Employee Compensation Challenges in the United States

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Abstract

Compensation professionals in the United States face myriad challenges as they work to ensure the interests of companies and fair pay for employees. The purpose of this paper is to help illuminate three vexing challenges with which compensation professionals must address. The three issues are the effects of the Great Recession, anticipation of possible changes to the Fair Labor Standards Act, and the influence of rising wages in China. In addition, the goal of this paper is to offer a brief discussion of each one and to advance reasonable conjecture about how these issues may influence compensation practice.

Introduction

"I felt like I was an arrow, pulled back and ready to be launched into something big."
— A.B. Shepherd [e.g. 1]

Compensation professionals continually manage current challenges and they anticipate how they will approach new ones. A.B. Shepherd's quote can be applied to the world of compensation professionals in which they must stand ready to engage in understanding and take action. In this paper, three issues have been identified that define some of the challenges facing compensation professionals in a rapidly changing business environment. The three issues are the effects of the Great Recession, anticipation of possible changes to the Fair Labor Standards Act, and the influence of rising wages in China.

Ripple Effects of the Great Recession

The U.S. economy experienced an economic recession from December 2007 through June 2009. The term "Great Recession" is widely used to describe the significance of this recession. It was the longest recession since World War II, lasting 19 months. Although the recession ended a few years ago, its effects still remain evident in employment activity in general, and compensation in particular. In this section, a brief review of the definition of an economic recession and its relevance to a pressing matter – the compensation–productivity gap.

The Great Recession

Economic recession refers to a general slowdown in economic activity. Evidence of economic recessions include reduced gross domestic product (GDP) and increased unemployment rates. Multiple complex factors lead to recessions. Reduced consumer spending is

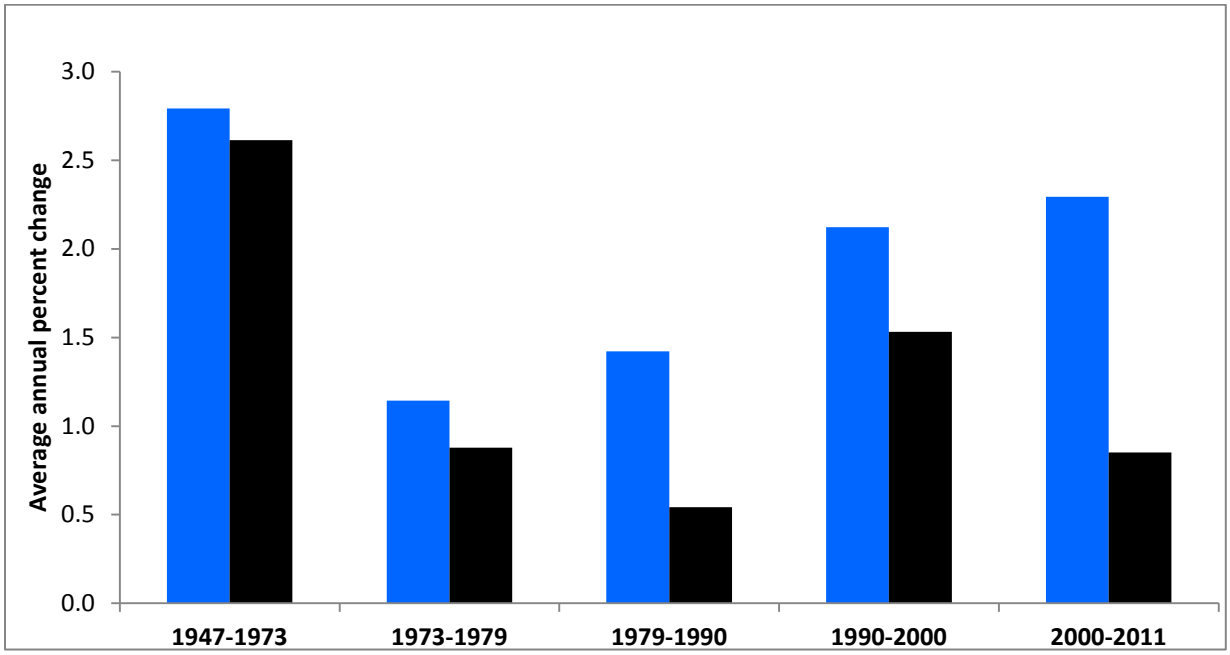
among the primary causes of economic recessions. Consumers' demand for products and services, particularly large ticket items such as automobiles and homes, declines. For example, automobile manufacturers, among them General Motors and Chrysler, respond to lower consumer demand for their products by cutting production levels in order to avoid excess inventory.

