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The average U.S. company spends 35% of its operational budget on people – by far its biggest expense. In most cases, that 35% is considered a fixed cost. The only way to trim it is by layoffs or attrition, and that takes time.

But what if 5% or 10% of those costs could be moved to the “variable costs” category?

The potential cost savings, risk management and operational benefits of having a flexible workforce are huge. Contingent labor is the obvious tool. And yet, most companies are still in the dark about how to use contingent labor strategically on an enterprise-wide basis. Many companies still tend to use contingent workers reactively, to plug holes, rather than proactively, to help achieve long-term financial and operational goals.

“One out of every three corporate dollars is spent on people, and yet no one is responsible for it. The HR department certainly isn't,” says Jac Fitz-enz, a long-time human capital consultant and founder of the Saratoga Institute (now part of PricewaterhouseCoopers). “Contingent labor is a management

tool, and management should use it from a systems thinking mode, not just from the perspective of how much money can I save this quarter.”

Clearly, shifting more of a company's operational structure to the variable cost side rather than fixed has become a higher priority in recent years. The volatility of the economy has fueled that. After plunging quickly from a boom into recession in 2000 and 2001, the U.S. economy unexpectedly bounced back to its highest growth rate in 20 years in the 3rd quarter of 2003 – higher even than the most optimistic forecasts. Consumer and corporate spending have gone along for that roller-coaster ride, wreaking havoc on the ability of corporations to manage their cost structures, and their workforces.

The Shift to Contingent

A study by consulting firm Towers Perrin, released in December, found that employers are now trying to manage their people costs without cutting staff as they gear up for renewed growth. And most companies are focusing on two key strategies to manage people costs: segmenting their workforce (separating high-performing individuals and reserving the most significant rewards for the roles or functions most critical to business success), and shifting fixed compensation costs to variable. While there are various ways to shift fixed costs to variable costs, companies reported that performance management and variable (i.e. incentive) pay programs “have not had the anticipated success in delivering maximum value to the business.”

Shifting Fixed Labor Costs to Variable

By Michael Molinski

How to Use Contingent Staff Strategically

That leaves the use of contingent labor as a clear alternative. And in fact, as the chart on page 24 shows, companies' use of contingent staff has grown significantly since 1990. Note the upsurge during most of the 1990s, while the economy was booming, followed by a downturn in the economic slowdown and then a recent return to growth. While the pattern is clearly cyclical, the long-term trend is toward the use of more contingent staff. What the chart doesn't show is that there is a difference in the drivers of that growth between the 1990s and today.

From Passenger to Driver

In the 1990s, growth in the use of contingent staffing was driven more by employees than by employers. "The power in the relationship had shifted to the employee in the 1990s," says Tom Davenport, a principal in Towers Perrin's San Francisco office and author of the book *Human Capital: What It Is and Why People Invest It*. "People realized they could have more flexible work arrangements as a contingent worker; could work out of home in their pajamas if they wanted."

That flexibility dried up in the downturn, and many companies sliced their use of contingent staff to cut costs. Now, as the economy recovers, it is the employers rather than the employees that are driving the use of contingent staff, in large part due to the uncertainty of where the economy is heading and companies' desire to remain flex-

ible. "And in a jobless recovery, we have learned that all bets are off, and people are willing to work on a contingent basis," Davenport says.

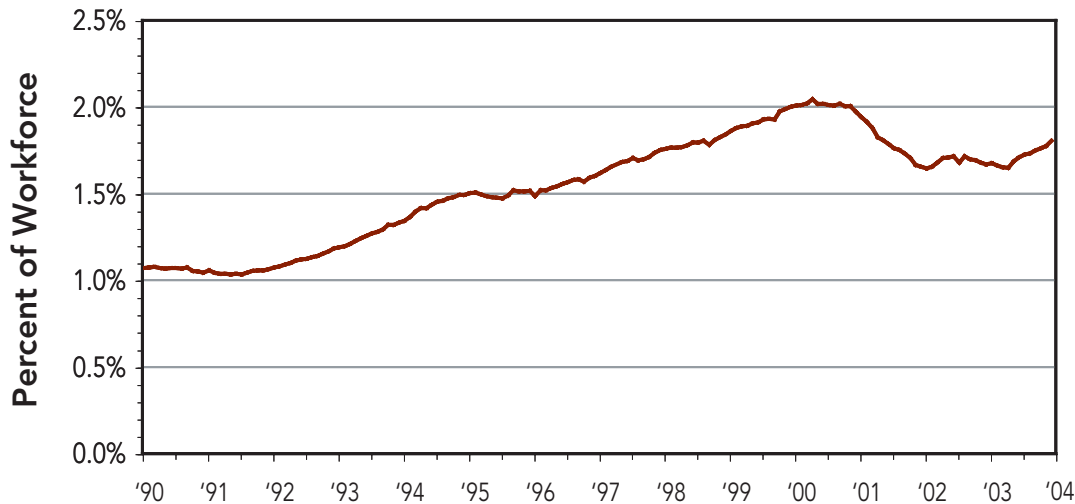
"Taking the vantage point of the employer, the organizational perspective views contingent labor as a strategic response to increasingly competitive and turbulent environments," writes Stephen Barley along with colleagues Gideon Kunda and James Evans in a white paper for Stanford University's Center for Work, Technology and Organization.

