

# Cutting Down On Labor Costs

*"Pay-for-Performance" can cut costs and increase productivity. Is it right for you?*

Woodruff Imberman

**W**hat can be done about the rising cost of labor? Mr. Robert Reich, U.S. Secretary of Labor, has already indicated the administration's intention of pushing the minimum wage from \$4.25 to \$4.50 per hour and indexing it for inflation. That means that every jiggle in the inflation chart will push the minimum wage higher.

But of course, boosting the minimum wage does not merely raise the wage rate at the bottom. In order to maintain skill differentials, every wage level above the minimum would have to move up also. This is what employees will expect, and presumably the only ways to avoid that outcome are to freeze wage levels or raise productivity. The Germans have recently chosen the first alternative; i.e., freezing wage rates and benefits. Some American companies, such as Frigidaire, have chosen the second alternative — raising productivity by instal-

ling pay-for-performance wage systems. It may be of interest to discuss both of these alternatives.

## Germany's Solution

In September, 1993, Germany's metal fabricating and heavy industries association cancelled a wage agreement for the first time in their history. According to the *Wall Street Journal*, "the announcement by the Gesamtmetall employers' association caused a stir because it broke precedent."

Reached through collective bargaining, Gesamtmetall's labor agreements cover wages, training programs, vacation days and the "vacation money" paid to workers to help fund their holidays. The contracts cover Germany's automotive, metal, electrical, electronics and machinery industries.

Germany's generous wages and benefits and flagging productivity have made German labor costs the highest in the world — 25% higher than in the U.S.



## MANAGEMENT MATTERS

and about a third higher than in Japan. In western Germany, manufacturing workers receive an average of \$26.89 an hour, of which benefits account for \$12.47. Blue chip companies such as Daimler-Benz AG and Thyssen AG have been shedding tens of thousands of jobs, idling capacity or shifting production to other countries as higher costs cripple their ability to compete at home and abroad. Hans Peter Stihl, president of the German Chamber of Industry and Trade, said that unions must realize that unrealistic wage demands will force companies to cut even more jobs.

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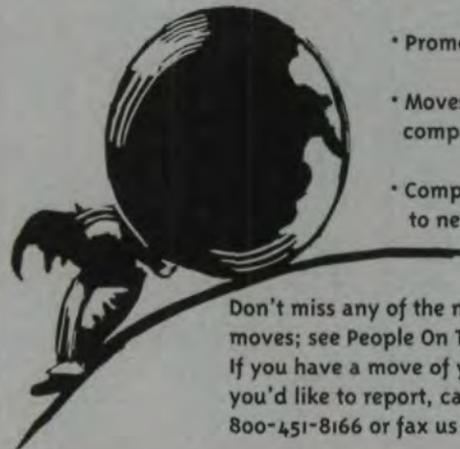
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## U.S. Experience

In the U.S., we have seen a slow but steady rise in labor cost. "The government has made the cost more expensive," according to Richard Vedder and Lowell Gallaway, professors of economics at Ohio University. "The only way to raise the real wage rate is through productivity growth," both professors maintained at a conference in Washington in July, 1993.

"In Europe, wages are high, on top of which governments have imposed a laundry list of costs on employers. Consequently, unemployment rates in Europe now average about 12% and are as high as 24% in Spain. Surely, we want to avoid having the U.S. government imposing any more labor costs on U.S. employers," the professors said.

How has the U.S. government contributed to increased labor costs? According to Professors Vedder and Gallaway, "By raising the minimum wage, by such legislation as the Davis-Bacon Act (which mandates prevailing union wages to be paid on federal construction projects), by the Fair Labor Standards Act, the National Labor Relations Act, and because of programs such as public assistance and unemployment compensation, which pay people to sit and wait until they can find jobs with a higher level of compensation."

Japan offers an excep-  
tion, says Steve Hanke, pro-

fessor of applied economics at Johns Hopkins University, who spoke at the same Washington conference. "In Japan, wages are very flexible, with about two-thirds of compensation fixed and a third in the form of bonuses that can be varied," Hanke said. "Such wage flexibility gives Japan a current unemployment rate of 2.5% and long employee tenure."

