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RIGHT APPROACH**

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Reducing Labor Costs: Choose the Right Approach

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CEO's are increasingly saying that their company's human capital is its most important asset. It is also obvious that it is many companies largest business expense. Because they are a large business expense, salaries and benefits are a logical place to cost cut. Thus it is not surprising that in response to the current recession many companies have laid off thousands of employees. But, wait a minute, aren't mass layoffs inconsistent with the idea that human capital is an organization's most important asset? I believe that they may or not be; it depends upon the nature of an organization's talent management strategy and whether there are better approaches to reducing labor costs.

There are numerous approaches that can be taken to reduce labor cost. They all potentially have both positive and negative impacts on an organization's current and future performance. Most of the negative impacts are obvious and predictable. They can result in the loss of key talent, damage an organization's brand as an employer, reduce an organization's ability to function effectively and result in lawsuits. Although labor cost reductions may not immediately cause employees to leave an organization, they may weaken their bond to the organization and reduce their confidence in it such that when other jobs are available, they are much more likely to leave. A bit more subtle is the impact layoffs can have upon survivors. One of them is guilt over surviving. Survivors may also experience anxiety about whether they will be next.

Little attention is given to the positive impacts that cost reductions can have. Without question, the major positive impact of most approaches to labor cost reduction is lower operating expenses for companies. They may result in a short term and/or a long term reduction. But, if

labor cost reductions are handled properly they may do more than just reduce costs. They can potentially focus the organization more on business performance by clarifying the business strategy and they can improve an organization's talent level. The latter, of course is only likely to happen if an effective job is done of eliminating poor performers and/or positions that are not critical to the performance of the organization. Finally, the right approach to labor cost reduction can improve an organization's brand as an employer and increase the loyalty of its employees if it is perceived to be superior to the approach that is taken by other companies.

Overall, decisions about when, how and how much labor costs are cut are critical strategic decisions. They can significantly affect the long and short term survival of an organization. They need to be made with an eye on their short term impact on cost and performance and with a long term focus on how they affect the competitive position of an organization.

In order to make effective decisions about whether and how to reduce labor costs, organizations need to focus on how their approach fits with their talent management strategy. There are three currently popular talent management strategies being used in large U.S. corporations. The first is well known and has been used for decades. The other two have evolved over the last several decades as responses to today's rapidly changing environment and the growing importance of human capital. Let's look at how each one can most effectively achieve labor cost reductions.

Structure Centric

Most traditional bureaucratic organizations use a structure centric approach to talent management. Organizations that use it typically have hierarchies, tight job descriptions, well defined career tracks, seniority based rewards and often have union representation. In this

approach, talent and its management is not a key strategic issue or source of competitive advantage. It is a matter of executing a series of rules and procedures that determine pay amounts and increases, layoffs, promotions, training availability, etc. There is a commitment to training and development for key senior executives and in some cases technical experts. The rest of the workforce receives only the amount of training they need to do their current jobs.

Partially in response to the reality that the traditional structure centric approach to talent management tends to produce a poorly motivated, high cost and inflexible workforce more, companies are adopting a “low cost operator” version of the structure-centric approach. In this approach, even when times are good, wages and benefits are kept at a low level. Pay is not related to the success of the organization or designed to encourage individuals to learn and develop themselves. Turnover is expected to be high in most lower level jobs. Low end retailers like Wal-Mart and fast food restaurants like McDonalds are good examples of companies that have adopted this approach.

In a structure centric organization when it comes time to reduce labor costs, non-exempt employees are typically laid off based upon seniority. In recent years exempt and management employees are also frequently laid off, particularly if the need for cost reductions is expected to last for many months or years. Employees typically do not have any type of safety net or support when they are laid off. To some extent employees are seen as disposable and easily replaceable so there is no need to focus on their returning to employment with the firm that has laid them off. Little emphasis is placed on protecting the employer brand of the companies so that they will be able to attract the right kind of employees when and if it is time to begin hiring again. The main outcome sought is simple and straightforward - lower operating costs because there are fewer employees.

Figure 1 shows the labor cost reduction options that fit the structure centric approach. Some have a bigger cost reduction impact than others, but they all are effective ways to reduce current and in most cases long term labor costs. They all, however, lead to a number of negative outcomes with respect to the ability to attract, retain and develop human capital. They damage the employer brand of the organization and typically tend to drive away valuable employees and may result lawsuits. However, these negative outcomes often are less important than the long term and short term business expense reductions they produce. This is particularly likely to be true when human capital is not seen as a key source of competitive advantage. Thus, these approaches to labor cost reduction generally fit well with this approach to management and are reasonable ways for companies that use it to respond to a recession.

Development

Without question, companies that adopt a high performance approach to management face the biggest challenge with respect to reducing labor costs. They typically have a commitment to a development approach to talent management that views human capital as the company's most important asset and a major source of competitive advantage. The development approach calls for large investments in training and developing people and building a stable, highly committed workforce. This approach positions labor cost reductions as one of the least desirable alternatives to reducing the costs of an organization. But, what if the decision is made that labor costs simply have to be reduced because there is no other way to achieve the operating cost reductions that are needed?

An important principle to use in evaluating approaches to labor cost reduction in high performance organizations is the degree to which they result in shared losses of income for all employees. It is very important that they are not hierarchal in their impact and that they are

consistent with the organization's talent management strategy of developing and providing careers for individuals who are committed to the success of the organization.

It is also important that the approaches chosen be consistent with the principles and management practices of the organization concerning employee involvement and participation. Individuals must feel the organization is still true to its commitment to providing a workplace that is characterized by transparency, due process and fairness. In other words, it is important that reductions do not damage the culture and relationship between the employees and the organization. One key to this is creating a strong economic case that all employees understand for any labor cost reductions.