Recessionary forces create a domino effect that disrupts business activity and employment throughout an industry's supply chain. For example, in the automobile manufacturing industry, supply chains of vehicle components (for example, dashboards, winshields) are disrupted because production slows down. Reduced production adversely affects other companies' operations. Hundreds of companies alone supply components to automobile makers. Layoffs occur in these companies as well as in automobile manufacturing companies.

The Compensation–Productivity Gap

The gap between real hourly compensation and labor productivity indicates whether workers' pay is keeping up with productivity. The pervasive concern is that real compensation falls short of productivity gains notwithstanding increases in nominal pay. Real hourly compensation measures the purchasing power of a dollar while nominal hourly compensation is the face value of a dollar. Figure 1 shows this trend for the period 2007 – 2011, which straddles the period of the Great Recession. Increases in the costs of goods and services cause nominal pay to be less than real pay, which further complicates the problems discussed earlier. The left bar represents productivity and the right bar represents real hourly compensation. Quite simply, employees as consumers have less money to spend on essential items such as housing and discretionary items such as leisure and entertainment.

Figure 1. Trends in productivity and real hourly compensation growth, 2007-2011



Source: U.S. Bureau of Labor Statistics.

Productivity growth promotes rising living standards in the following manner. Increases in productivity growth indicate companies' investments in capital equipment and information technology. Examples of capital equipment include new manufacturing facilities, research and development labs, and sales distribution centers. Examples of information technology include structured databases containing expert information to help end users make informed decisions in complex situations. For instance, physicians may access databases to help them diagnose health conditions based on patients' symptoms and health histories. Another example occurs in the marketing field where information systems enable companies to identify customers for new products and services based on a variety of factors including household income and purchase history.

Since the 1970s, real hourly compensation has lagged behind labor productivity growth [e.g. 2]. The growth of productivity and real hourly compensation in the nonfarm business sector (which accounts for three-fourths of output and employment in the total U.S. economy) was comparable until 1973. The annual change in productivity averaged 2.8 percent and real hourly compensation growth averaged 2.6 percent during the 1947–1973 period. In 1973–1979, the annual averages were at 1.1 and 0.9 percent, respectively. Real hourly compensation growth failed to keep pace with accelerating productivity growth over the past three decades, and the gap between productivity growth and compensation growth widened. During the 2000–2011 period, average annual growth in productivity and real compensation equaled 3.3 percent and 1.0 percent, respectively.

For the 18-month period following each recession after World War II, companies experienced increases in productivity each time, but the gain in real compensation was substantially less. Most noteworthy is the difference between increases in real compensation relative to increases in productivity since the end of the Great Recession, which is much more substantial than in any of the prior recessions.

There are two reasons that may explain the compensation–productivity gap. First, high unemployment following recessions leaves employees with relatively lower power to bargain for higher pay because the supply of individuals seeking work is greater than the company's demand for new workers. Second, most companies experience profit losses during economic recessions, and, then, profits generally increase following recessions. Companies promote profits, in part, by holding down employees' pay.

Oftentimes, companies respond to lower demand through significant layoffs of employees. Among the economic reasons for extended mass layoffs, events related to seasonal factors accounted for 39 percent of events and 39 percent of related separations during the first quarter of 2013 [e.g. 3]. Over the year, the largest decrease in separations occurred in layoffs due to business demand reasons such as in this example.The number of layoff events along with separations and initial claimants rose dramatically during the recession and began decreasing following the recession, although the numbers following the recession remain substantially higher than prior to the recession [e.g. 4].

Anticipation of Possible Changes to the Fair Labor Standards Act

The Fair Labor Standards Act of 1938 contains three major provisions, including minimum wage, overtime pay, and child labor. In 2013 and 2014, the first two provisions were brought to the national stage, causing great consternation within companies, particularly, in small companies.