Right now, the United States occupies an intermediate position, with wages more fixed than in Japan, but with fewer costly regulations than in Europe. If administration officials try to preserve high wage rates while putting new regulations and taxes on business, "we could be in for some bad times on the unemployment front," was Hanke's conclusion.

## A Way Out?

Japan's wage practices have suggested a course for many U.S. businesses. About 2,200 American employers have instituted a pay-for-performance system called "gainsharing," which provides basic wage rates, plus bonuses for the achievement of higher levels of productivity and quality.

Speaking recently at an industrial symposium on how to achieve improvement in productivity and quality, David S. Hoyte, executive vice president (operations) of Frigidaire pointed out that *lasting* boosts in productivity and quality are not achieved by adding new equipment or

tinkering with the manufacturing process. According to Hoyte,

"In building a team dedicated to total quality, problems must be viewed as buried treasure, to be unearthed by a workforce motivated to improve the process and the product. Equipment cannot do it. Only workforce corrective action can do it, and here we must recognize the role of gainsharing, which is really a pay-for-performance system. With such a system, people become willing to make problems visible and work toward their elimination and improvement. Gain-sharing leads the whole organization to develop a fundamental understanding that the cooperative

ing the sights of an organization and developing its confidence that exceptionally high standards can be achieved."

Hoyte concluded: "The domestic home appliance industry is an American success story that attests to the use of such pay-for-performance wage systems. Over 84% of the major appliances sold in America are made in America. Excellence in design and productivity has contributed greatly to that success."

Whether the current federal administration will succeed in raising the minimum wage rate to \$4.50 and indexing it for inflation remains to be seen. After all, Congress has proven to be a rather stub-

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**With a pay-for-performance system, people become willing to make problems visible and work toward their elimination and come to understand that the cooperative process creates positive results.**

process creates great results. Such results are not a chance occurrence; they flow only from systematic efforts. We have seen it at Frigidaire, at the GM-Toyota joint venture in Fremont, CA, and elsewhere. Gainsharing has become accepted as the preferred method for rais-

ing the sights of an organization and developing its confidence that exceptionally high standards can be achieved."

born body and may balk at this boost in labor cost. But Congress has nothing to do with companies trying pay-for-performance systems on their own. Some 2,200 companies now use some variety of such gainsharing programs with varied success. Gainsharing need not be

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limited to productivity and quality. It can also lead to improvements in on-time deliveries, can speed up work-in-progress, cut down on the accumulation of inventory, lead to savings in use of gas/electric energy, and so on.

## Two Conditions for Success

Successful gainsharing programs require at least two programs:

1. A careful study of a company's wage and qual-

wage rates in various industries. And they will certainly be affected by any federal legislation.

The only salvation is to work ardently to boost internal productivity and quality, thereby cutting unit costs. Prayer alone will not do it; nor will exhortation succeed for long. What is required is a systematic effort to improve workforce cooperation on new ways of doing things. The payoff can be great and lasting,

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**Pay-for-performance can lead to improved productivity and quality and to improvements in on-time deliveries, work-in-progress, inventory control, and lead to savings in utility and maintenance bills.**

ity records for the past two years, so as to provide a benchmark to gauge current improvements.

2. Careful indoctrination of the entire workforce — middle managers, supervisors, engineers, technical employees and hourly workers — as to what is expected of them under gainsharing and the rewards they may anticipate.

There is no halting the rise in labor cost, even though a company may be non-union. Non-union companies are not isolated from the industrial world; they are affected by union

provided the systematic effort is done carefully with some guidance. ■

*Note: Readers interested in gainsharing should refer to the following articles: "Gains Through Gainsharing," (Area Development, May, 1990), "Boosting Plant Performance with Gainsharing," (Business Horizons, Indiana University, Nov./Dec., 1992), and finally, "All You Ever Wanted to Know about Gainsharing," (Target Magazine, Association for Manufacturing Excellence, May/June, 1993).*