That flexibility comes not only from the ability to add or trim salary costs on a whim, thus being able to respond quicker to economic, strategic or technological changes, but also due to the reduction in fixed staffing-related costs. These can range from fringe benefits and employment taxes to recruitment, training and termination costs; and the infrastructural costs of employment (especially for contractors who work at home).

Additionally, "By using contingent labor, firms can skirt hiring freezes and increase headcount without affecting measures of productivity," the Stanford researchers said.

Barley, in an interview with *Contingent Workforce Strategies*, said the long-term trend appears to favor the hiring of more contingent workers. "It pushes the burden of training off on individual contractors or to firms than maintain contingent workers. It makes it far less costly to find people of the

Contingent work usage has nearly doubled since 1990



Source: Bureau of Labor Statistics

◀ While the long-term trend for the use of contingent work is up strongly, the decline in 2001 through 2003 illustrates how employers moved quickly to reduce contingent spending in difficult times.

right skill set. Contractors, if they want to remain marketable, have to keep up to date with skill sets. That makes it easier to find contractors whose skills are up to date than it does to find people with those skills amongst your full-time workers.”

Getting Top Talent

There are other trends, too, that could fuel growth in the use of contingent labor as a cost management tool. One is the mobility of the workforce during the recovery.

“One of the first things that happens in a recovery is turnover goes up dramatically,” Fitz-enz says.

A large part of the workforce, roughly 20% according to Fitz-enz, typically moves jobs every two years, but during hard economic times there is nowhere to go, so that 20% stays put and increases – with pent-up desire to move as soon as there’s an opportunity. Often, these are among the top workers at each firm.

“What that means is that at times like now, when the economy is coming back, at least 30% of your best people are either going to leave or are open to the idea of leaving,” Fitz-enz says. “If I ran a large company, I’d be frightened.”

In a Towers Perrin study, the numbers were even more dramatic – 53% of the 40,000 employees polled in 2003 said they were either actively or passively looking for another job.

Smart companies can do three things to ease the impact of that trend. First, they can recognize that they’re going to need to hold onto their best employees in order to remain competitive, and to do what it takes to keep them. Second, they can take advantage of the mobility of workers by cherry-

picking top talent from other firms.

And third, they can make use of talented pools of contingent workers, giving themselves a flexibility advantage and transferring some of the burden of frequent comings and goings to a staffing firm. It’s sort of an “if you can’t beat ‘em, join ‘em” strategy, but it can be effective at attracting talent and keeping costs down.