Minimum Wage

The amount of the minimum wage has changed several times since it was first introduced in 1938. Most recently, this wage rose from $6.55 to $7.25 per hour in 2009. In 2013, President Barack Obama called for an increase in the hourly federal minimum wage rate from $7.25 to $10.10 by 2016 only to be struck down by the U.S. Senate in early 2014. Even though the federal and some state governments raise the minimum wage from time to time, President Obama has argued that most workers who earn the minimum wage argue that it is insufficient to afford the basic necessities. In the summer of 2013, fast food workers across the United States walked off their jobs to protest against what they believe is insufficient pay.

Nearly half the states plus the District of Columbia enacted minimum wage laws throughout the years and several more states are debating the issue in the legislatures. Recently, some states have passed provisions to increase the minimum wage, including Maryland, Minnesota, Delaware, West Virginia, and Hawaii. Three of these states will make substantial increases to their minimum wage rates. In 2015, Maryland's minimum wage rose to $8.25 in increments until it reaches $10.10 by 2018. Minnesota's minimum wage is increasing to $9.50 by 2016 and, beginning in 2018, the wage will be indexed to inflation. Until this change, Minnesota's minimum wage was set to the federal level. In Hawaii, legislators approved a four-step hike from the state's current wage floor of $7.25 to $10.10 by 2018.

Within some states, pushes for higher local minimum wage rates have taken hold. For example, in Los Angeles, unions are lobbying for a minimum wage rate for hotel workers – the lowest paid in the city – to $15.37. If successful, concerns about layoffs could arise. However, one study found municipalities with higher pay didn't suffer job losses among low-wage restaurant workers [e.g. 5]. This study also found that restaurants often instituted modest prices increases to avoid layoffs. And, higher wages often resulted in lower turnover that can be attributed to higher wages.

Not all economists believe that raising the minimum wage will be harmless to the overall economy. Many argue that increasing the minimum wage will have negative ripple effects throughout the U.S. economy. These arguments are based on the economic principles of supply and demand. In this context, raising the minimum wage could lead to increases in the price of goods and services as companies try to offset some or all of higher labor costs. As the prices of goods and services increase, consumers are more likely to buy less. In turn, reduced demand for products and services stand to cut into profits, which may lead to cost reductions in the form of layoffs rather than further prices increases.

Much scholarly research supports this conclusion. An exhaustive review of recent research concluded that approximately 85 percent of minimum wage studies provide strong evidence of negative employment effects resulting from minimum wage laws[e.g. 6]. However, a recent study by the Congressional Budget Office indicates mixed outcomes. On one hand, an increase in the minimum wage rate to $10.10 would likely lead to the loss of 500,000 low-skilled jobs. On the other hand, raising the minimium would raise pay of nearly 1 million workers to above the federal poverty levels [e.g. 7]. Some of the loss in labor would be offset by lower cost automation. In the fast food industry, for example, labor-cost saving alternatives include online ordering and touch-screen kiosks.

Notwithstanding these broader dyanmics, compensation professionals face the challenge of managing pay inequities between a company's employees who are distributed across municipality or state lines where minimum wage rates differ. In addition, rising minimum wage

rates stand to compress pay structures that include minimum wage jobs. Compression in this context occurs when a higher minimum wage rate boosts the pay range minimum rate. Unless all the pay rates are increased commensurately, the reduced pay differences effectively understate the relative value of higher paying jobs, creating opportunities for more highly paid employees to feel pay inequity.

Compensation professionals also face the challenge of planning budgets. Dozens of states are considering possible increases to their minimum wage rates. Political debates, business and labor lobbying efforts, and politicians' interest in boosting re-election chances create uncertainty about whether minimum wage rates will increase, and, if increased, by what amount.

Finally, increases in the minimum wage force companies to reconsider its total compensation offerings. Mandated higher wage costs are not necessarily accompanied by increased total compensation budgets. It is possible that compensation professionals will have to eliminate or reduce the level of some benefits offerings. For example, a company could choose to offset the cost of a higher minimum wage by eliminating a tuition reimbursement benefit.

