CMC Compensation Group

Cost of Living vs. Cost of Labor: What is the fuss about?

Why doesn't my Company consider inflation when determining my pay increase?

What this employee is asking is, shouldn't my annual increase percentage at least match the cost of living? And as management is always talking about the company's "pay-for-performance" philosophy, shouldn't my increase be higher than that, given that I'm a good worker?

Have you ever been in a situation where an employee complains to you that their pay increase is no better than the inflation rate? Or worse, that it's lower? As a further aggravation they might ask you how the company can say there's a pay for performance policy when all they do is grant increases that no more than match the inflation rate? Isn't that like treading water, staying in place without moving forward? Is that fair? Where is the reward for good performance? Shouldn't *everybody* receive <u>at least</u> the inflation rate?

The truth of the matter is that it is common practice for companies to only give a side look at inflation (cost of living) when determining their annual increase budget. They do make note of it as a reference point, and to compare against a final decision, but what they're actually focused on are two prime considerations: 1) competitive market survey data that tells them what everyone else is paying for like jobs in their area; and 2) the expense (annual grant and fixed costs) to maintain competitiveness.

Companies routinely promise to pay competitively, and as such will analyze what they consider the marketplace to learn what other companies are paying for jobs (base salaries) and granting for increases. Their so-called "promise" does not include the granting of inflation-proof increases, or even to reflect the cost of living in their analysis. What their intent is, is to pay employees a competitive wage (including increases), and competitively means what others are doing, *not* necessarily what is happening out there in the world of inflation.

If affordability is an issue for any given year, it's likely that maintaining competitiveness will have to suffer.

Is that fair? Well, let's imagine your name is on the company door. How would you plan to spend your money? Likely you would seek to pay the <u>least</u> that you can, while still attracting, motivating and retaining qualified talent for your business. That does not suggest you would lower pay levels, but as the owner you would want to allocate your substantial payroll expense as effectively and efficiently as possible to staff your business with qualified and engaged employees. It would not make good business sense to spend more than you need to, either for bricks & mortar, raw materials or employee compensation.

Consider the market for talent similar to a purchase at a retail store. How frequently would you pay more than the advertised price if your extra money gained you nothing more but the same item? Chances are you would not often take that approach.

Now let's consider the employee perspective. What factors weigh heavily on their minds when considering the potential for pay increases?

Most employees expect management to reflect either the inflation rate (cost of living), the average increase for their industry / geography (typically as pointed out by newspaper "factoids"), or if the company had a good year to share the financial success with them. You can be sure though, that the figure employees have in mind is the highest of the three possibilities just mentioned. And lest you forget, that figure is only for the average performer; better employees should receive more.

Now this view is not necessarily wrong, from their perspective, and one can certainly not blame employees for a viewpoint that puts their interests first. However companies typically maintain a "this is a business first" strategy, one that seeks to minimize controllable expenses without losing sight of their competitive pay target. The goal of paying competitive wages, a concept hard to argue against, is not likely to be overturned by changes to the cost of living, newspaper snippets or a feel good moment following company success.

Another factor to consider is that employees are comfortable with changing their reasoning from year to year, while companies are stuck on the same track. So when inflation goes up or down, or the company has had a good (or not so good) year, or the media is touting industry averages, employee expectations may likely swing from one argument to another, rationalizing a consistently more aggressive pay increase strategy.

Now a little tongue-in-cheek: turnabout is not considered fair play. Employees would <u>not</u> want the size of their increases to fall with their chosen economic indicator. It should only rise. They would object to smaller increases if the company hit a rough patch, or if inflation nosed downward. You shouldn't be surprised that they want their cake and to eat it too!

Management strategies though tend to be consistent over time, continually focusing on the marketplace and its affordability to maintain their posture of providing competitive pay and pay opportunities.

So how do you avoid a clash of employee expectations vs. management strategy? If companies would communicate their pay philosophy or strategies they would be able to allay the employee guesses and assumptions that always accompany the grapevine and rumor mill. Employees would know in advance what to expect. They might not like what they hear, but the employer - employee relationship would be improved by some straight talk about how the company determines pay increases.

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