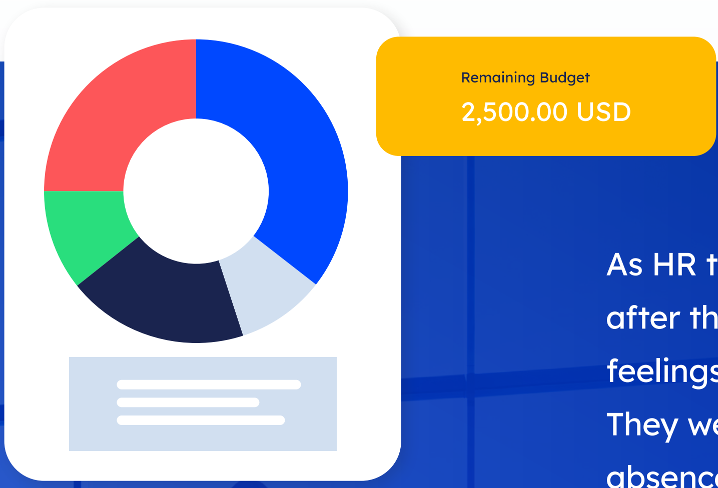
Will your staff need a pay rise this year?

Record rates of inflation and a spiralling cost of living mean employees are feeling the squeeze—but HR can help without the need for wage hikes

By Jo Faragher | As printed in People Management



As HR teams returned to their (mostly virtual) desks after the festive break in January, any residual feelings of relaxation evaporated immediately. They were rushing to cover Omicron-related absences, desperately ramping up recruitment to deal with skills shortages and the threat of the ‘Great Resignation’ and wondering whether the next government announcement could be the one that pushed their stress levels over the edge. But there’s another spectre at the table, and one that could have even longer-term impacts on HR strategy—high and rising inflation.

After decades of reasonably low UK inflation and relatively low wage increases as a result, when inflation hit 5.4 per cent in the year to December—its highest rate in 30 years—many economists and observers saw this as a cause for concern. Unions called for immediate action to protect workers on lower pay, claiming they would face a cost of living crisis without real-term pay rises. In April, when the national living wage is set to increase by 6.6 per cent to £9.50 per hour, this won't be enough to absorb the cost of living rises caused by inflation, as workers will also face a 1.25 per cent hike in national insurance contributions and tax. The Institute for Fiscal Studies said that "price increases of this magnitude have significant implications for living standards", using the example of an individual with a salary income of £30,000 in April 2021 (and post-tax income of £24,060) needing to see wage growth of 7.1 per cent to April 2022 in order to maintain the same standard of living. Former Bank of England chief economist Andy Haldane, meanwhile, warned of "the sort of wage-price spiral familiar from the 1970s and 1980s" if organisations tried to outpace prices with wages.

While a return to "stagflation" of the 1970s is unlikely (see box below), Haldane's warning is not without foundation. A poll by the British Chambers of Commerce in January found that 58 per cent of businesses planned to raise prices for goods and services in the next three months, and from April the cap on energy bills will be reviewed, meaning thousands of households could face huge rises in utility payments. Faced with mounting bills and higher prices at the supermarket, a 1 or 2 per cent pay rise gets eaten up pretty quickly. And in a tight labour market where workers are evaluating their employers with a critical eye, the knee-jerk reaction could be to increase pay across the board. Ruth Thomas, pay equity strategist at Payscale.com, offers a word of caution: "Tracking real wages gives us a sense of just how much money you have after you have adjusted for the impact of inflation," she says. "In the years 2000 to 2008, real wages

were rising steadily. But since the financial crisis they have flatlined, and we have experienced a decade of lost real wage growth." The recent rises in inflation will drive workers' expectations, she adds, and many employers will increase wages amid fears that staff will move for a better offer. "Raising wages is one solution in the face of immediate demand and perceived talent shortages, but this is a very transactional approach," says Thomas. "Our research supports that perceptions of fair pay are more important when it comes to talent retention than actual pay. So hiking pay for new hires will drive pay compression internally and you actually put more talent at risk."

