire less experienced people at great cost when conditions improve.”

Companies are budgeting for hard times even if they aren’t feeling them. “They’re not getting growth, but they are hitting their targets. They read the bad news every day and wonder why to date they haven’t seen it yet,” Gross said. “Business is just kind of ho-hum. They haven’t experienced the potential downturn for themselves yet, but they’re waiting for it to come.”

For industries that are hurting, there is no doubting the hurt. “One of my clients in mortgage lending lost money for the first time ever. It’s in crisis and it cut 35 percent of its workforce.”

In financial services, he senses something of a tempest in a teapot. “Even with the job losses announced on Wall Street, there are still more people working in financial services than a year ago,” Gross noted. “It’s still a net plus. It might not see growth, but it’s not yet in contraction and Goldman Sachs had a best year ever.”

Gross’s survey showed a greater degree of uncertainty over future hiring and compensation. Around a third of respondents plan to reduce their rate of hiring or reduce wage increases. A full 10 percent of respondents saw a salary freeze somewhere in their organization in the future, which would roughly splice around a half percent from the typical 3.5% to 4.0% annual increase.

At a function this week, Gross asked his audience what adjustments they plan to make for the other pressing issue of that day, \$115 oil.

“All the responses were limited to subsidizing mass transit, encourage bicycling to work and finding other alternative forms of transit. Nobody talked about adjusting wages,” Gross said. “Employers know that when you give something, it’s hard to take it away.”

There are consequences to workforce reductions now that will be costly when the upturn comes around, said Lenny Sanicola, practice leader, professional development at WorldatWork in Scottsdale, Arizona, an association of compensation professionals.

“As the economy softens and certain employers attempt to reduce labor costs through job reductions, the hope is that one’s labor costs, one of a company’s largest expenses, will decrease,” he said.

However, “when things pick up again, how much will it cost you to attract the quality workforce you need to compete in the marketplace?”

Eliminating jobs doesn’t always result in immediate savings to the bottom-line because, as so often happens, draconian measures often impact productivity of the remaining workforce. Also when companies become known for laying off in bad times, they run into problems recruiting when times get good, he added.

Recession or any other difficult economic condition often induces companies to pass on more costs to workers. But management is in a bit of knot over how to retain workers to gain a competitive edge, while at the same time risking alienating workers by passing on the costs of healthcare, he said.

In the tug of war between workers demands for higher wages to pay for higher living costs and companies looking to cut costs, the upper hand usually goes to management. But there are exceptions.

“In industries like healthcare where there is a projected need for 500,000 jobs by the year 2016, workers that have

the right skill sets and are in short supply will have the upper hand,” Sanicola noted.

“Right now we have the crises in the housing and financial markets, the rising cost of gasoline and transportation, inflationary pressures, low consumer confidence all converging at once, so overall, employers have more of the upper hand, but it will vary based on the circumstances,” he said.

With the U.S. economy in a deep state of flux, and the repercussions of the stimulus package on consumers still not clear, Sanicola sees companies opting to monitor and postpone decisions related to the workplace until the turbulence plays itself out, leaving compensation issues up for future grabs.

Holding the Fort on Wage Inflation

Paul Gavejian, managing director of Total Compensation Solutions in Armonk, New York, sees short-sightedness among companies reducing their workforce so drastically considering that the jury is still out on the severity of this recession.

“Layoffs will certainly save money for the companies that implement them. However, they are also cutting out the resource that helps them generate a positive revenue stream: people,” he said. “After the contraction is over, they’ll hire all new people to fill the positions vacated in this current round of layoffs.” And that means lots of costly training to get inexperienced people up to snuff.

He has been advising companies to implement so-called “at risk pay” strategies to align compensation with the fortunes of companies through good times and bad.

Such variable pay programs reduce the peaks and valleys in the workforce created by massive layoffs and re-hiring programs, while minimizing costly retraining, he said.

His eye right now is on the unintended consequences of loose monetary policy, and the prospect for a deeply inflationary cycle already visible in the cost of energy and food, and the unwillingness among employers to raise salaries if and when living costs get out of control.

