

From Main Street to Wall Street

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**Compensation Consultants: 4Q Wages Hold Steady Despite Shrinking Labor Pool
Health Benefit Cost Increases Continue to Moderate
Minimum Wage Hikes, More Disclosure on Executive Pay Will Be Felt in 2007
Bush's Healthcare Proposals Seen as Start of a "Long Conversation"**

By Gary Rosenberger

NEW YORK (EconoPlay) Jan. 25 – Salary budgets held steady in the fourth quarter in the face of a shrinking labor pool as ebbing energy and other living costs helped to dispel systemic demands from workers for higher wages, say compensation consultants.

Health benefit costs also continued to moderate, but might rise again in 2008 with so little fat left in benefit plans to squeeze out – and with a Democratic Congress unlikely to endow a sitting Republican president with a legacy of having fixed a broken healthcare system.

Minimum wage hikes in California, New York and a handful of other states on Jan. 1 will ripple through 2007 – along with a Federal measure that, if signed into law, would raise the wage floor nationally by \$2.10 from its current \$5.15 an hour in three steps over 26 months.

But wage increases arising from the lowest rungs of the labor force could be partially offset by new disclosure rules on top executive pay aimed at obviating extreme abuses.

Still to be determined is whether the ascendancy of the Democrats does anything to narrow the wage divide. As one source put it, “productivity is way up, corporate profits and Wall Street bonuses are through the roof, and worker wages are just inching along – which makes the outrage over minimum wage increases amazing.”

It also remains to be seen how companies will respond in 2007 to the relentless pressure to show earnings growth, whether by tightening the leash on fixed labor costs or by doling out more to attract and retain the best and brightest.

“Companies don’t mind paying people more if they had a good year. But no one wants to commit to raising fixed costs as opposed bonuses, which are variable,” said Steven Gross, employee compensation leader for Mercer Human Resources Consulting.

“We survey all the time and we still see people budgeting for 3.7 and 3.8 percent salary increases,” he said. “I was at a conference the other day with 60 people in the room. I asked who is still budgeting for a 3.5 to 4.0 percent wage increase, and 80 percent raised their hands.”

If variable pay is the first play, then “the second play is more segmentation,” Gross said. “More money is going to high performers and for people in greatest demand. There’s more dicing and slicing inside companies about where the rewards go.” Currently, he sees such rewards disproportionately going to accounting people, a skill that is in greatest demand relative to supply.

Wage Pressures Ebb with Inflation

For Gross it is not all that mysterious why wage increases would stay flat even as the supply of labor tightens. “You would expect salaries to increase as the labor pool shrinks,” he said. “But I’ve been tracking this for more than 20 years, and salary budgets tend to be more reflective of inflation in the prior year.”

And, despite some inflationary scares in 2006, CPI wound up relatively tame at around 2.5%, “so that an increase in the 3.7 percent range is well within the historical norm of 1 to 2 percent above inflation,” he noted.

With inflationary pressures ebbing, “you see spot pressures on wages as opposed to systemic pressures,” he added. “While there are certain industries or job functions that get hotter – on the other side, you have a merger or you have a Pfizer. Where there are 10,000 layoffs, there won’t be big increases for the remaining people.”

"Employers have a challenge in today's economy in attracting and retaining talent. So far this is having only a modest impact on plans for base pay increases across the board," said Jim Stoeckmann, practice leader at WorldatWork, an association of compensation professionals.

WorldatWork's annual Salary Budget Survey showed employers reporting an actual average increase of 3.8% for all employee categories in 2006, up from 3.7% in 2005 - with projections for 3.9% in 2007, Stoeckmann said.

"Wage increases are responding to the lower inflationary pressures. In fact, most companies are sticking with their pay budgets of early to mid 2006," said Paul Gavejian, managing director of Total Compensation Solutions in Armonk, New York. "There are no pay spikes at this time. With inflation calming down, there's no need."

Pay increases ranging from 3.5% to 4.2% overall are considered the norm among his clients, and they are likely to continue that way for several years, he suspects.

Some of his clients, particularly in underwriting, are finding it difficult to recruit executive, middle management and lower-echelon staff with the specific experience required for the job. But instead of resorting to wage increases, they seek to "home grow" their talent. "That means hire out of college, train them for a couple of years, promote them to senior underwriter, then manager, then director."

In the financial services world, Wall Street bonuses "are back in form, as outrageous as it may seem," Gavejian added.

"The overall lesson that I preach is that bonuses motivate people to perform better. Without bonuses, they're just going to do what's expected. With bonuses, companies can squeeze out or demand maximum performance and productivity from their workers," he said.

As Gavejian views it, bonuses have a way of keeping wages "depressed" by not obligating employers to reward workers during a bad year, or who under-perform.

“I know it sounds contrarian, but I don’t see wages going up significantly. People are just making sure they’re paying the right amount of money. Not too low or too high, but just what the market dictates,” he said.

Democrats and Executive Pay

The Democratic Congress is likely to impact top executive pay, according to David Leach, president of Executive Compensation Group in Santa Monica, California.

He notes that inside the minimum wage bill was a little-noticed amendment that places stricter limits on the amount of compensation that can be deferred, limiting it to the lesser of one million dollars or the average of the last five years. (Failure to satisfy the cap would trigger ordinary income tax plus a 20% penalty!)

Even more pressure is likely to come with new disclosure requirements for publicly traded companies. “There are eight additional tables. They have to explain their supplemental retirement plans. They have to provide much more analysis on what executives get and why,” he said. “There’ll be more exposure in the next proxy season, and closer scrutiny on executive benefits from compensation committees and boards of directors.”

