Retooling labor costs

How to fix workforce pay structures
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Faced with the one-two punch of the financial crisis and the Great Recession, companies have been working tirelessly at cutting costs to survive. Much of that effort has been focused on reduction of the workforce — manifesting itself in waves of layoffs. Less addressed throughout this crisis, however, has been the need to restructure wages and benefits. Of course, some companies have cut wages, with broad-stroke reductions across large pools of labor. But most companies have been wary of the underlying risks associated with such widespread cuts — worker disengagement, litigation, unionization, brand damage, and other concerns. It’s a vicious cycle — continue to reduce the workforce, put more and more of the load on the remaining workers, and expect quality and employee morale to stay the same!

But there is another way to rein in labor costs, a process that replaces the budget ax with a tailored approach. This approach is less damaging to workers and less risky to companies — and should allay many of the concerns of those who have stayed on the sidelines. At the same time, it exposes rich veins of potential savings that remain despite the ax’s blows — making it worth consideration even by companies that have been the biggest cost cutters. With proper execution, net labor savings of 15 to 20 percent are possible.

These potential savings relate to a variety of systemic and sometimes dysfunctional wage and salary practices that affect all companies. Such practices have resulted in pay scales for many jobs that far outstrip what the market says those jobs are now worth.

The way to restore order is to “retool” labor costs. The first step is to determine a company’s correct pay scales and job roles through a blend of market data and internal benchmarking. Once appropriate pay scales are fixed, job categories can be redefined and workers reclassified. Then a customized application of management levers will get at the systemic and dysfunctional practices themselves. If rigorous controls are put in place, the savings, and resulting competitiveness, will continue into the future.
Joe has been a machinist for 25 years at the same company, a steady and reliable worker. Though he is a great asset to the company, his wages have gone up steadily over the past quarter century while his responsibilities haven’t changed proportionately. The result is that Joe is grossly overpaid as a machinist when compared with fully functioning co-workers with just two years of service who do the same job. The company does not want to fire Joe — because he’s been a fantastic employee, it would send a bad message to the other workers (loyalty being rewarded with dismissal) and there would likely be severe legal implications to such a move. However, the company realizes that it can’t allow this wage inconsistency to continue and it is now considering what to do.

This story is not a rarity — sizable discrepancies in pay, multiplied countless times in factories and offices, have largely escaped the budget ax of the past three turbulent years. Together with other disconnects in payroll spending, they represent a core area of savings that still needs to be tapped to stay competitive in an economy that remains highly uncertain.

Hit first by the financial crisis and then by the resulting Great Recession, companies have been under siege and have struggled to cut costs as quickly as possible to respond to a disintegrating marketplace. Much of that effort, of course, has been directed at the workforce — waves of layoffs have been accompanied by unfocused, sweeping reductions in wages and benefits. Indeed, the cuts have been deep enough to make some companies more profitable than they were before, even though revenues may be depressed for quite some time.

These cuts haven’t come without their own costs, however. For the workers who remain, morale is down, anxiety is up, and burnout threatens. When the economy improves, many of the most valuable employees may bolt at the first attractive offer. Companies face a raft of other potential risks as well, including litigation and brand damage. Some companies have been so concerned about the long-term
ramifications of draconian cuts that they have sidestepped the basic need to restructure wages and benefits.

But companies can’t afford to simply let their labor costs slide, especially when it comes to pay scales for many jobs that greatly exceed what the market says those jobs are now worth. Given the competition that incumbents face — from both upstarts and emerging markets — the gap between a job’s high wages and its market value has to be narrowed, if not closed. For some companies, the choice is stark — either reduce the gap or jeopardize their future.

Now that the recession seems to have eased somewhat, there is time to step back and consider an additional, more sustainable way to deal with labor costs. This multifaceted and tailored approach is less damaging to workers and less risky to companies — and should allay many of the concerns of companies that have stayed on the sidelines. At the same time, it exposes rich veins of potential savings that in all likelihood were overlooked by those who recently wielded the budget ax — making it relevant even to companies that were the most proactive cost cutters. With the proper execution, net labor savings of 15 to 20 percent are possible.

