How to Cut Compensation Costs

My boss wants me to suggest some ways that we can cut compensation costs. Are there ways that we can deal with reduced revenue and remain competitive without making the hole we are currently in deeper? We would like to avoid layoffs, if possible.

By Jim Fox and Bruce Lawson, Managing Directors, Human Resources & Compensation Consulting Practice

When the situation you describe arises, your organization can either deal with compensation issues or defer them. Unfortunately, if you defer addressing one problem, you are probably deferring others as well. The problems will then become evident when the situation finally does turn around and there are resources available to begin to address the problems that were deferred. Then you will have to decide which problems are the most pressing and how much is available to deal with the deferred problems. There are sometimes policy makers who want to throw an insufficient amount of money at every problem thereby ensuring that few are properly fixed.

As public sector managers and custodians of the public purse and trust, our obligation is to use the limited resources that are available to get the most value. You might find it informative to know that organizations who were able to provide some pay increases to employees during an economic challenge were much better off when the downturn ended. Those who decided to cancel raises because they thought that “no one else was giving pay raises” found that when their situation had turned around and they went to the market to hire new employees, the labor market had left them in the dust and they were substantially behind the market. They were having difficulty hiring new employees at rates that did not cause severe pay compression with their current employees. They discovered that other organizations had raised employee pay, and found other ways to reduce compensation costs.

We would like to suggest several things that you might do now to at least better position your agency for the future.

One strategy is to simply downsize the organization—hopefully without crippling it by decimating every service area. That of course means that you need to decide whether the agency can or should continue to provide the full range of services that it has historically provided. If you decide that you should focus on only selected or the most critical services, then it becomes a lot easier to do those things well.

Unfortunately, we see many organizations take the easy way out—cutting everyone’s budget by 5%, 10%, or 20% so that everyone feels a little pain (this is really not a solution since it is just delaying the tough choices). These reductions can come in the form of
layoffs, unfilled vacancies, or other steps that may reduce employee headcount but will create other, longer term problems. For example, one agency cut back on general fund parks and recreation staff so that additional police and fire personnel could be added.

Assuming that there is no way to avoid across-the-board cuts, your next decision will be to do layoffs or try other measures. Below are some steps we have seen used to cut costs without layoffs. Obviously, for those agencies that have labor agreements, some or all of these approaches may require you to work collaboratively with your employee organizations.

- **Transfer employees:** This is a version of having all members chip in for the good of the team. Essentially, this involves transferring employees from functions with lower needs or work volume to areas with higher needs or work volume. For example, support staff in the planning and building functions could be transferred to other departments where workloads are greater, thereby reducing or eliminating the need for overtime in those departments or functions. We see this in counties during elections and property tax collection time. Staff from other departments are “loaned” to another department for a short period of time to handle the increased workload.

- **Freeze hiring:** By holding vacant positions open and transferring employees from other departments or areas to cover critical needs, layoffs can often be averted. Again, you need to think organizationally—not just departmentally. Employees work for the whole organization, not an individual department. That is just their current duty assignment. Having said that, layoffs may not be the worst thing to happen if you have the ability to address performance in the process. If you are able to eliminate the least productive employees, you can often increase overall efficiency within the organization. This can be beneficial to those organizations that profess to have a high performance culture. Recognize too that governments normally experience about a seven to nine percent turnover rate per year. If you just leave vacant positions open, you can substantially reduce overall compensation costs, although not as fast as you might like.

- **Reduce hours:** Reduce the number of hours worked by each employee. Many organizations have asked employees to work only 32 or 36 hours per week with proportionate reductions in compensation. Obviously, this strategy does not work in all functional areas (such as public safety) and may require agreement by labor organizations, but it certainly can reduce costs while eliminating the need for reductions in force.

- **Reduce the workweek:** Some organizations have explored moving to a four-day workweek. This is more complex than reducing hours because there may be expectations that public services should be available eight hours a day, five days a week (except public safety which is typically a 24/7 operation). The success of this approach has not been validated, but these organizations are certainly evaluating whether it is something that should continue even after the immediate crisis is over.