Challenges

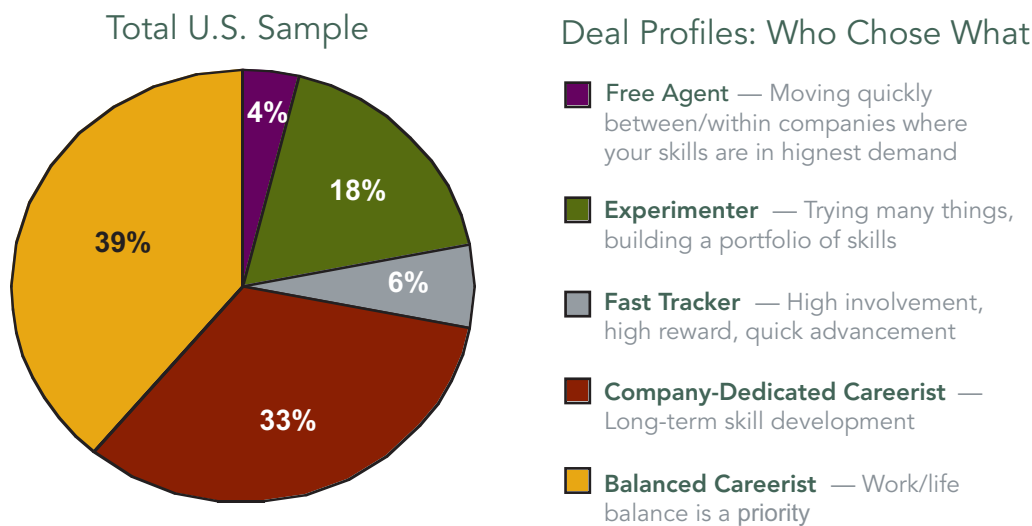
The decision to shift fixed labor costs to variable costs isn’t as simple as flipping a switch to increase the number of contingent workers. There are a host of other factors to consider. Adding contingent workers may add cost flexibility, but it also may have a dampening effect on the company in other ways. One is the impact that contingent labor has on your traditional workforce in terms of morale and stress. Another is the extra costs of training and supervising contingent staff. Security can also be a concern, depending on the industry. And probably the most important consideration is the flow of knowledge.

“Adding contingent workers can bring new ideas and new experience, but if you have a lot of contingent people in key positions, you lose those people and the knowledge goes with them,” Fitz-enz says.

Davenport agrees: “Sometimes contingent workers aren’t as well integrated and can’t take advantage of the embedded knowledge within a company, and also don’t transfer knowledge back to the company.”

“If you look narrowly at input and output, it makes sense to shift labor costs (to contingent staff),” Davenport says.

28% of the salaried workforce is open to non-traditional career paths



Source: Towers Perrin 2003 Talent Management Study

◀ While most employees prefer traditional "careerist" employment, a significant group would prefer more flexible work arrangements, representing huge pent-up demand for contingent work.

"But one of the things that often gets overlooked is the total cost of the output. Is there a quality cost borne in there that is an expense to the organization? Additionally, do customers perceive a quality difference if the workforce is contingent?"

Kunda, Barley and Evans point out that the prevailing view among organizations is, "Firms in stable markets should avoid contingent workers or only use them in peripheral tasks to preclude the loss of proprietary knowledge. Under conditions of rapid technological change, however, firms should actively employ contingent workers, especially professional and technical contractors, because they bring with them useful knowledge from competitors."

However, they question that view, arguing that as more people enter the contingent workforce, firms looking for the best talent will have to draw from that pool during both stable and fast-changing markets in order to remain competitive. The key is to understand the challenges in using contingent staffing so that you can benefit from the advantages.

Supply, Supply, Supply

The supply of contingent workers is going to be a large factor in just how effective their use will be to corporations over the next several years. Due to massive layoffs, large numbers of people were forced in the past few years into contingent work, either as an independent contractor or with an agency. If they decide to stick with contingent work, that could make it easier for companies to draw from that pool as needed.

However, there are some indications that the downturn in the economy and the difficulty of being a contingent worker during that downturn may create a backlash against contingent

work and a desire to return to the "stability" of a traditional job.

The 2003 Towers Perrin study, which polled workers in midsize and large U.S. firms, showed that 72% would choose to be a company "careerist," up from 70% in 2001, while only 4% would choose to be a "free agent," down from 6% two years earlier (see related pie chart).

Still, it's important to note that the study didn't include any workers who are currently free agents or temporary workers. What's more, according to the Bureau of Labor Statistics, the penetration rate of "free agents" in the United States is only 2%, meaning that if 4% of those people in corporate jobs would prefer to be free agents, then there is already huge pent-up demand for a shift to contingent work. In other words, the pool for contingent workers still looks strong from an employer's perspective.

What all of this says for companies that are debating how to balance their traditional and contingent workforces in 2004 is that there is a definite trend among companies to hire more contingent workers as a strategic move to shift fixed costs to variable, thus allowing more flexibility in managing overall labor costs in volatile economic times. There are, however, challenges that companies should take into account when doing so. What's more, trends in the labor market should be watched carefully because the decision whether or not to increase contingent staff will have as much to do with the supply of contingent workers and the quality of the contingent workforce as it does with demand. 🌀

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