We call this approach the “retooling of labor costs” since it goes beyond the need for immediate savings and addresses the systemic and sometimes dysfunctional wage and salary practices that affect all companies in all industries. These practices have distorted and bloated the payroll that companies spend on employees of all stripes, whether they work on the factory floor and the administrative side or as managers. The bottom line is that companies have not been able to take advantage of the truly dynamic nature of the labor market.

Some of the gap between wages and market value is evident in the buildup of annual increases in pay for veteran workers like Joe — workers whose responsibilities have remained essentially the same over the years. Wide disparities in pay levels within job categories are another sign of the soft labor midsection at many companies. And categories that are ill defined or filled with employees who should be re-categorized are still another sign.

By using a mix of external data and internal benchmarks, a company can realign its wage and salary structures so that they relate in a much more rational and consistent way to the market value of the work being performed. The exact approach depends on each company’s type and mix of employees and a host of other characteristics unique to the organization.
But in general, a customized mix of adjustments needs to be applied — for example, job categories need to be scrutinized to reset wages and responsibilities so that they are aligned with current market conditions and consistent within the company. Voluntary and involuntary separations can be deployed on a case-by-case basis, and after retraining, new responsibilities, counseling, and other options can be considered. Broad wage reductions usually come into play only after the other levers have been used. As for wide-ranging layoffs, they wouldn’t be part of the formal mix at all and would be held in reserve as a last resort should the company’s situation become precarious.

To be sure, this approach will not make all worker anxiety disappear. Some people will lose their jobs, and some who stay will be paid less (for Joe’s story, see “The Front-Line Wage Earner,” page 8). Companies will still face risks but in a greatly mitigated form (see Exhibit 1, next page).

Another obvious caveat is that this process will not save as much up front as the broad budget-ax option will. This process requires a commitment of one to two years or even longer, for analysis, decision making, and implementation. Over time, though, the payoff will be as systemic as the problem once was.

In a sense, addressing this opportunity is no longer a choice but a necessity. Startups are hiring people at deeply discounted market rates, taking advantage of today’s steep unemployment. These rates are much lower than the historical average wages paid by incumbents. And the other incumbents themselves are not sitting still — they are already working on reducing wages.

Because this effort goes to a company’s core, the strategic decisions and overall planning should be overseen by the chief financial officer and/or the chief operating officer in conjunction with line management and the human resources department. A logical wage strategy is not a one-time thing — rather, it must encompass a long-term approach to keep it in place.
**Exhibit 1**

A nuanced strategy is needed to reduce the risks in cutting labor costs

| People risk | – Potential departure of key staff due to uncertainty about future  
| – Inadvertent loss of long-term capabilities while pursuing short-term cost actions |
| Productivity risk | – Significant dips in productivity caused by low morale, fear of job loss, and overwhelming change (e.g., new processes and systems) |
| Financial risk | – Inability to deliver prior levels of service and/or business support  
| – Lack of due diligence on broader financial impact to business and customer experiences |
| Transition risk | – Insufficient knowledge transfer by departing subject matter experts  
| – Behaviors, incentives, processes, and systems misaligned to support new priorities |
| Survivors risk | – Flight risk stemming from survivors’ disappointment about how reductions were handled  
| – Inability to retain valuable talent at a time when extraordinary efforts will be required |
| Reputation risk | – Possibility that angry and hurt employees will go to the media, steal IP, leak information to competitors, or disrupt work  
| – Potential for negative perceptions of management actions to damage company branding |
| Compliance risk | – Fines or litigation resulting from noncompliance with applicable labor laws |

Source: Strategy&
The front-line wage earner

Joe was hired in 1985 by a midsized manufacturing firm to work in a tool room, machining parts in the company’s major manufacturing facility. Over the years, he has been a solid, reliable employee. He has had limited time to expand his skill set and prefers the familiarity of the work he learned 25 years ago. He does not supervise anyone, but he does train new hires on occasion.

During his tenure, Joe has consistently received annual raises based on his performance, separate annual raises tied to the company’s performance, and regular cost-of-living adjustments.

He started out making $7.50 an hour as an apprentice machinist and now makes $20.50 an hour. This wage is sharply higher than the current market reference point, or MRP, for this job. Based on surveys of a number of companies, the MRP for machinists performing the same work in the same general geographic area is $12 an hour. Furthermore, the average compensation for all 105 workers in Joe’s category at his company is $12.50 an hour, and the average wage for a fully functioning machinist with two years of tenure is $11.50 an hour.

