Economic Factors Affecting Compensation

Inflation

Inflation has a substantial impact on compensation practices. Managing a compensation program is especially difficult during periods of high inflation. Some multinational corporations with divisions in countries with rampant inflation are required to revise their salary schedules monthly or even weekly.

In the United States the annual rate of inflation for the past several years has ranged from three percent to eight percent as measured by changes in the Consumer Price Index.[24] At this rate of inflation, compensation systems must be revised annually to keep wages and salaries competitive, and the value of long-term savings and investments tends to erode. When employers revise their wage structure to adjust for moderate inflation, they have the opportunity to penalize low performers without cutting their wages by failing to raise their wages as fast as the rate of inflation.

Inflation is disruptive to an economy and can create severe personal inequities if it gets out of control. When compared to other countries, the United States has been relatively successful in controlling inflation. Austria, whose rate has been about half the U.S. rate, has controlled inflation even better. But the annual inflation rates of many other countries have been much greater, especially in Argentina, Brazil, Bolivia, Israel, and Mexico, where prices have sometimes doubled every four to eight months. Runaway inflation creates as much managerial chaos as it does economic chaos, since wages, salaries, budgets, and human resource planning are severely disrupted.

Interest Rates

Interest rates are related to inflation and closely tied to economic growth. Employment levels are influenced by interest rates because of the effects of interest on the cost of capital. When interest rates go up, the cost of capital increases, which reduces the amount of business investment. Therefore, high interest rates tend to reduce employment levels because of reduced economic activity. Employment in the construction and auto industries is especially hurt by high interest rates since consumers use loans to purchase houses and cars. As interest rates decline and employment levels improve, there are growing pressures to increase wages and benefits.

Industry Competition

Competition occurs in both the public and private sectors. In industry, competition occurs when firms vie for a customer's business. A clear illustration of industry competition is when two gas stations are located at the same intersection. Price pressures usually result since motorists generally buy more gas from the station with the lower prices. Similar pressures also exist among organizations such as hospitals, colleges, and government agencies where there is competition for scarce resources or clients.

Economic pressure through competition forces organizations to change their human resource strategies. As competitiveness increases, organizations offer fewer rewards to employees. In competitive industries, only the highly successful firms are able to offer high wages and benefits and favorable working conditions. Less effective firms may be severely limited in the wages and salaries they can offer, which means they may experience difficulty recruiting and hiring skilled employees. The less successful firms also may not be able to maintain positive worker attitudes, and they may experience higher absenteeism and turnover and more pressure from their employees to organize a union than the successful firms.