“I think we’re in for a very bumpy ride,” Gavejian said. “This is the first inflation cycle that I’ve seen with such a massive devaluation of the dollar at a time when we’re more dependent than ever on foreign trade and importing goods from foreign sources.”

Employers already have their salary budgets in place and have begun to implement them “whether its 3.8, 4.0 or 4.2 percent,” he said. “At midpoint of 2008, they will begin to ask whether we can afford to keep doing it for the rest of the year – and when they look at 2009, maybe they’ll pare it back to 3.5 percent.”

“But I think we’re headed into a period the likes of which we’ve never seen before. The dollar is shrinking, the cost of imported goods is going way up, and the inflationary pressures will be amazing – and because it’s all imported inflation, the Fed will be powerless to stop it,” he said.

With inflation pummeling the workforce, employers are not likely to accommodate wage demands. “They’ll be thinking how can we reduce costs when we’re raising wages?” Gavejian predicts.

“It means we’ll have to work longer hours, become more productive or take two jobs because employers are not going to give up the one competitive advantage they have in this environment, mainly that we’re a low-cost producing nation – something we would give up if we have wage inflation,” he said.

For his core clients in the office and corporate world, the impact of inflation might take a while to reach, after all \$115 crude doesn’t reach beyond the cost of utilities and the daily commute. “In a production environment it’s a whole other story,” he said. “Companies are feeling the pinch and have started to lay off employees. It’s not the smart thing to do, but step one has always been to layoff, the second step is wage freezes and the third step is cutting back on compensation.”

He doesn't think they should be doing that in that order. "They should be freezing as a first resort, but many employers believe that by laying off workers they can save salary dollars and benefits dollars and the cost of providing a work space. It's short sighted," Gavejian said. "They will have to rehire people and retrain people who don't know their systems and that will cost them even more money."

David Leach of Strategic Apex Group, an executive compensation consulting group in Santa Monica, California sees paralysis until decision-makers get a better grasp on the magnitude of the recession.

The additional 4,000 layoffs at Merrill Lynch and the 9,000 more at Citigroup coming on top of the nastiness at Bear Stearns do not bode well, to say the least. "People are still holding back in terms of doing things. My clients are holding back and not making major investments waiting to see what happens. Everyone is being so cautious," Leach said.

But an enlightened few still see opportunities. "Some might see recession as a chance to hire new people. The contrarians make their investments when the economy is down," he said.

Leach specializes in executive compensation, where the one-year lag between performance and payout fosters a huge perception problem for investors and everyone else offended by pay spikes for the few when the rest of the economy is tanking.

"It's something of a timing issue," Leach said. "Proxies that are coming out now explain compensation for last year. Now that things have soured, it looks really bad," he said, adding that next year's bonuses, or lack thereof, should reflect this year's worsening realities.

"Wall Street pay will be down – but on Wall Street down is a very relative term, isn't it," he said.

Downturns Fuel Health Inflation

For Jim Watt, president of Employee Benefit Solutions in Houston, a down economy can only presage higher healthcare costs for workers and their employers.

"What we tend to see is more significant client activity during a time of recession or economic downturn," Watt said, noting that workers seek a greater amount of medical attention when they sense an approaching loss of employment and benefits.

The evidence for that hasn't come in yet, however. "We don't see it until 90 days into a recession when claims begin to come in – and I haven't seen claims come in yet to validate that," he said.

Insurance companies in uncertain times "come across more tentative in their pricing and re-pricing," he added. "They're on the hook, so they're back in the mindset of mitigating risk."

Insurers are more worried about the bottom line than they are about political attacks. "We're in an election cycle when typically you see pricing become depressed," Watt said. "But if you have a downturn, you also see the claims-loss ratio significantly higher than normal. So they'll lay off accepting risk and would just as soon not take the business."

But that, too, depends on the customer and the industry. "In Houston, there's an aggressive pricing situation for anyone in energy, but they won't go near a mortgage company," Watt said.

The U.S. Labor Department is scheduled to release the Employment Cost Index for the first quarter on Wednesday, April 30 at 8:30 a.m. ET.

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