The company can take a holistic approach to the wage issue presented by Joe and others with similar tenure, giving it a variety of levers to pull. Because Joe has been a steady employee, the company can first evaluate the option of increasing his value through training and expansion of his role — better aligning Joe’s contribution with his wages. This is a first step to “protect” high-caliber performers and retain talent.

Given Joe’s proximity to retirement age, the company can offer him and similarly tenured employees voluntary separation packages, providing an incentive for the employee to leave before the full benefits of a retirement plan kick in. How well the package is crafted will determine the response rate (greater than 15 percent is a success). In preparing the offer, employee “town hall” sessions and paycheck analysis are essential steps. It’s important for the company to deliver the offer with the message that further, more draconian measures may come later — and that this offer is an opportunity.

If Joe does not accept the package, the company can consider a focused reduction in wages — eliminating the effective premium he is paid. Assuming a 40-hour week, that premium is nearly $19,000 a year. The wage reduction, implemented in stages, would also be applied to others in a similar position. During this phase, communication is key. The goal is for the entire workforce to understand the reasons for the wage reduction and how it’s being implemented. In other words, the workforce needs to understand that the reduction is being targeted at a select group of highly compensated employees.
Causes of wage and salary inconsistency

A single culprit is never responsible for wage issues. Multiple factors are always at play: Inertia, the passage of time, sloppy or nonexistent standards, and ad hoc decisions are usually on the short list of reasons for the sprawling and sometimes stunning differences in pay at many companies.

Tenure-based wage escalation

In the case of a large installed workforce that’s been employed for several decades, wage disparities can be particularly striking. Joe and other workers with many years of service typically have seen their wages grow in a steady trajectory, fueled by adjustments for inflation as well as annual merit raises. These increases are often provided without any increase in skill levels or responsibilities. As a result, the overall cost of the role has risen dramatically, far beyond the value placed on that role by today’s marketplace. The disconnect is unfortunate — and very often a symptom of a management team nervous about worker organization and eager to quiet unrest with the easy “solution” of a wage increase. It is also a clear sign that the team has not given much thought to a longer-term workforce strategy — or does not understand the actual value of labor in the marketplace.

Variations within a band

Many companies have an inconsistent approach to setting salaries within different parts of the company or even different parts of a business unit. This can often result in similar bands of jobs (and sometimes similar positions) having a wide variance in salaries. And though survey-driven industry data known as the market reference point, or MRP, is used to help set wages and salaries, the line manager often makes the ultimate decision. The result is that there can be departures of plus or minus 40 or even 60 percent from the suggested MRP guidance.
**Lack of band definition**

Without a clear sense of what a band is meant to contain, it would be hard to impose a range of wages that had any consistency or logic. Companies that do not enforce a rigorous set of salary bands are opening themselves up to wage escalation and to dissension among employees in similar bands (“Why does he make more than I do?”). This situation is often symptomatic of limited oversight and strategy setting. It means that a company is not thinking about broader workforce issues — for example, if we are going to pay these people more, shouldn’t they be in a higher band with more responsibilities? Again, it’s easy to pay someone more, but it’s quite another thing to realign that person’s responsibilities or band classification (see “The Salaried Knowledge Worker,” next page).

**Poorly defined processes or controls**

Having a rigorous process for controlling wages is paramount — in fact, it is one of the most important functions HR can provide to a company. Ad hoc or one-off decisions, when repeated enough times, can morph into a very costly trend. Excessive merit raises, side-item bonuses, cost-of-living increases that surpass the rate of inflation, and automatic raises that are out of step with market conditions are among the villains that come in all shapes and sizes. The end result is a complicated web of salary logic and history that does not lend itself to a holistic perspective, making an integrated strategy tricky to develop, difficult to implement, and nearly impossible to sustain.
The salaried knowledge worker

Sally was hired by a global media firm in 2000 as a manager to run its print business. She consistently performed well and met all her budget targets. Recognizing her achievements, the firm promoted her to director of operations in the Northeast region. Sally was again successful and was able to improve operating performance. She was also given a President’s Award for her performance.

