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What Does High Inflation Mean for the Upcoming Compensation Cycle?

What impact is high inflation in many parts of the world, coupled with higher turnover, having on salary budgets? And what can companies do to keep employees feeling engaged in the face of these trends? We discuss what the latest data reveals and potential strategies for combatting inflation and turnover.

Inflation is making headlines worldwide. The cost of goods and services rose 5.4 percent for a 30-year high in the United Kingdom to close out 2021 and stands at around 7.5 percent in the United States. Many countries, from Singapore and India to South Africa and much of Europe, are experiencing inflation above 4 percent[1].

As companies prepare for their next compensation cycle, managers will likely be hearing more questions from their direct reports along the lines of: How does my salary increase account for inflation and a higher cost of living? How companies respond to this type of question, both in terms of rewarding employees through compensation and messaging the reasons behind their pay increases, will be critical in the effort to engage and retain talent in a tight labor market where workers are on the move.

Aon's survey data is already showing the impact of inflation and high turnover from the Great Resignation phenomenon on salary increase budgets. The Aon 2021 Salary Increase and Turnover Study shows 2022 salary increase budgets went up from when companies submitted their data in June and July 2021 and then again in October 2021. In the summer, companies reported a median salary increase budget of 3.5 percent (undiluted, meaning companies reporting zero salary increase budgets were removed). Months later, the median increase was up to 3.8 percent. The survey participants for this analysis are based in the U.S. and include 1,480 organizations in July 2021 and 1,757 in October 2021, many of whom are the same organizations reporting data during each time period.

When we limit the analysis to companies that reported during both time periods, we find three out of 10 organizations reported an increase to their salary increase budgets for 2022. While a majority of these firms said they increased the budget for merit increases, other reasons included introducing or changing promotion budgets and adjustment budgets. These actions are likely a response to retaining employees when they are a flight risk, compensating employees that may have experienced smaller or no increases due to pandemic-related business disruption and inflation increasing the cost of living for employees.

"It's unusual to see salary increase budgets go up as much as they have within a matter of months, and it speaks to the unusual labor and business market dynamics happening right now — not just in the U.S. but across many parts of the world," says Tim Brown, a partner in Aon's human capital business who leads the Market Practice Studies.

Don't forget the principles of pay for performance.

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[1] Trading Economics, December 2021

There are a couple of reasons companies may want to exercise caution when raising salary increase budgets or utilizing other compensation tools like sign-on bonuses, spot bonuses and counteroffers in response to inflation and high turnover. For one, employee pay should be set by the market supply and demand for labor — not the cost of living. Secondly, increasing pay to attract or retain talent in a hot market may be unsustainable, create or worsen internal pay equity gaps and lead to unrealistic employee expectations.

"There are times when taking unusual compensation measures are warranted," notes Anthony Scardino, director in the employee rewards practice for Aon's human capital business. "These circumstances may occur when a job is particularly hard to fill because it calls for specialized skills or an employer is targeting high-performing and high-potential employees that it can't afford to lose."

In general, though, employees need to focus on the principles of differentiating pay for performance to make merit budgets and incentives have a bigger impact. They should also refine their thinking and communication to employees on how inflation influences their pay outcomes. While cost of living can have a subtle influence on pay in the form of geographic pay differentials, for example, it has less influence over the pay of a job than the job requirements and labor market demands. Salary increases are largely dependent on the supply and demand for certain skills along with the overall compensation budget and the performance of the business and the individual employee.

Tying salary increases to the inflation rate can create systemic problems, such as overpaying or underpaying employees in certain regions, pay disparity within the organization, and the need for review and implementation mechanisms to change or reverse salary increases when economies stabilize. In the same vein, many of the factors responsible for the historic levels of inflation are cyclical in nature. Adjusting salary increases as a short-term response could misalign with the longer-term costs of many goods and services. The cost of energy and food, for example, has been exacerbated by global supply chain issues and many economists expect prices to fall as supply catches up to demand in a post-pandemic world.

Focus on delivering a consistent and fair message to employees.

Ultimately, it is crucial for employers to keep in mind that in today's historically tight labor market, employees in high-demand roles have many options for work that were not options to them just two years ago. The acceptance of remote work combined with greater demand for talent, have made today's labor environment a worker's market. Because of this, organizations should have clear messaging around their pay programs, especially as they relate to inflation adjustments. To a certain extent, most employers can't expect to retain employees through singular measures like salary increases and the goal with salary increase budgets should not be to win the loyalty of every employee.

"In the end, achieving fairness and reasonableness in pay for key contributors supersedes the impossible goal of universal satisfaction with pay increases during challenging times," notes Brown.

Managers should reiterate to employees during compensation and performance conversations how their pay increase connects to the firm's compensation philosophy and that salary increases largely reflect the cost of a job not the cost of living.

For employers who do choose to grant pay adjustments to account for inflation, it would be prudent to design programs and practices that are variable in nature and can be unwound where allowed for by local statutes. In doing so, employers can ensure they are not bound to unusually high levels of compensation while still accommodating employees real-time who are seeing varying levels of real wage deflation.

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