Figure 2 provides a list of labor cost savings approaches that fit the commitment to development approach. They are characterized by all employees sharing in the cost reductions; some of them also provide employees choices about whether to participate or not to participate.

The approaches do differ in the degree to which they fit well in a situation where a long term reduction in labor costs is needed versus a shorter term. Some of them are not sustainable over a long period of time because they run the risk of eventually driving away employees and they should only be used when short term decreases in labor costs are needed. Clearly in the category of short term only solutions are pay reductions for all employees, short work weeks and benefit reductions. They run the risk of undermining the attractiveness of working for the organization and therefore may drive away some of the best employees in the organization and make it difficult to hire new ones.

One of the approaches, increased training is unlikely to reduce current labor cost at all in the short term. However, it can position an employee to operate more effectively in the future so that it can reduce the cost of producing products and services in the long term.

Travel Light

The essence of the travel light approach is to acquire and discard talent as needed. It makes little or no commitment to long-term employment and only a minimal commitment to “as needed employee development.” Continued employment depends on individuals performing well and having the right skills. The responsibility for development rests with individual employees. Unlike the structure-centric approach, it sees talent as critical and tries to attract the best talent by paying them well and providing interesting work.

Well run travel light strategy companies have very good data on the importance of individuals and positions to the competitive performance of the company and they know the return on investment that they get from individual employees and the development programs they offer them. They typically also have excellent performance management systems so that they can use performance as a basis for reducing labor costs and eliminating poor performers.

In a turbulent world, this approach has some clear advantages over the commitment to development strategy. It gives organizations great flexibility with respect to talent and allows them to shift competencies relatively quickly. However, it does have its problems. It can lead to a relatively high level of turnover, and its success is dependent on individuals with the right skills being available in the labor market and being attracted to the company.

The travel light approach to talent management, positions companies well to deal with the need for labor cost reductions. Figure 3 presents the approaches that travel light companies can use. Properly executed they should lead to a quick and effective reduction in labor costs. If well executed, they may even lead to a performance increase because the employees who are let go are the ones that are performing least well and are also doing the least critical work.

The challenge travel light organizations face is balancing what they need to do to be a good place to work with what they need to do to achieve effective reductions in cost. Layoffs that are sudden, unexpected and contain no safety net or support for laid off workers potentially can create a situation where employees will be hesitant to rejoin the organization and the brand of the employer may be damaged. Thus travel light organizations need to make careful and thoughtful decisions about whether to make layoffs and outsourcing decisions that damage their ability to recapture the employees who are laid off and/or hire new ones with key competencies and skills. Often they can do this by offering generous severance packages, extended health care coverage and other features as a part of their layoff program.

Travel light organizations are particularly well positioned to selectively reduce staff in work areas that can be outsourced and are not critical to an organization's performance. Reducing positions in non-critical areas of work is much less likely to lead to major reductions in organizational performance because they often can be done at an acceptable level through outsourcing.

Choosing the Right Approach

No approach to reducing labor costs fits all types of organizations. In deciding what approach to take, organizations need to start with their talent management strategy. It should dictate which actions are taken. When this is done correctly, organizations should be able to accomplish the labor cost reductions they need without disrupting their existing approach to talent management and overall approach to management.

But what if an organization doesn't have a clear talent management strategy, doesn't have the right one, or for that matter one at all? In many respects this is a great time to establish the right one, if for no other reason than that having one is critical to choosing the best ways to

reduce labor costs. In addition, the actions that are taken and the explanations that are given for taking them speak loudly to present and future employees about how the company regards its employees. Thus it is a very good time to put in place the “right” talent management strategy.

What is the best approach – the commitment to development approach? The travel light approach or the structure centric approach? The answer depends very much on an organization’s rate of environmental change and on its strategic intent. The more an organization expects radical and rapid changes to occur in its strategy and the harder it is to predict its talent needs, the more an organization should lean toward the travel light approach. The major rationale for this is the high cost and time commitment required to significantly reskill an existing workforce.

From a strategy point of view, the more an organization intends to gain a competitive advantage by exceptional customer service (e.g. the employee is the product) or depth expertise in a technical area, the more it should lean toward the development approach. Yes, there are organizations where the structure centric approach fits well, namely those that don’t rely on talent for competitive advantage because the work they do is relatively simple and stable.

Organizations need to choose the right approach to labor cost reduction. The scars of a poorly handled reduction can be permanent and significantly hamper an organization’s ability to operate effectively for decades. On the other hand, if it is done correctly, it can provide an important source of competitive advantages.

Figure 1
Structure Centric

- **Seniority based layoffs**
- **Temporary shut-downs**
- **Outsourcing of operations**
- **Eliminate overtime**
- **Decrease benefits**
- **Hiring freeze**
- **Eliminate training**
- **Use of temporary employees**
- **Pay cuts**

Figure 2
Commitment to Development

- **Increased training**
- **Company supported development while on reduced pay**
- **Sabbaticals at reduced pay or no pay**
- **Pay reductions for all employees**
- **Short work weeks or work days**
- **Benefits of all employees reduced (e.g. retirement)**
- **Company supported community service**
- **Hiring freeze**
- **Voluntary unpaid vacation**
- **Voluntary buy-outs**

Figure 3
Travel Light

- **Layoff/fire poorest performers**
- **Outsource non-pivotal work**
- **Reduce staffing in non-pivotal work areas**
- **Pay reduction or freeze for non-pivotal jobs**
- **Targeted hiring freeze**