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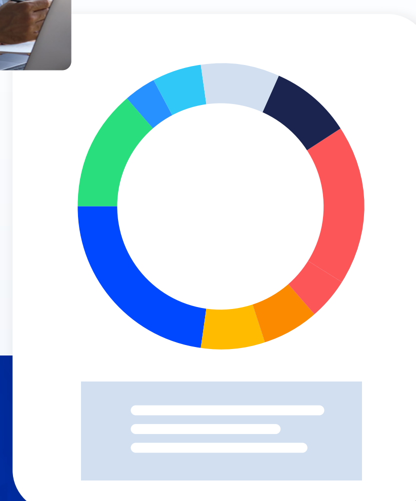
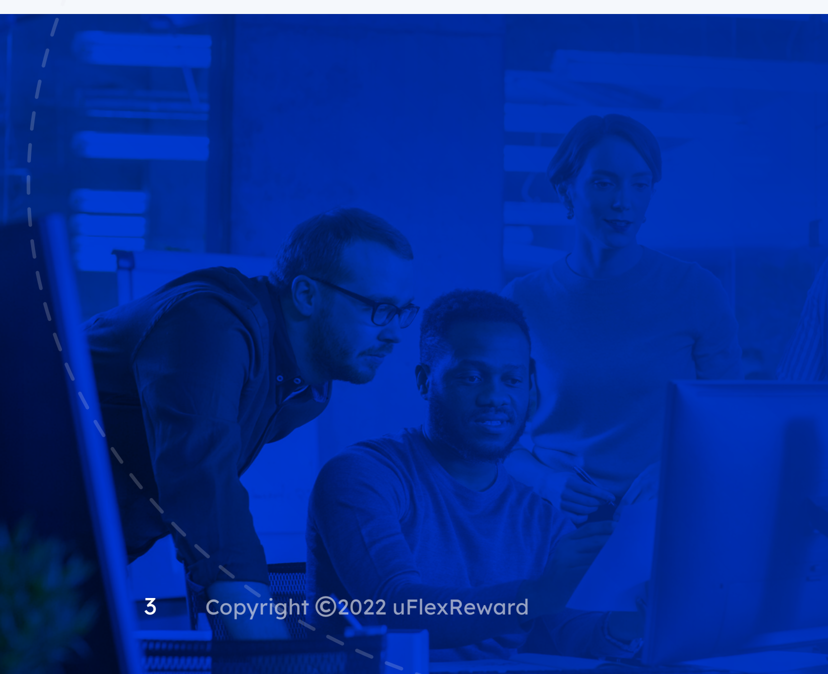
Over the course of 2021, the average pay rise in the private sector hovered around 2 per cent, despite the economic pressures of the pandemic. But pay analysts predict this will climb in 2022 due to the pressure on reward teams to reflect cost of living rises and hold on to restless staff. The CIPD's latest Labour Market Outlook, covering autumn 2021, found that pay intentions for the coming year had already grown to 2.5 per cent in the private sector. Ken Mulkearn, director of research at Incomes Data Research, takes a similar view. "Most pay setting takes place in January and April and we'll probably see the median [pay rise] increase further," he says. "Inflation affects everyone so is important for annual pay reviews. But pay tends to lag behind inflation, so most rises will lag the former and be below it. Employers generally want to maintain the value of their employees' wages relative to the cost of living, affordability permitting. If they don't, there's an impact on morale because employees are dealing with petrol price rises, the cost of clothing and the like."

CIPD senior reward adviser Charles Cotton warns against simply offering lucrative starting salaries in a bid to lure in hard-to-find talent, however. "The problem with giving new recruits more money is that you have to justify why they're getting it and the rest of the workforce isn't. Perhaps it's new skills, but over time that diminishes as existing staff acquire them, creating potential pay disparities and disputes," he says. Being open and fair about how pay is set, and offering a rate that provides employees with a reasonable standard of living is more important, he advises. This could take a number of guises: increasing pay frequency so employees can cope if there is a sudden financial emergency; financial education or awareness programmes; higher than statutory occupational sick pay or support with living costs such as childcare or travel. "Crucially, employers need to normalise conversations about money so people don't feel embarrassed seeking help. The earlier they can act, the less likely money problems will impact their mental wellbeing and productivity," Cotton adds.





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If across-the-board pay rises are not manageable, how can reward teams make their reward budgets go further? “First, have a strategy that’s longer than one or two months,” advises Duncan Brown, an independent reward adviser and principal associate at the Institute for Employment Studies. “For much of the pandemic, HR and reward teams were simply getting through to the end of the week, dealing with issues such as furlough. Now they need to give this time and resource. Think about what will recruit, retain and engage staff rather than the cost. If you’re looking to cut costs first, you’re looking at it the wrong way round.”

