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10 New Rules for Managing Compensation in a Recession

As recently as early fall 2008, companies across the board reported that they were only making small corrections in response to a sluggish economy, with an overwhelming majority expecting 2009 base pay increase budgets to remain steady, in the 3 percent to 4 percent range.

To say that a lot has changed in just a few months is an understatement. The consensus economic forecast seems to be that fourth-quarter 2008 was the worst of the recession, but unemployment will continue to increase, the recovery will be slow and we will have at least another quarter of negative growth. Consider the following statistics:

QUICK LOOK

- Restricting the use of base pay increases to recognize only those employees who are stepping up and taking on additional responsibility is a cost-justified way to keep the right people motivated.
- As rewards will be lean in the near future, the organization should reduce talk about pay and increase communications about its employment value proposition — the mission and attributes associated with working at the organization that make the work experience superior to that at other organizations.
- Focus less on market pay competitiveness and more on total payroll effectiveness.

By Brad Hill and Christine Tande, Tandehill Human Capital

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- On Dec. 11, 2008, the widely watched *UCLA Anderson Forecast* reported an expected decline in real gross domestic product (GDP) of 4.1 percent in the fourth quarter, followed by declines of 3.4 percent and 0.8 percent in the first two quarters of 2009.
- According to its January budget report, the U.S. Congressional Budget Office expects a 2.2-percent contraction of the economy this year.
- Companies are now in various degrees of crises mode, with unemployment expected to reach above 9 percent by late 2009/early 2010, 2 million jobs expected to be lost in 2009, and a slow post-recession growth projected at about 3 percent, according to various media outlets.

The Response

In response to these very serious economic pressures, organizations should consider 10 new rules for managing compensation. Keep in mind that these rules are specific to the current economic situation and should not necessarily be applied on an ongoing basis.

1 **Centralize compensation management.** Immediately take a more macro perspective on performance and pay to ensure that the right dollars get allocated to the right areas of the organization in the timeliest manner. To that end, human resources needs to flex its cost-control muscle to ensure that local managers are making pay decisions that best serve the entire organization and not just doing what's best for them. What's required is an HR coup d'état (a formal takeover of approvals on compensation decisions) until business returns to normal.

2 **Provide base pay increases only to those employees who took on more responsibility during the past 365 days.** Base pay increases represent a permanent escalation in fixed salary costs and must be aggressively managed. Restricting the use of base pay increases to recognize only those employees who are stepping up and taking on additional responsibility is a cost-justified way to keep the right people motivated. Rather than spread the financial pain around at the risk of losing or demotivating high performers, take at least half of your available funds and deliver it to the 20 percent of employees who have taken on the most additional activity/responsibility.

3 **Tie incentive pay directly to the financial health of your organization.** All nonsales incentive pay should be influenced by the financial performance of the entire organization. (See rule six.) The best way to ensure this link is to: 1) insist on goals that cascade top-down from the short-term business strategy, and 2) use organization performance as an incentive modifier, increasing or reducing the amount earned by the individual. For example, an individual with a 20-percent incentive based on his/her performance may earn 10 percent to 30 percent, depending on the organization's financial performance. With this approach, incentives are still paid and individual performance will still have an impact on the payout, but the actual payout will reflect the organization's ability to pay.

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4 **Change the time frame of incentives.** The traditional performance period for incentives does not serve anyone well during troubled economic times. The time frame of incentive plans must focus the lower levels on immediate initiatives and the senior ranks on longer-term viability. To that end, a company can take the following approaches:

- *Create a quarterly, self-funded incentive opportunity for nonexecutives.* Keeping employees motivated and directed during tough economic times requires the constant feedback, communications and attention inherent in a quarterly incentive plan. This plan should focus employees on the perfect execution of short-term tactics that may

be necessary to the company's ability to succeed. Note that it should exclude executives responsible for longer-term decisions that will ensure future viability.

- *Offer only results-based, longer-term incentives to executives.* Executives need to stay focused on generating cash and directing a short-term business turnaround that ensures the entity's long-term survival. Annual stock-based compensation is not relevant or motivational in this situation. Instead, set a meaningful two- to three-year financial performance hurdle for executives and reward them handsomely, but only for performance above the hurdle.