Overtime Pay Protections

In 2014, President Obama announced his intent to amend an element of the overtime pay regulations that pertain to the weekly pay or annual salary amount below which a salaried employee is entitled to receive overtime pay. In 2004, the U.S. Department of Labor FairPay rules set the amounts to $455 weekly (or, $23,660 annually). To qualify for the "white-collar" exemption, employees must be paid at least $455 per week on a salary basis and their job duties must meet specific tests. In general, their duties must include managing a part of the enterprise and supervising other employees or exercising independent judgment on significant matters or require advanced knowledge. Job titles do not determine whether employees are exempt from the overtime requirement.

Although the President did not specify a new threshold, widespread speculation suggests that the new salary criterion would approximately double to nearly $970 weekly (or, $50,440 annually). It is believed that part of the reason for President Obama's request is pressure from California and New York already having salary threshholds that are higher than the federal level. California and New York State recently begain raising salary threshold for overtime exemption to $800 and $675 weekly, respectively, by 2016. If the federal rules were to change, it is expected that at least 10 million employees will benefit [e.g. 8].

In principle, raising the overtime pay threshold could create economic advantage for employees and companies. If millions of additional workers qualify and earn overtime pay, perhaps discretionary incomes will rise, encouraging higher spending. In turn, some companies could benefit through higher revenue, assuming that any price increases put in place to compensate for higher overtime payroll costs are minimal.

However, it is possible that making more employees eligible for overtime pay may have an unintended consequence. Raising the threshold does not necessarily equate with a pay increase. By moving millions to qualify for overtime pay, however, may place these workers at a disadvantage. For example, it is possible that employers would likely require managers to schedule more cautiously, to avoid higher payroll costs.

Another unintended consequence pertains to workplace culture. Higher overtime pay thresholds may undermine cultures characterized by trust. Employers may require that managers and supervisors increase monitoring of nonexempt employees through greater observation and review than would usually be the case.

In reality, it is difficult to predict how employers would respond to a higher federal threshold, and how this increase might influence compensation practice. Nevertheless, some changes are within the realm of possibility. It is possible that employers will choose not to modify its hiring plans or choose not to backfill jobs that are subsequently vacated. Rather, compensation professionals could adjust (lower) base pay for newly hired employees in anticipation of bearing greater overtime pay expenses. Unless under a collective bargaining agreement or an individual's employment contract, employers could choose to lower current employees' base pay. This choice does not come without risk. Well qualified and high performers, who stand to have good job alternatives elsewhere, may leave. Alternatively, employers may adjust to higher thresholds through additional job creation. If planned and executed carefully, employers could avoid the need for employees to work on an overtime pay basis. Compensation professionals, then, would analyze patterns of past overtime work activity and the costs based on the current pay structure as well as the current and proposed overtime pay thresholds.

Finally, compensation professionals could identify which employees possess job duties that fit exemption criteria, and whose base pay is within close proximity to higher overtime pay threshold. To the extent that these employees generate substantial overtime pay costs, it may be worthwhile to consider pay increase awards that just exceed the higher threshold if and only if the cost savings is substantial.

Responding to overtime pay changes could create a competitive disadvantage, particularly where starting base pay is lowered, because not all employers will follow suit. In any circumstance, compensation professionals must take care not to propose policy changes that would lead to adverse impact or to create grave pay inequities across the pay structure. Lowering base pay could be difficult for other reasons. As we discussed, President Obama is committed to raising the federal minimum wage level, we have already seen upward movement at the state level, and many additional states are debating future increases. Lowering base pay today may pose a challenge where such changes may inadvertently set base pay below newly instituted higher minimum wage standards.

Influence of Rising Wages in China

In recent decades, many U.S. companies relocated manufacturing facilities from the United States to other countries such as the People's Republic of China because the cost of labor was substantially lower there than in the United States. In recent years, the costs of labor in China have been increasing rapidly. Rising costs are quickly reducing the competitive advantage gained from closing manufacturing operations in the United States and re-establishing those operations in China.

Among developing Asian economies, China's average pay rate is highest (versus Indonesia, Philippines, Vietnam, and Bangladesh). In recent years, the Chinese central government has been substantially raising minimum wage rates, creating pressure throughout the wage structure. Minimum wage rates recently increased an average of 13 percent across the country's provinces [e.g. 9]. Widespread news reports suggest that the Chinese government has been planning annual increases in minimum wages at least through 2015.