Eva Jesmiatka, rewards director at Willis Towers Watson, says this approach is becoming more common among clients. “A lot of companies are looking at reward in the context of the broader employee experience,” she explains. “Lots of people right now are thinking about a change in career so they’re considering ‘what do we offer as a company?’ and ‘how can we be an appealing employer?’ because they don’t have an endless amount of money to throw at the issue.” In the talent-hungry digital sector, she adds by example, employers are looking at what skills development they offer rather than over-inflated salaries. Willis Towers Watson’s research into what employees value identified four, non-financial elements: the purpose of the organisation and whether they feel inspired by it; the type of work people do; the type of career they can have; and how they are treated. “Leaders assume employees want more money, but really they want opportunities to grow and develop, or a better work-life balance,” she says.

Indeed, changes to work patterns or job design can have a major influence on employees’ satisfaction with their salary. “Take stock of how you organise jobs and whether you can improve employee productivity by making people work smarter rather than harder,” advises Cotton. “Productivity improvements will pay for increases in wages, while upskilling people means they can progress in their careers but is also beneficial for the company.” Offering flexible working arrangements, reasonable notice of shifts and guaranteed hours not only improves the financial wellbeing of workers, but the reputation of the business. He adds: “This not only impacts employees, but also the organisation as it helps you to stand out in the labour market. Customers don’t want to buy from businesses that exploit workers, and investors scrutinise this too.”

The pandemic increased employees’ focus on physical wellbeing and mental health support, so ensure these benefits are prominently communicated, advises Steve Herbert, head of benefits strategy at Howden Employee Benefits and Wellbeing: “Many group income protection plans have tools free of charge that they didn’t have five or 10 years ago, such as free remote GP appointments. Or helping employees understand how to manage their salary through a financial intelligence session is nothing compared to the cost of a pay rise.” Smaller, relatively low-cost perks such as local discounts or subscriptions to mindfulness apps can also have a positive impact on engagement where reward budgets are tight, he adds.

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And if employees don’t know what’s available, that budget will go to waste whatever you offer. Stuart Hyland, head of reward advisory for Europe at Aon, says the current situation is an opportunity for reward professionals as well as a challenge. “During the last recession when pay was higher than inflation we reminded employees that, for example, they get life insurance so they don’t need to get that from their mortgage provider. Or that their reward package included a tool that can help with the value of their shopping. Communicate with employees about the other benefits they receive from working for you as an employer—not just salary,” he says. Where organisations have invested in large-scale online reward platforms, reinforce areas that can soften the impact of price rises—a purchasing scheme that enables the business to buy supermarket vouchers at a discounted rate, for example. “There will always be someone that can pay people more,” adds Hyland, “but you can build loyalty by showing employees you were there with them through thick and thin. This year will be difficult for a lot of people, and showing them what they can have can create a sense of togetherness.”

Looking forward, organisations are taking a broader, longer-term view of how pay sits with their values. As part of the push towards ‘good work’, they argue, that should also mean a fair wage and transparency about how wages are set. This is reflected in the huge number of companies signing up to become Living Wage employers, offering a higher minimum rate set by the Living Wage Foundation rather than the government’s statutory minimum. More than 3,000 organisations have signed up to pay this rate—£9.90 an hour outside London and £11.05 an hour in the capital—since the start of the pandemic. “Covid upped the ante on awareness of the Living Wage in the UK and its counterparts in other countries,” adds Brown. “The low-cost, low-pay, just-in-time model has been exposed as totally undesirable in many settings. At the moment we have high price inflation but low employee bargaining power, and this could be an opportunity to turn this around.” At the lower-paid end of the spectrum, real cash rises make more of a difference, he argues: something that has driven a rise in unionisation in recent years (6.2 million to 6.6 million between 2016 and 2020, according to the Resolution Foundation) in a bid to secure a decent standard of living for those in precarious employment.

With some predictions of a 2023 election, it's unlikely the current government will ignore the Low Pay Commission's recommendations that the national living wage hits two-thirds of the median wages in 2024, adds Mulkearn. "The pressure on the statutory floor is generally upwards and with talk about a high-wage economy and levelling up, there's political pressure to keep it that way, so I don't see the target changing."

Nikos Bozionelos, professor of international HR management at emlyon business school, adds that unions and other bodies will use inflation to argue for a hefty increase, but this does not guarantee it will happen. "On the other hand, the government may use the argument that it has already pumped substantial amounts of money to support the economy and the active population, along with the healthcare system, during the Covid crisis. Or it might argue that the Covid situation is only temporary, so it cannot implement long-lasting changes as response to a temporary state," he says. There have been some discussions in government about not going ahead with April's tax and NI increases, but Bozionelos adds that "much will depend on the will of the government, as Covid showed that health and social services are critical and they must be funded accordingly. NI contributions serve exactly that purpose."