5 Trumpet your employment value proposition. As rewards will be lean in the near future, the organization should reduce talk about pay and increase communications about its employment value proposition — the mission and attributes associated with working at the organization that make the work experience superior to that at other organizations. Fill employees with dignity and a sense of purpose in coming to work each day during difficult economic times by emphasizing the contributions that the organization makes to society.

6 Compensate salespeople using a cost-of-sales approach. In a contracting market, those salespeople who are best able to take market share from your competitors become your rainmakers. Pay the salespeople in direct proportion to their contribution to the bottom line, without regard for market pay practices. Seriously consider reducing their base salary levels and enriching incentive pay tied to results. Reduce your fixed salary costs, but uncap the incentive upside and allow good salespeople to earn more than ever before.

7 If you must have a layoff, eliminate the person, not the job. It's easier to teach a new job to employees who embrace your vision, values and work ethic than it is to instill passion and purpose to a mediocre jobholder. And in tough times, teaching a high performer a new skill is a better investment than sustaining mediocrity. Identify the positions and people that are critical to your success and understand that they may not be the same.

8 Pay a premium to those employees most impacted by a layoff. Anxiety, sadness and anger for the increased workload now that their team has been reduced can be devastating to the productivity and engagement of those who still have jobs. Recognize that the organization may now expect more of some employees and compensate

New Rules

1. Centralize compensation management.
2. Provide base pay increases only to those employees who took on more responsibility during the past 365 days.
3. Tie incentive pay directly to the financial health of your organization.
4. Change the time frame of incentives.
5. Trumpet your employment value proposition.
6. Compensate salespeople using a cost-of-sales approach.
7. If you must have a layoff, eliminate the person, not the job.
8. Pay a premium to those employees most impacted by a layoff.
9. Temporarily embrace a forced distribution of performance.
10. Reduce your payroll by paying above market for fewer high performers.

A forced distribution of performance can harm a healthy workforce morale, but **if there must be layoffs, they should be based on a well-thought-out and well-executed ranking** of those employees most necessary to your survival.

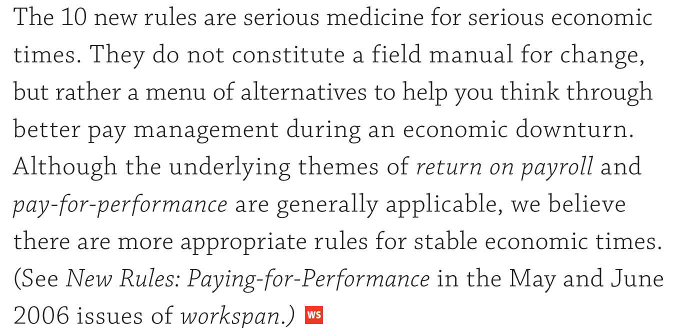
them for the additional energy and hours that they must expend. For example, for every $10,000 in payroll cuts, consider increasing the pay of those who will be expected to pick up the workload by $1,000.

9 **Temporarily embrace a forced distribution of performance.** A forced distribution of performance can harm a healthy workforce morale, but if there must be layoffs, they should be based on a well-thought-out and well-executed ranking of those employees most necessary to your survival. Performance should examine competencies, results and propensity for growth. Note that this exercise is not a replacement for sound performance management principles that focus on employee development, but a temporary tool to assist you in evaluating the resources you need to survive and prosper.

10 **Reduce your payroll by paying above market for fewer high performers.** Focus less on market pay competitiveness and more on total payroll effectiveness. For example, Nucor Steel hires five people, works them like 10 and pays them like eight. It may look to the uninformed compensation analyst that Nucor pays too much. In reality, its return on payroll far exceeds industry norms.

In 2007, Circuit City made a bet that the drop in sales from firing its 3,400 highest-paid associates would be offset by the lower pay that it gave to less-capable replacements. In 2009, Circuit City was liquidated. It makes sense that if you employ talented, experienced, motivated people, then you will need fewer of them. But, our time-honored myopia of managing the pay of individual jobs without consideration for overall payroll management may lead us down the wrong path for effectively managing compensation in a crisis.

Conclusion



The 10 new rules are serious medicine for serious economic times. They do not constitute a field manual for change, but rather a menu of alternatives to help you think through better pay management during an economic downturn. Although the underlying themes of *return on payroll* and *pay-for-performance* are generally applicable, we believe there are more appropriate rules for stable economic times. (See *New Rules: Paying-for-Performance* in the May and June 2006 issues of *workspan*.)

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