Not helping matters is Home Depot CEO Robert Nardelli’s severance package said to be worth \$210 million or the options backdating scandals that shook United HealthCare and now Apple. “What all that will do is prompt compensation packages to become less extreme because no one wants to be too out there,” Leach said.

Leach sees no evidence of wage wars or spiraling labor costs stemming from a low unemployment rate. “I don’t see much change in salary budgets. Employers are responding to a tighter labor market by making sure they’re more responsive to employee needs and by providing a better work environment,” he said. “Pay alone is not necessarily the solution.”

Employers are taking a look at the Google model (No. 1 in Fortune Magazine’s list of 100 Best Companies to Work For), famous for its windfall bonuses, free meals and recreation areas to work off the calories. “It’s a campus-like atmosphere conducive to creativity,” Leach said.

Healthcare Costs “Flattening”

All agree that healthcare benefits costs have moderated in 2006 and should continue to moderate in 2007 – but there’s a divergence of opinion about what happens beyond.

“This last quarter, renewals have pretty much flattened out,” said Aaron Berg, president of Health Plan Manager Corp. in Mount Arlington, New Jersey. He saw rate increases ranging between 8% and 12% on premiums, without any plan changes. “We actually negotiated a rate decrease for one client that was being overcharged.”

He believes insurance carriers are slowing the rate of increase under pressure from customers and politicians alike. “There’s been a lot of consolidation, they’ve been making a lot of money and they want to stay one step ahead of the complaints by moderating a little bit on costs,” Berg said.

Small groups continue to get shafted, primarily because the major national health carriers want to unload them – and there he sees increases continuing to spiral. But there, too, he sees small businesses buying health insurance through associations that have negotiating power and economies of scale that individual small businesses lack.

Berg also sees a continuing cost shift to workers. “They’re definitely increasing co-pays. I’m also seeing more dual co-pay systems where it’s a lower co-pay for the primary doctor and a higher co-pay for the specialists. That’s usually a couple percentage points reduction in rates.”

Hospital co-pays on the order of \$100 to \$200 a day are also increasingly common, Berg said.

“Health care costs are still rising, but the rate of increase has stabilized,” said Lenny Sanicola, benefits practice leader at WorldatWork.

He notes that 2006 was forecasted to be “a banner year for the implementation and enrollments in consumer-driven health plans.” But the latest research indicates “that

inception of these plans is slower than expected – and with a Democratic Congress in place, there will be little support for the growth and enhanced design of health savings accounts.”

More likely, there will be proposals on some form of universal health care coverage at the federal level – but, most certainly at the state level, like California is attempting, he predicts.

“Costs of many brand-name drugs will go down as several come off of patent,” he added. “The push for generic drugs in health plan designs will continue, and we will continue to see further consolidation among pharmacy benefit managers and distribution channels.”

There should also be support for the government to negotiate prices with drug manufacturers, which was not allowed under the Medicare Modernization Act. “There most likely will be further scrutiny of pharmacy benefit managers’ practices on rebates, pricing, and the sort,” Sanicola said.

Jim Watt, president of Employee Benefit Solutions in Houston, also sees health benefit costs increases continuing to moderate in 2007, with anticipated increases of 8% to 9%.

But he argues that an increase is likely in 2008, as much as 12%, with Democrats likely to enact legislation that would increase administration costs, to say the least.

“Democrats historically bring up the cost of healthcare by over-legislating benefits, which has the net affect of increasing costs, restricting access, et cetera,” Watt said.

“They talk a good game of affordable healthcare, but history is not kind when it looks upon healthcare costs while they are in control of Congress or the White House.”

In an interesting aside, Watt has noticed wage pressures erupting in Houston, particularly in the energy sector, where “labor shortages are compounded by employer growth and investment,” he said. “Signing bonuses as well as retention bonuses are prevalent to hold onto employees.”

Gross of Mercer Human Resources Consulting agrees that health benefit costs have moderated but warns that “people have reached a limit on how much they can change their plan designs,” leaving little room for cost decreases going forward.

Bush Proposes, and the Trenches Respond

Gavejian of Total Compensation sees health benefits leveling off even more in the first quarter in response to lower inflation and in anticipation of a Democrat in the White House. "The health and pharmaceutical lobby has influence with the Democrats. However, the Democrats are under mandate to reduce these costs. We should see a paring back of the features of these programs and a dramatic decrease in costs reflecting lower levels of service," he said.

Berg of Health Plan Manager is skeptical of Bush's healthcare proposals enunciated in his State of the Union speech Tuesday night. "Clearly he's reaching over to appease and find a way to communicate with the Democrats who are in the ascendancy," Berg said. "But the amount of money Bush is spending on a useless war would have solved a whole host of problems with the healthcare system, and we wouldn't have had to worry as much about the uninsured."

He perceives the proposals as "the start of a conversation" that won't end until Bush leaves office. "There is no way that the Democrats will let Bush steal their thunder and take the credit for solving the healthcare crisis in this country," he said.

Tax policy might reduce the cost of health insurance, "but it won't do anything to change how healthcare is delivered or the high cost of delivery," he noted. "With health insurance you get what you pay for. By not buying a Mercedes you don't necessarily raise or lower the price of a Chevy."

The U.S. Labor Department is scheduled to release the Employment Cost Index for the fourth quarter on Wednesday, Jan. 31 at 8:30 a.m. ET.

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