Average Hourly Earnings Increase Is Reducing Profits: Why It Is a Better Time than Ever to Focus on a Total Compensation Approach to Controlling Overall Labor Costs

Background

Average hourly earnings increased 2.7% in June from a year earlier, according to the Labor Department's monthly jobs data released last Friday. That is good news for U.S. workers who have seen minimal wage increases over the past few years. But the higher costs pose a threat to some U.S. companies that are already facing trade-related tensions and a limited ability to raise prices to keep up with inflation. Economists at Goldman Sachs predict that every percentage point increase in labor cost inflation will drag down earnings of companies in the S&P 500 by 0.8%. The bank estimates labor costs equate to 13% of revenue for companies in the S&P 500.

According to a report from Bank of America Merrill Lynch Global Research, 10% of companies in the S&P 500 mentioned higher labor costs as a factor that weighed on their first-quarter results, up from 8% in the fourth quarter. Labor costs equal 21% of revenue for companies in the industrials sector, and analysts expect that a percentage point increase in labor cost inflation would dent the sector's earnings by 1.5%.

Some industrial companies are already struggling to find workers, a sign that they may be forced to raise wages. In a traditional economic cycle, companies would attempt to pass along the increasing cost of labor to customers, but that is not happening this time. A National Association for Business Economics survey for the first quarter showed 56% of respondents reported rising wage costs, but only a fraction of those companies indicated that they could pass along these increasing costs to their customers.

What Is a Total Compensation Philosophy?

Compensation in all forms is a critical component of attracting and retaining talent, at all levels. Critical components of total compensation include (in order of average cost):

1. Direct pay
2. Medical/Rx
3. Paid time off
4. Statutory benefits

5. Retirement Plan benefits
6. Ancillary benefits (life, disability, vision, etc.)

Organizations with excess costs in areas not fully valued by employees will find it difficult to attract and retain employees. Without diligence, it is possible that employees may perceive a total compensation program which costs more than average as below average; resulting in the employer being viewed as non-competitive by the marketplace.

We believe development of a sound total compensation program includes:

1. Framing the program within the strategic plan of the organization
2. Benchmarking all components of total compensation against targeted competitors and industry norms as well as regional norms.
3. Identifying critical groups of employees
4. Determining employee priorities
5. Addressing budgetary issues, including current situation and targeted budget levels
6. Designing the program to maximize perceived value, within budgetary realities.

Once the above are addressed, the total compensation program can be assessed and alternative designs can be presented for consideration. If one area (such as wages) is increased, less must be utilized for other components – like a salary cap structure in the NFL, which has negative consequences if a team overpays a running back. Remember: piecemeal approaches have historically proven to fail. Understanding how each piece of a total compensation puzzle fits together, with pre-established objectives and priorities, will yield better bottom line results.

Please share your thoughts!

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