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Ken Charman, CEO of uFlexReward, a spin-off of Unilever, believes HR and reward professionals must become more data driven so they can offer employees a package that matches their needs but also those of the business. "Digitising reward makes a big difference," he argues. "It means you can target tools to help employees while not increasing the total labour cost of the business by trying to keep wages apace with inflation." In theory, this would allow employees to, for example, consider swapping out certain perks for cash one year because they need the money. "The technology is there to allow employees to decide for themselves rather than companies making paternalistic decisions about what they think employees need, and I predict we'll see more of this as we see more pull in the marketplace," he adds.

As employment itself becomes more flexible in the longer term, with workers taking up multiple contracts or juggling side hustles with their core roles, reward will need to become more responsive to follow suit, Charman says. And while it's complicated to take a global view on fair pay, a number of global employers are now looking at how they build sustainable and fair policies across their regions and into the supply chain. Schneider Electric, for example, has a global pay equity framework that helps teams in different countries to benchmark salary data and overcome some of the complexities, and extends expectations around fair play to its bigger suppliers. Other options to increase wage flexibility include 'earned wage access' tools such as Wagestream, which allow employers to offer workers access to money they have already earned before their usual pay day.

The pandemic has brought almost two years of disruption, with HR having to think on its feet and react to events and announcements as they dropped. The labour market may be tight and employees eager to chase a pay rise while their skills are in demand. But with high inflation predicted to last beyond 2022—providing pay decisions are fair, transparent, and enable a reasonable standard of living—is it time to play the long game on reward?

How does inflation actually work?

Put simply, inflation is the rate at which prices are rising for goods and services. Small increases in inflation may feel unnoticeable, but over the long term can have an impact on how far our wages will stretch—the cost of living. If wages rise in line with inflation, in theory that cost of living should be manageable. Above or below-inflationary pay rises could mean the difference between being able to manage an unexpected bill and being thrown into debt.

That cost of living rose 5.4 per cent in the year to December 2021: the highest rate of inflation for 30 years. This is measured by the consumer price index (CPI), which tracks the average price of more than 720 goods and services purchased by households. But a number of unions want employers and the public sector to base wage increases on the retail price index (RPI), which tends to be higher. The RPI takes into account the cost of mortgages, so unions argue this is a more accurate reflection of what employees spend. In their terms, the 6.6 per cent rise in the national living wage from £8.91 to £9.50 in April 2022 will be below inflation, and workers on this rate will struggle to cover the rising cost of living.

In December, the Bank of England decided to increase interest rates for the first time in three years in response to rising inflation, from a record low of 0.1 per cent to 0.25 per cent. Increasing interest rates is a way of preventing inflation from rising at an unmanageable rate, as it softens demand for goods as the cost of borrowing rises. Interest rates have been at a record low since the start of the pandemic.

In November 2020, the government announced plans to overhaul the way it measures inflation, so by 2030, RPI will be replaced by CPIH. CPIH includes housing costs, but uses 'rental equivalence' that looks at how much someone would pay in rental for their property. While this is unlikely to have a major effect on pay bargaining, thousands of employees with pensions in defined benefit (or final salary) schemes could end up worse off.

Why we don't want to go back to the 1970s

While the current rate of inflation may seem high at around 5 per cent, this will seem like small fry to anyone who was in the workforce in the 1970s. In the early part of the decade, it was assumed that periods of high inflation were not a problem—a growing economy meant businesses would hire more people, there would be more demand for goods and services and this would keep consumer prices down. But after the oil crisis of 1973 forced petrol prices up sky high, inflation spiked, reaching a high of 22.6 per cent in 1975.

The end result was stagflation, where the prices of staple goods grew quicker than overall economic growth. The government ended up rationing electricity, there were queues at fuel pumps and unemployment grew because factory production became more expensive. An enforced three-day week was introduced. In the latter part of the decade, trade unions began making pay increase demands way above the 5 per cent cap the Labour government had imposed, and 1979 brought a wave of strikes and what became known as the 'winter of discontent'.

Thatcher's Conservative government came into power in May that year, and its first task was a sharp rise in interest rates. This tamed inflation, but unemployment and industrial unrest continued to soar until the late 1980s. The following three decades have seen governments maintain a balance of relatively low inflation and interest rates, but also minimal wage increases in real terms.