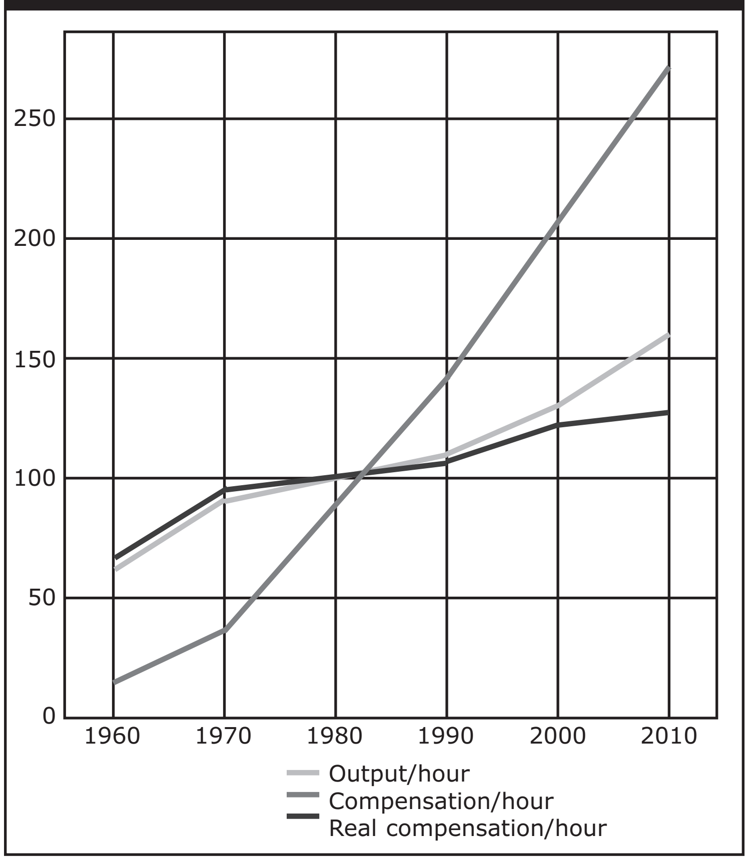
Foreign Competition

International competition results in similar job movement. Many companies have been forced to close because of their inability to compete successfully with foreign competitors, and many other companies have been struggling to survive. For example, American automakers have faced heavy competition from foreign car manufacturers, especially the Japanese. For more than a decade, American automakers experienced a loss in market share before they succeeded in designing new products to reverse the trend.

Economic Growth

Compensation is tied to productivity. Real increases in wages and salaries, as opposed to increases due to inflation, are directly related to increases in productivity. Productivity largely determines how effectively companies and nations compete in international markets. Productivity data are compiled by the Bureau of Labor Statistics from information submitted by various establishments.[25] **Productivity** is the total goods and services produced by society divided by the total number of employee hours required to produce them. From 1939 to 1973, productivity increased approximately three percent per year. From 1973 to 1995, the rate of productivity growth in the private sector was about 1.4 percent, and since 1995 it has averaged about 2.3 percent annually.

Exhibit 17: Productivity and Compensation



Productivity improvements have a major impact on economic prosperity. A nation's standard of living and changes in its real compensation are closely tied to changes in its productivity. Increasing productivity is one sure way a nation can afford to raise wages while remaining competitive in an increasingly global economy. The relationship between productivity, compensation per hour, and real compensation per hour (after adjusting for inflation) is illustrated by the data in Exhibit 17.

Demographic Trends

Compensation practices are influenced by the supply of labor; an excess supply tends to depress wage rates, while labor shortages tend to increase wages. The size of the labor market and an analysis of the major demographic forces influencing the supply of labor are described in Unit 1. The labor market is primarily influenced by five demographic forces: birthrates, participation rates, immigration, education, and unemployment.

Birthrates
Since 1900, three drastic shifts have occurred in U.S. birthrates.[26] The first shift took place during the Depression era when the birthrate, which is the number of live births per 1,000 population, declined from 30.1 in 1910 to 18.7 in 1935. The second shift in the birthrate occurred during the **baby boom** years (1945 - 1964) following World War II, when the birthrate increased to 25.0. The third shift followed the baby boom years when the birthrate dropped below 15.0. Since the 1970s the birthrates have remained relatively low, except for a slight increase during the period when the baby boomers reached their prime child-bearing years. These declining birthrates will contribute to labor shortages in future years.

Participation Rates
Changes in the **participation rates** over the past 50 years have had an even greater impact on the size of the labor force than changes in birthrates. The participation rate refers to the percentage of people in a specified age category participating in the labor force. Statistics collected by the Bureau of Labor Statistics indicate two important trends during the past century:

1. Male participation rates have declined in every age category, especially for older males.
2. Female participation rates have increased in almost every age category, especially for women in the prime working ages, 25-54.

The statistics suggest that younger people, both men and women, want to participate in the labor force, probably because it is a financial necessity, while older people want to take early retirement as soon as they can financially afford it. As these trends continue, one would expect to see a smaller disparity between the percentages of men and women in the labor force and greater equality in the average wage levels of men and women.

Immigration
Since 1970 the rate of immigration has increased significantly for both legal and illegal immigrants; it is roughly equivalent to the first decade of the twentieth century before there were quotas. Although legal immigration has been limited to about 1,000,000 per year, the actual immigration is much greater when the number of illegal aliens is considered.