Unfortunately, the print business was not doing as well as Sally. The industry was undergoing a transition, and Sally’s firm was losing advertising revenue to Google and other new-media companies. Everyone thought Sally was ready to be promoted again and given a vice president’s position. But because of the declining fortunes of the print business, there was no open position at that level.

Nonetheless, the firm did not want to lose Sally. So management decided to keep her in the same role but to give her a salary increase of 20 percent, almost four times the company average. Since Sally was a star performer, she was already at the upper end of the salary band for the director’s position. With the new raise, Sally’s salary was now more than 20 percent higher than that of anyone else at that level.

At most large companies, there are many people in this situation. The employer has essentially one option — to rightsize the employee to the appropriate job category. In Sally’s case, that would mean finding her a vice president’s position somewhere else in the company or cutting her salary back to the appropriate level for a director, even if that meant she might quit as a result. It’s a difficult decision to make, but a necessary one, in order to properly cultivate management ranks and ensure that outside hires are viewed as an asset among the peer group — rather than as “hired guns” paid much more than team members who have been with the company through thick and thin.
Understanding your relative position

Where exactly should wages and salaries be set? How do you identify the right pay rate? Are you a “top tier” company in regard to salaries — or can you make do with median wages?

As noted above, most businesses use market guidance in the form of an MRP. An MRP is usually provided by third parties that conduct regional surveys across a wide sample of companies to build representative data that can be used to set wages and salaries in banded or tiered structures. It provides a pulse of the market and can be quite helpful when used correctly, since it suggests a range of wage targets for a given job or category of jobs. For example, in a survey for an assembly-line job, the hourly wage might be broken down by quartile. The lowest-paid quartile might earn less than US$13.50 an hour, while the top quartile earns between $15.70 and $16.25. Clearly, the decision about where a company should be paying along the market scale is just as important as the actual market data.

Despite providing a sample of the market, the MRP approach is fraught with potential problems that need to be considered.

For one thing, third parties put together a weighted average wage, which can skew the data higher or lower depending on which companies are surveyed. Larger firms with more employees will influence the result more heavily than small businesses. Given that some larger firms have a “premium brand” strategy or possibly a large union presence that supports higher wages, there is the potential of producing an MRP higher than what the client company actually needs to pay or can afford. Conversely, a volume discounter with a low-cost provider strategy may skew an MRP downward, resulting in wage guidance that is unrealistic for a firm without the market clout to get workers to accept lower pay. The makeup of the sample set is central to understanding the accuracy of the data.

What’s more, variability exists from one survey to the next. Companies using external guidance tend to purchase information from multiple survey houses, using multiple inputs for the same job category to
triangulate the “right answer.” Often an internal HR professional simply makes a call on what the numbers should be — based on his or her experience and how “honest” the HR person thinks the respondents have chosen to be with their wage information.

Sometimes, the job category may not be correctly defined or could be too general. The label “data analyst,” for example, encompasses a wide range of roles and responsibilities — and thus a wide range of appropriate salary levels. A number of job definitions within that category would be needed in order to assess where a given data analyst belongs.

Finally, it makes sense that a survey company would want to avoid providing guidance that proves frustrating to HR professionals and hiring managers because they can't find people to employ at the wages suggested by the survey data. Therefore, if hiring turns out to be too easy, it's an indication that the wage guidance was too high, leading to large amounts of unnecessary expense.

**A complementary approach: The benchmark analysis**

In our experience, companies can get a more actionable understanding by using an MRP in conjunction with internal benchmarking. Benchmarking helps to determine the wage required to bring qualified candidates “in the door” and to keep them until they become fully functioning in their position. Leveraging this, the company gets a much better sense of its internal wage performance. For example, if it takes two years to become proficient in a particular role, then the benchmark wage for that job would be the average wage of all individuals in that position with two years of tenure.

This approach reveals a target wage that is exactly relevant to the company in question, given its own strategies, location, and presence in the labor market. The overall body of resulting data, together with the guidance from an MRP, can identify the point at which the pay of long-tenured employees may exceed the value of the jobs they perform.

