How inflation affects pay raises

If you work a job long enough, you eventually come to expect a salary increase, just as most companies expect to give you one. But what happens when the raise you receive ends up leaving you with less money than you had before? How is that even possible? One word: inflation.

According to the Bureau of Labor Statistics, 2022 saw a historic rise in cost of living items across the board. Everything from healthcare to housing surged to become more expensive than ever—gas prices, for example, rose as much as 75%—leaving purchasing power stretched further and further by the month. No matter which grocery store aisle you browsed, inflation rates made life vastly more expensive, with no help from the federal reserve in sight.

One might think inflation negatively affected employers as well—maybe interest rates were too high, or they lost too much money and couldn't kick any down to workers—but that notion doesn't hold up under scrutiny. On the contrary, corporate profits reached record highs in 2021, peaking just above $2.8 trillion. For some in the white collar camp, life wasn't much different from before, which was vastly different compared to those affected by the steady increase in pandemic-related homelessness. Some saw typical wage growth and bonuses, but most of us received salary cuts as inflation ate up more and more of our paychecks.

"Labor shortage" was one widely used term used to describe companies whose wages failed to keep up with inflation. These employers couldn't keep staff, suddenly faced with a growing body of workers who, as each 8-hr workday provided less and less of what they needed to live, asked themselves, "why work at all?" Companies like American Airlines received billion-dollar bailouts in the Payroll Support Program to make up the difference, but they chose to use the money on executive bonuses and a fleet of new jets instead.

Understandably, people are frustrated, making it harder for companies to find the proper talent they need to stay in business. So what's the answer? In this blog, we're talking about how small businesses should handle wages as they relate to inflation.

Raising wages is good for business

Yes, you heard that right. Far from being a problem, wage raises are a sign of good things to come. Revenues weighed against costs are the nuts and bolts of any company. When more money comes in than goes out, companies have more money to spend. Unfortunately, the payment of wages has to come from the company budget, and if wages are too high, logic would suggest that the company won't be able to stay in business. In short, raising wages beyond the absolute minimum ought to be a bad idea.

The science says otherwise.

Economists Alan Kreuger and David Card studied the effects of a minimum wage increase on 400 different fast food restaurants in New Jersey. Shockingly, rather than hurting stores and forcing them to cut staff, stores affected by the increase were able to hire 2.5 *more* employees on average. Their prices didn't skyrocket, their service didn't suffer, and better hourly wages meant more workers were able to pay their bills.

If you're confused, you're not alone. Raising wages doesn't immediately seem to translate to more business in

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the long run, yet it does, and there are many reasons why.

First, higher wages increase local spending, thus increasing the health of the local economy by giving more people more money to spend. Unlike the “trickle-down economics” of the 80s and 90s, wage increases among the non-executives spread money among people more likely to spend, rather than executives who are more likely to stash.

Second, well-paid workers do better work. It’s not rocket science (though it is science). When you have money in the bank, your brain works better, your emotions are healthier, and you’re more capable of doing the job you’re paid for. Conversely, when you’re watching your paycheck shrink in the face of inflation, your memory suffers, happiness dwindles, and you’re more likely to look for a different job—one that doesn’t leave you fending for yourself.

Can my business afford inflation raises?

It’s a courageous leap of faith to pay workers more when the economy screams at you to pinch every penny, but it’s a leap many businesses have to make. More than ever, high-performing workers are switching jobs if they no longer feel their current situation suits them, and as any business expert can tell you, turnover is expensive.

The few bucks you saved on raises last year are likely to incur costs in turnover and training this year. You’ll also have to offer higher initial salaries to prospective employees next year, since your reputation will be one of poor compensation and weak benefits. Pay people more, however, and you’ll attract better, more loyal talent who feel appreciated and properly compensated.

Many businesses today adopt policies of annual cost-of-living adjustments (COLAs)—pay increases meant to keep salaries at pace with inflation. In effect, though, they can hardly be called raises since they result in the same buying power as before. Still, they will be well appreciated by your employees.

Salary budgets must include COLAs. If they don’t, you’re effectively asking your employees to take a pay cut every year, and that just isn’t a great long-term strategy, especially in a tight labor market like today. If your business is struggling to keep up with inflation, your employees are struggling even more.

Consider retention bonuses

Even with an inflation increase, employees are likely to seek better compensation if they feel their skills aren’t being rewarded. One way to combat this flightiness is with employee retention bonuses (ERB).

Basically, ERBs are used to keep key employees from leaving the company. They’re often used during times of reorganization or peak volume periods, but inflation is as good a reason as any to roll them out on a red carpet and let employees know they’re worth it.

On average, these bonuses are 10-15 percent of an employee’s annual salary, but by offering the highest rate possible, you will see better results. The advantage of a mid-year bonus over a wage increase is that it’s a one-time payment. Rather than budgeting for increased monthly expenses, ERBs let employers dole out the dough just once and forget about it—and the benefits are great.

People who receive such bonuses are far more likely to stay with the company, even bragging about it to their colleagues and enticing more people to join your staff. The result is lower turnover, better recruitment outcomes, and happier employees. If you aren’t considering ERBs yet, now is the time.

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How do I budget for inflation increases?

Perhaps a better question is how can you not budget for inflation increases? Inflation is a constant: whether or not it’s as bad as it is right now, it will always be a factor in your business budget. Inflation won’t ever stop unless the economy stops, in which case wage increases will be the least of your problems.

Remember the fast food wage increase study from earlier? While their employees began to earn more, customers somehow never saw significant price increases in food costs. What this means is that paying employees more doesn’t automatically cause prices to increase elsewhere. But with that said, inflation does offer a nice excuse to raise prices and soften the economic blow, and it’s one customers are likely to understand. You will still need a good strategy in place, as raising prices is rarely the solution to a business’s economic woes.

Focus on your most profitable products. If you have one consistent, large-ordering client, now would be a good time to let them know they have your complete and unflinching loyalty. Prioritize what makes the most money for your business. This doesn’t mean letting your other products fizzle out completely, but when push comes to shove, it’s your cash cows that deserve VIP treatment.

This applies to your top performers as well. If you have an employee who consistently delivers and keeps business running smoothly, don’t wait until human resources approves a promotion and the accompanying raise. Chances are they won’t stick around long enough if they don’t receive the recognition they deserve.

Wage increases are part of life

We humans are simple creatures: when income is steady, we stick around. On the other hand, if we’re constantly wondering where we stand with our employers, the grass on the other side of the hill starts to look a lot greener. While good businesses realize that regular raises are unavoidable, great businesses know how and when to use them effectively.

Any money you save on wage increases will likely be lost on turnover costs if you refuse to give raises when they’re due. Moreover, doing so will give your company a bad reputation that will be broadcast on Glassdoor and LinkedIn, making it harder and more costly to find good talent in the future. Being stingy with salaries is never a sign of a successful company, so it’s best to get rid of any such notions now rather than later.

Paying high salaries positions you among the great companies that everyone wants to work for. Competitive pay suggests a positive future, and people are more likely to feel confident about the stability of their jobs. So, when it comes to wage increases to compensate for high inflation, don’t rely strictly on market data, the consumer price index, or the average salary increase. Instead, take the road less traveled by funding your compensation budgets and giving workers the pay they deserve.

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