Chinese policy makers are supportive of increased wages for the following reason. In recent history, the growth in the Chinese economy was based largely on a trade surplus. That is, the value of goods and services being shipped for sale outside the country, in this case, China,

exceeds the value of goods and services shipped from other countries to China. Encouraging higher wages promotes domestic consumption, that is, the purchase and use of goods and services within its national borders. Increased domestic consumption will decrease the country's reliance on exports to sustain growth. Reduced reliance on exports is particularly necessary as labor costs within China increase rapidly. As China's labor costs rise, so would the cost of its exports, making the country less competitive in the global economy.

Labor shortages have also contributed to wage increases in China. These shortages are due, in part, to the rapidly aging Chinese population after 30 years of its one-child policy. This policy, still in effect, limits most couples to having one child only. The Chinese government implemented the policy to curb population growth in large cities. Economic growth is creating the need for new jobs; however, the one-child policy has slowed population growth as intended, vastly reducing the number of young workforce entrants. As a result, this policy has inadvertently contributed to an aging population. The largest segment of the Chinese population is currently in the 35–44 age range, and the 15-64 age segment is expected to decrease by 11 percent through 2050 while the 65 and over segment is expected to increase by 17 percent [e.g. 10].

Altogether, these factors are contributing to the rise in reshoring activities and domestic sourcing. Reshoring occurs where previously outsourced personnel and services are being brought back to the United States, and domestic sourcing happens where firms move jobs to lower cost regions of the United States instead of to other countries [e.g. 11]. Advocates of reshoring believe that manufacturers should calculate the total impact of offshoring because there are often hidden expenses such as higher costs for travel, packaging, shipping, and inventory [e.g. 12]. Also, reshoring has become a part of recent labor agreements. For instance, a portion of the 2011 labor agreement between Ford Motor Company and the United Auto Workers involved Ford agreeing to reshore some work presently being done in Mexico, China, and Japan.

There are additional numerous examples of reshoring by American firms. GE is reshoring its appliance manufacturing with an investment of about $432 million in its facilities in Kentucky, Tennessee, Alabama, and Indiana. Some of the reasons cited included rising costs due to unfavorable currency exchange rates, transportation, and labor in countries that were once much less expensive [e.g. 13]. A whole host of companies have chosen to move some or all of its manufacturing back to the United States. Wham-O, a company that makes inexpensive toys, recently announced it was moving 50 percent of its Frisbee and Hula Hoop production back to the United States from China and Mexico, which will create hundreds of new American jobs [e.g. 14]. Vaniman Manufacturing, a dental equipment producer that has been offshoring most of its sheet metal fabrication to China since 2002, is now returning to the United States. NCR Corporation, which has been producing its ATMs in China, India, and Hungary, is returning all of its production to a facility in Columbus, Georgia [e.g. 15].

Upon return to the United States, companies typically locate their manufacturing plants in right to work states. Twenty-three states, located primarily in the South and West, have adopted such laws. Right-to-work law**s** prohibit management and unions from entering into agreements requiring union membership as a condition of employment. These laws are state statutes or constitutional provisions that ban the practice of requiring union membership or financial support as a condition of employment. They establish the legal right of employees to decide for themselves whether or not to join or financially support a union.

U.S. Bureau of Labor Statistics data reveal that weekly wages in the private sector construction industry (an industry that is highly unionized) are generally lower in right-to-work

states. For example, the average weekly pay was $832 and $782 in Alabama and Florida, respectively. In Illinois and Massachusetts—non right-to-work states—average weekly wages were $1,115 and $1,233, respectively [e.g. 16].

Reshoring activities do not come without challenges. Increasingly, employers recognize a skills gap that has created staffing challenges, in part, because of more complex manufacturing processes that require specialized knowledge and skill sets. Also, while ongoing debates continue about the value of vocational education and the practicality of college education are evident, it is clear that companies must take on this challenge now by providing extensive training opportunities. Compensation professionals may have opportunities to develop skill-based pay programs to set starting base pay lower than the market average that will increase as employees complete essential job training.

Summary

Compensation professionals face numerous challenges. The focus here was on the compensation-productivity gap, changes to the Fair Labor Standards Act or minimum wage increases based on state and municipal laws, and rising wages in China. Each issue is a mix of complext economic, social equity, and demographic dynamics. Each of these challenges will require that compensation professionals anticipate policy and compensation system design features that will serve the interests of shareholders and employees.

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