One caveat: The benchmarking approach is much more appropriate for large groups of workers with a similar role, rather than for more differentiated management positions for which salaries are often driven by factors unique to the employee, the position, and the company. For more discrete one-off positions, an external market perspective is necessary.
Coordinating the levers for change

Through careful and consistent application of a full range of levers, order can be brought to the helter-skelter pay structures at many companies. As mentioned earlier, the application of the levers must be tailored to the particular circumstances of each company. But the “cure” will typically involve some combination of these five levers (see Exhibit 2, next page):

- Natural attrition
- Appropriate job categorization and policy adjustments
- Voluntary separation
- Involuntary separation and performance management
- Wage reduction

**Natural attrition**

Natural attrition will reduce the ranks, albeit slowly, of employees with long tenure and high wages. A determination then has to be made whether to replace those workers. If they are to be replaced, a well-calibrated MRP should be used in conjunction with internal benchmark analysis to set wages at the correct rate.

**Appropriate job categorization and policy adjustments**

As a first step, discrepancies between job categorization and actual roles need to be identified. In some cases, perhaps many, employees will have to be reassigned to other categories where their roles are more aligned. For each category, floor and ceiling pay levels should be established. Once employees and pay levels are in the right places, the calibration process has to be sustained through rigorous policies for starting salaries and merit raises.
### Exhibit 2
The five key levers to realign wages and salaries

<table>
<thead>
<tr>
<th>Lever</th>
<th>Description</th>
<th>Time needed for implementation</th>
<th>Difficulty of implementation</th>
<th>Degree of business risk</th>
</tr>
</thead>
</table>
| Natural attrition                          | – Allow natural attrition to reduce the number of long-tenured/high-wage employees  
|                                            | – Develop replacement strategy at lower wage level | ![High](https://example.com/high.png) | ![Low](https://example.com/low.png) | ![Medium](https://example.com/medium.png) |
| Appropriate job categorization and policy adjustments | – Identify discrepancy between job categorization and actual role  
|                                            | – Create floor and ceiling salary levels for each job category  
|                                            | – Remap and reassign employees to new job categories based on their actual roles  
|                                            | – Sustain process via rigorous policies for pay levels at hiring and for merit raises | ![Medium](https://example.com/medium.png) | ![High](https://example.com/high.png) | ![Low](https://example.com/low.png) |
| Voluntary separation                        | – Segment employees with a “needs analysis”  
|                                            | – Offer voluntary separation package to long-tenured employees  
|                                            | – Develop replacement strategy at lower wage level | ![High](https://example.com/high.png) | ![Low](https://example.com/low.png) | ![Medium](https://example.com/medium.png) |
| Involuntary separation and performance management | – Design selection criteria  
|                                            | – Identify affected employees and manage exit process  
|                                            | – Develop replacement strategy at lower wage level | ![High](https://example.com/high.png) | ![Low](https://example.com/low.png) | ![Medium](https://example.com/medium.png) |
| Wage reduction                              | – Across-the-board wage reduction within each band | ![Medium](https://example.com/medium.png) | ![High](https://example.com/high.png) | ![Low](https://example.com/low.png) |

Source: Strategy&
**Voluntary separation**

A “needs analysis” will be used to segment employees in terms of roles and compensation levels (see Exhibit 3, next page). The voluntary separation option will make the most sense, both for the company and for the employees, if it is offered to long-tenured workers who are getting close to retirement. Of course, it’s critical that the company “set the table” around these offers by explaining to the employees the company’s need to cut costs and the details of the voluntary package. The key is to make sure that the workforce understands that after the offer of the voluntary packages is complete, the company may have to look at more aggressive ways to reduce wages. Clearly, some employees will welcome the voluntary option; others will not. Generally speaking, a well-crafted voluntary separation plan will deliver an acceptance rate of anywhere from 15 to 50 percent — the rate is directly proportional to the success of the communication plan, size of the package, and average years to retirement of the targeted workforce. For those who turn it down, efforts will be made to close the gap between what they are paid and the market wage for that job. The gap can be closed by an expansion of responsibilities through retraining and other means, by a staged reduction in pay, or by a combination of the two.

**Involuntary separation and performance management**

While most companies have a structured plan for managing out poor performers, these plans can differ considerably. What is needed is a disciplined approach that provides for regular reviews and decisions to separate poor performers from the company. As an indirect benefit, this approach will also allow a company to address wages in a sustainable way by replacing those who are managed out with new workers at a more targeted wage. The company should expect a backlash from the workforce — especially if its actions are construed as a plan to bring in less expensive replacements instead of as a decision to become more disciplined about an existing performance process.

