



# PENSION & BENEFITS



**DAILY**

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## The Top Five Things You Should Know When It Comes to Employee Pay in 2010

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**T**he year 2009 was unprecedented in terms of actions organizations took related to employee pay. Pay freezes and pay cuts were more prevalent than any time reported since the Great Depression. For organizations that did grant a pay increase, the rewards for “satisfactory” and “outstanding” performance narrowed to a difference that was hard to distinguish.

While to some degree normalcy has returned, a great deal of uncertainty still exists. One thing we do know for sure is that organizations will continue to change how they manage employee pay. Here are some trends to look for as the economy continues to improve.

### 1. Pay freezes are dissolving but could resurface.

Labor cost is generally a fixed cost and is one of the largest, if not the largest, expense on an organization’s financial statement. To cut back on labor costs, organizations typically begin with layoffs and job eliminations, followed if necessary by a second round of job cuts, then a pay freeze.

Historically, the first step of layoffs and job eliminations has been sufficient to get most organizations through business downturns. During 2009, however, many organizations needed to take the additional steps of resorting to pay freezes and even pay cuts in some situations.

According to a January 2010 survey by Buck Consultants, *Recovery, Restoration and Retention: 2010 Compensation Trends*, almost two-thirds (64 percent) of respondents reported that they froze pay in the timeframe

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between July 2008 and January 2010, compared to 5 percent to 10 percent in prior surveys. Over the past six to nine months, this trend has been reversing rapidly, but the experience from this downturn may make organizations more likely to use pay freezes and pay cuts in the future, if needed.

### 2. Pay increase budgets will be slow to bounce back.

As we emerge from the throes of the recession, 2.5 percent is the “new black” when it comes to pay increases. For a number of years, the average or typical annual pay increase was 4 percent, dipping gradually to 3.5 percent by 2008, according to most published survey reports. The presumed minimum or floor was 3 percent, with anything less considered not worth giving. The next step down, the “basement,” or zero percent, was used by less than 10 percent of organizations and only when they faced tough business conditions that warranted a pay freeze.

In 2009, the average pay increase fell sharply to about 2 percent, due largely to the substantial number of pay freezes. (For organizations that did not freeze pay in 2009, the average pay increase was in the 3 percent to 3.5 percent range, consistent with the gradual downward trend.)

Average pay increases have rebounded slightly and are expected to settle around 2.5 percent for 2010. This should be consistent across organizations and less influenced by zero pay increases than the situation that occurred in 2009.

Looking ahead, the average pay increase will climb only when the unemployment rate declines. Unless and until employers increase the demand for labor, which will be driven by the demand for goods and services, the abundance of available workers will continue to suppress the growth in pay.

### 3. Creative ways to deliver pay increases will emerge.

Downsizing has forced many organizations to jettison their weaker performers. These organizations tend to be more inclined to reward everyone who is “doing a good job.” With only a 2 percent or 3 percent budget, meaningful differentiation requires that organizations withhold pay increases from some employees to give more to higher performers. As a result, even a nominal merit increase has become commonplace and expected by most employees as long as pay is not frozen.

While there are no silver bullets or easy answers for generating additional merit funds, organizations will continue to seek and develop new ways to stretch their pay increase budgets, especially when it comes to rewarding their top performers. Here are a few resourceful approaches to make rewards more meaningful for employees.

*Limit eligibility for pay increases.* This may be the easiest measure to take, yet one of the hardest to implement. The math is simple: Limiting participation to half the workforce doubles the average pay increase for employees who receive one. The first challenge is to limit participation enough to generate significantly more funds; the second challenge is to determine the basis for receiving a pay increase that is presumably performance-based. Measuring performance in a credible way can be difficult. If not done properly, stakes this high can put so much pressure on the performance evaluation system that it could break.

Many employees have not received a pay increase in more than one year. During that time, many organizations have downsized and asked the survivors to do more for the same pay. So, while a 2 percent pay increase may not seem like much, expecting some employees to give it up while others receive a 4 percent increase could create a culture of winners and losers as well as negative longer term repercussions.

*Accelerate the timing of pay increases, especially for top performers.* More frequent pay increases, even if they are relatively small, can send a positive message to employees. Frequent positive reinforcement can be especially important to top performers.

*Contribute pay increases to a defined contribution plan, such as a 401(k) or 403(b) plan.* The benefit to employees is current tax savings. But employers must give them the opportunity to opt out and receive their increases as usual in their paychecks. Augmenting the employee contribution with a special employer match could make this approach even more meaningful and attractive, and could provide employees with an incentive to save for the future, which is a major issue for many employees and employers. Of course, the usual qualified plan contribution limits and nondiscrimination rules apply.

*Monitor budgeted funds and invest as planned.* Budgeted pay increases that are not awarded due to an employee's termination or poor performance should be reallocated to other employees. Some organizations factor these dollars into the overall pay increase budget. Others reallocate them as they become available. In any event, reinvesting and redistributing budgeted but unused funds ensures the greatest return on investment.