- **Early retirement incentives:** Another way to shrink a force without layoffs is through voluntary reductions and/or early retirement options. While not painless, at least the reductions are limited to those who are in a position to leave voluntarily. The risk here is that employees who you most want to retain could exercise the option and leave while those that you want to leave may choose to stay.

- **Phased retirements:** Here is an idea whose time has come, but may require so much debate and changed policy that, by the time you figure out how to do it, the current downturn will be over. This option simply means that you allow eligible employees to phase into their retirement. It goes something like this: The first year, the employee cuts back their work to 75 percent of their normal
workweek. They receive 75 percent of their pay as an employee, and 25 percent from their retirement pay (this is not 25 percent of their regular pay but 25 percent of the pension that they would normally be eligible to receive, if applicable.)

The next year, they reduce their time to 50 percent, and income is split proportionately. The third year they reduce work to 25 percent, and their retirement pay increases to 75 percent of their pension amount. In the fourth year, they are off of your payroll and fully retired. This option, coupled with an early retirement incentive, might work for some populations.

- Reduced, or elimination of, pay increases: This is an option we do not recommend. The actual cost savings will be temporary and may actually cost more in the long run. Organizations are at risk of losing good employees to the competition and falling behind in the market because of reduced pay increases.

- Cut temporary staff: Many organizations use temporary employees to fill a variety of needs. Use of regular employees to handle the work that would have been done by temporary employees can reduce the need to eliminate regular positions. See “transfer employees” above.

- Create efficiencies: While some organizations have used “gain sharing” as a technique to look for more cost effective ways to do business, now may be the perfect time to pursue efficiency efforts. Employees who understand that changing the way business operates will be better positioned to weather the turbulent times ahead than those who eliminate jobs just to maintain the status quo. There is an old saying in compensation circles that “what gets measured gets done.” Sometimes the simple fact of measuring performance and posting the results on a periodic basis so all can see can cause employees to improve their efficiency.

- Broaden your class structure: From a classification and compensation standpoint, one of the best approaches to becoming more efficient is broadening the classification and compensation structure: fewer titles but broader responsibilities. This gives the organization the flexibility needed to change work assignments as needed without having to deal with the bureaucratic process related to reclassifications. It reduces wasted manager, employee and HR staff time in documenting, justifying and rationalizing changes in job duties. It also allows you to reorganize more easily if you decide to take a critical look at how you are delivering services.

- Donate services: Offer to provide services for other agencies that may have greater needs than your organization. Conversely, you may want to ask other agencies to provide services to your agency if you have needs that you can no longer meet. This approach also relates to how you can most cost effectively provide certain services.

Our biggest concern when organizations face economic difficulties is that they take actions that may save a dollar or two now but will cost significantly more when the economy turns around. While layoffs may reduce costs now, the combination of unemployment costs, severance costs, loss of knowledge and trust, and the subsequent costs of hiring, training, lost productivity or increased errors (which can exceed the new employee’s first year salary) can quickly drive your organization back to unsustainable costs. Because of the way layoffs are often structured, you may also lose some of your most valuable personnel. Not dealing with compensation programs will simply make it more difficult to recruit key talent when the need arises. We have been urging public agencies for many years to think ahead about organizational needs when adopting a compensation philosophy and strategy.

We know that there are other techniques that can be used to ease the strain but hopefully we have stimulated your thinking. Just keep in
mind that what you do now will impact your ability to be responsive and competitive a year from now. Often a unique combination of several of these ideas will help you see through the tough times and better position you for the future.

The Comp Doctor™ is the team of Jim Fox and Bruce Lawson, Managing Directors in the Human Resources & Compensation Consulting practice of Arthur J. Gallagher & Co. They specialize in assisting governments in fixing their compensation and classification systems.

You may find them on the web at www.ajg.com/compensation

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