**Wage reduction**

Often the last option, a wage reduction can be “across the board” within each job band or category or more selectively focused. The size of the reduction may vary from group to group depending on the degree to which each group has been misaligned with the correct market pay structure. Clearly this lever is the quickest to implement, but it carries the most risk in terms of its potential effect on morale. Using a more integrated plan will help to minimize the need to employ blunt force to reduce wages.
Exhibit 3
A strategy for voluntary and involuntary separations hinges on segmentation

Employee segmentation — a “needs analysis” (illustrative)

Years of service

Segment 1: Long-tenured, close to retirement
Segment 2: Committed to spending rest of career with company
Segment 3: Second career, less committed to company
Segment 4: Been elsewhere and building career
Segment 5: Second career, just joined
Segment 6: New generation

Common needs by segment
– Nearing retirement with long tenure: pension improvements and retiree medical coverage (1)
– Approaching retirement, longer tenure: pension, cash, and medical benefits (2, 3, 4)
– Not near retirement, short tenure: prefer cash now, compared with pension benefits (5, 6)

Objective
– Enable wage reduction through a transition program using voluntary and involuntary separation options

Implementation steps
– Segment employees based on employee demographics
– Configure and communicate voluntary separation package to transition-targeted employees
– Design selection criteria for involuntary separation
– Identify affected employees and manage exit process
– Develop a replacement strategy

Mitigated risks
– Loss of key talent
– Success dependent on external market conditions
– Loss of employee engagement in the long term and productivity in the short term

Source: Strategy&
Getting started

HR will have many roles to play in this effort. If a broad-based initiative is needed, then the department’s main job is to ensure a smooth and effective execution by removing roadblocks and protecting morale. In particular, HR will play a central role in gathering information, establishing MRPs, performing internal benchmarking, segmenting and communicating with employees, and implementing the program via the levers — all the while considering morale and making sure that the workforce is being incentivized through this difficult period.

Senior HR managers should have a seat at the table when strategy is being set, since they have more hands-on experience and knowledge in this area than anyone else. But the strategy for this initiative must fit perfectly with all other elements of the company’s financial and operating plans, and that mandates C-suite involvement. Furthermore, the company needs to understand that it is embarking on a lengthy initiative — one that will ultimately determine the morale and talent of its workforce for the long term.

Key findings

- To survive the financial crisis and the resulting Great Recession, companies have struggled to cut costs. Waves of layoffs have been accompanied by broad reductions in wages and benefits. For the workers who remain, morale is down, anxiety is up, and burnout threatens. Companies face a raft of other potential risks as well, including litigation and brand damage.

- There is another way to rein in labor costs besides using an ax. This multifaceted and tailored approach is less damaging to workers and less risky to companies, yet it exposes rich veins of potential savings that in all likelihood survived the ax.

- At issue is a potential net savings of 15 to 20 percent of overall labor expenses.

- The savings are so large because the treatment of labor costs at many companies has created numerous misalignments with outside market rates and inconsistencies among internal rates. Outside data and internal benchmarking are both needed to set proper pay levels.
Conclusion

It is one thing to swing a budget ax when a company’s very survival is at stake — but quite another to get at hidden or ignored labor costs that have cropped up over the years.

A well-executed plan to deal with errant wage and salary practices could produce net savings of 15 to 20 percent of overall labor costs, even at companies that have cut costs in the past. These savings are sustainable if rigorous controls are put in place to ensure that starting salaries and annual increases are pegged correctly to external and internal rates and that job categories and responsibilities are clearly defined and monitored.

Outside data in the form of survey-driven MRPs are important guides. But internal benchmark analysis is essential to setting proper pay levels. An interplay of external and internal data will provide the boundaries and the discipline to prevent wage “creep” from inflating the payroll costs for a job category beyond the upper limit of value that the category represents.

Senior managers of the human resources department should have a seat at the table when strategic issues relating to these savings are discussed. And HR will be charged with many aspects of the data-gathering process and the implementation effort.

But the chief financial officer and/or the chief operating officer should own this initiative and manage it through the top executives of the business units.
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