### 4. Pay for performance continues to evolve.

Reluctant to abandon their pay-for-performance philosophies, some organizations have shifted their spend-

ing to pay delivery methods that produce a much more meaningful return on investment than just a base pay merit increase. Two of these are incentive (or bonus) plans and employee promotions.

According to Buck's annual compensation planning survey for 2010, more than 80 percent of participants report having a short-term (annual) incentive plan for multiple levels of employees. Although these plans originally were reserved for executives, the increased emphasis on pay for performance has broadened their use. At the same time, organizations have been doing a better job at defining, measuring, and communicating performance goals and expectations, which are key factors in making such plans work.

The other meaningful reward for performance is a promotion. As a result of the recession and related staff reductions, many employees took on added responsibilities. Most, if not all, employees who are promoted at least meet performance expectations. More often than not, they exceed them. Promotion increases typically average 7 percent to 10 percent, about three times the average base pay or merit increase. Because bonuses and promotion increases provide much stronger reinforcement for a job well done, they may increasingly overshadow base pay increases in pay-for-performance philosophies. If they have not done so already, look for employers to reward employees with higher pay levels for their additional contributions.

### 5. Regulations on employee pay are likely to increase.

The financial crisis has resulted in greater scrutiny and criticism of executive pay, as well as calls for new restrictions and taxes on compensation. Measures to control risk-taking in broad based incentive compensation programs have been put in place by the Federal Reserve Board for the banking industry and by the Securities and Exchange Commission for publicly traded companies. Given public sentiment and the economic and political climates, the trend in increased pay regulations is likely to continue.

The first indication of increasing legislative control over employee pay came when President Obama signed into law the Lilly Ledbetter Fair Pay Act on Jan. 29, 2009. Some believe that the president was setting a tone and direction by purposely making the Lilly Ledbetter Fair Pay Act the first piece of legislation that he signed.

The House of Representatives linked the Lilly Ledbetter bill to a companion bill known as the Paycheck Fairness Act (H.R. 12)<sup>1</sup> and quickly approved both bills. The Senate, however, approved the Lilly Ledbetter bill, but the Senate version of the Paycheck Fairness Act (S. 182) stalled due to more pressing issues such as the budget crisis and health care reform.

<sup>1</sup> The Lilly Ledbetter Fair Pay Act amends Title VII of the Civil Rights Act of 1964 to extend the time for filing a pay discrimination claim with the Equal Employment Opportunity Commission. In doing so, it allows employees to challenge pay-related decisions years after they were made. While the Lilly Ledbetter Fair Pay Act and the Paycheck Fairness Act both deal with the issue of fair pay, the former is more about *when* pay discrimination occurs whereas the latter is more about *why* pay discrimination occurs.

The Paycheck Fairness Act is an amendment to the Fair Labor Standards Act of 1938 and the Equal Pay Act of 1963. The Equal Pay Act has failed from some peoples' perspectives to address what some believe are inherent market biases and underlying discriminatory pay practices.

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A third bill known as the Fair Pay Act (H.R. 2151, S. 904) was introduced in Congress in April 2009. Like the Paycheck Fairness Act, it seeks to remedy discriminatory pay practices that are already prohibited under the Equal Pay Act. The Fair Pay Act aims to eliminate pay differences between jobs that are predominantly held by a certain race or gender as compared to equivalent jobs dominated by others of a different race or opposite sex. The jobs do not have to be similar in terms of performing the same functions, just equivalent in terms of skill, effort, responsibilities, and working conditions.

Now that other legislative priorities have been addressed, particularly health care reform, the Fair Pay Act and the Paycheck Fairness Act may resurface. Given the political climate and the prior congressional votes on related measures, there is a high probability these bills could be passed. And if they are, the president is likely to sign them.

Employers need to tread carefully and balance competing objectives. Employee morale in many organizations is low due to the lack of pay increases. There may be a desire to try to do something for everyone. In addition, individual managers may want to do something extra to reward their top performers and high-potential

employees to help in retention, especially as the economy recovers. This situation, combined with an already unhappy workforce and a pro-employee regulatory environment, creates potential discrimination risks. Employers need to monitor performance and reward practices to ensure that decisions and results are fair and consistent.

### **Expect more changes.**

While we may not see much movement in employee base pay levels in the foreseeable future, we do expect other changes that will affect how pay is determined and the way rewards are distributed. It is likely that employee pay will receive increasing attention due to the magnitude of the investments that organizations make in their workforces and their desire to generate positive returns.

One thing is clear: The role that pay plays in attracting and retaining quality employees cannot be overlooked. The trends we have described, and others that will emerge over the coming months, will ensure that organizations have the resources they need to be successful as this recovery continues.