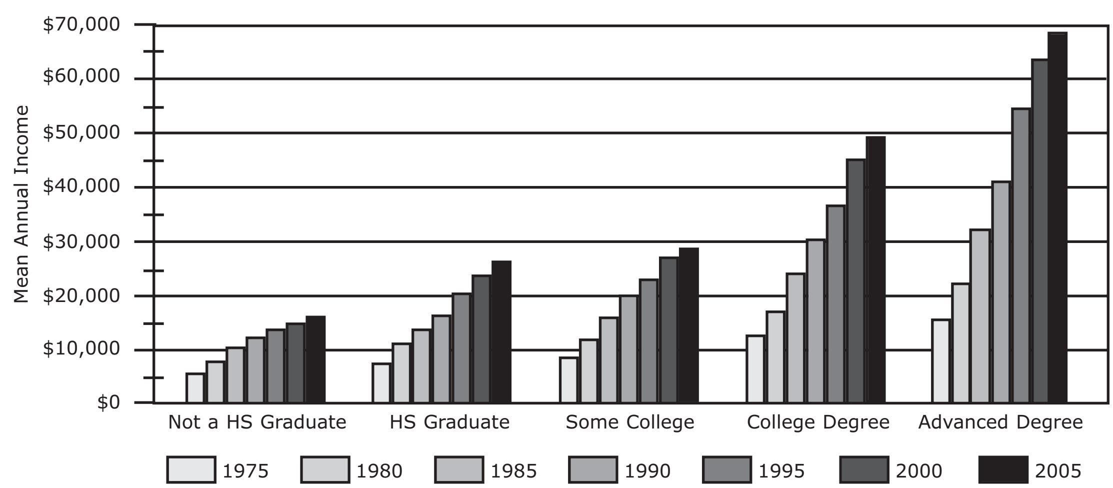
The availability of immigrant labor has a significant influence on wages and salaries. The influx of immigrants provides a large applicant pool of unskilled labor willing to perform unpleasant jobs for small wages. Some immigrants are also highly skilled in the areas of science, medicine, and technology, and they provide essential skills and talents to employers. Difficult economic and political conditions in Mexico and Central America have pushed millions of Hispanic workers to seek employment in the United States. Political instability in Southeast Asia has likewise caused significant numbers of Asians to emigrate. Illegal immigrants now play a major role in the economies of the Southwest, especially California and Texas. Many employers depend on immigrants to perform manual jobs, especially agricultural harvesting.

Education

Although the percent of high school students going to college has increased over the past two decades, the percent of high school dropouts has also increased. Consequently, the average education levels of new employees may not be changing much, but the disparity in education is widening. The educated are receiving even more education, while the uneducated obtain even less. New technology, particularly in the areas of electronics and computers, requires extensive education beyond high school for a large percentage of the workforce. Unfortunately, many new employees have rather low educational levels that limit their job opportunities.

Educational levels have important implications for society's ability to provide a decent income and fair wages. Unequal educational levels also impede society's efforts to reduce racial discrimination. A careful analysis of the relationship between education and employment levels reveals that people with more education tend to have higher labor-force participation rates, lower unemployment levels, and higher earnings. For example, college graduates have a high participation rate of 88 percent and a low unemployment of only 2.7 percent, while the corresponding rates for those who do not finish high school are 65 percent

Exhibit 18.: the Relationship Between Education and Income



Source: US Census: Mean Annual Earnings of Workers age 18 and over by Educational Attainment.

and 12 percent.[27] College graduates hold the majority of managerial and professional jobs. Also, the average money earnings of full-time employees is directly related to educational attainment: college graduates earn about twice as much as high school graduates, and those with graduate degrees earn almost three times as much as high school graduates. Exhibit 18 illustrates the relationship between education and annual income.

Unemployment

A labor surplus that is created by high unemployment levels influences the wages and benefits of most companies. When there are more workers than jobs, recruiting costs are minimal. Prospective employees readily apply for scarce positions, and employers can choose from a large pool of qualified applicants for each position. Those hired during periods of high unemployment tend to be more committed to the company and toward doing an acceptable job than those hired in periods of low unemployment. A surplus of labor also reduces employee pressure for compensation and benefit increases, since employees are aware that other qualified people are available to take their places if they press for unreasonable increases. For the same reason, disciplinary problems, absenteeism, and turnover are likely to decrease and equal employment opportunity goals may be easier to reach.

Test Your Knowledge

1. Can you describe the impact that environmental factors such as inflation, interest rates, and competition can have on compensation?

2. Can you explain how demographic trends in the labor market can impact wages?