Reward strategies in the cost-of-living crisis:

Are higher and cost-of-living pay increases really such a bad thing for the UK economy and employers?

By Dr Duncan Brown, principal associate at Institute of Employment Studies

I m not saying nobody gets a pay rise. But what I am saying is, we do need to see restraint in pay bargaining, otherwise it will get out of control . Governor of the Bank of England Andrew Bailey (whose personal earnings in 2021 were reported to be £575,538, 18 times average earnings in the UK) speaking on BBC Radio 4's *Today* programme, 3 February, 2022.

Should employers pay more?

Last week, I attended a meeting of the European HR Directors 'Circle in London, with on-screen link ups to audiences in Paris and Frankfurt. The focus of the discussion was the cost-of-living crisis and how employers and their HR leaders should be and are responding. I came away after my presentation to them having learned lots about these different countries, labour markets and cultures.

But the core employment and reward issue they face was consistent across them all. In tight, skills-short, post-Covid-19 labour markets, rocketing price inflation is, despite an upward if generally more sluggish trend in pay awards, driving record cuts in real earnings and living standards for their employees. This in turn is leading to demands for still higher pay awards from employees and trade union representatives, in some cases leading to disputes and industrial action. 'Back to the 1970s' is a common media headline.

So should employers pay their staff more, driving up their own costs and risking further fuelling still-higher rates of inflation? That's the core dilemma facing HR leaders today.

Looking at the UK for example, the latest monthly data from the Office of National Statistics, also published last week, revealed unemployment down to 3.5%, the lowest since records began in the early 1970s. In response the annualised growth in total earnings was up to 6.0%, and 6.2% in the private sector, a 20-year high.

Yet with price inflation by the ONS's CPI measure also up at 9.9%, real earnings actually fell over the past quarter, by a near-record 2.4% for total pay and 2.9% for regular base pay. So, if the recent energy and food price rises are making you feel poorer, you are correct, you really are poorer. In fact according to the Institute for Fiscal Studies, the last decade has probably been the worst for pay growth since Karl Marx was born more than 200 years ago.

'We want more pay'

It is hardly surprising then that public sector union Unison's decision on 27 October to ballot its 406,000 members in the NHS, whose 2022 pay awards averages 4% in a service that has a record 130,000 vacancies, is only the latest in a series of disputes where workers are demanding awards of at least the level of the cost-of-living from employers, who say they can't afford to pay that.

According to Anthony Painter, director of policy at the Chartered Management Institute (CMI), just under half of the employers they surveyed cannot afford to help with the financial pressures faced by their employees, as "cost pressures are hitting employers and employees alike". Perhaps not surprisingly, the HR leaders at our meeting had all made, or were planning, additional financial support for their employees.

From Aslef's rail workers to criminal barristers, to BT's 999 call handlers, to ports and postal workers we are, however, seeing a rising wave of action in response to well-below-inflation pay offers. Unite's combatative General Secretary Sharon Graham says "the double whammy of soaring inflation and falling wages is creating an historic cost of living crisis … business is trying to force workers to pay the price for the pandemic". After all, employers were happy throughout the 2010s

to reflect low rates of inflation in their austerity-driven historically low pay awards. So isn't it time to pay up now when inflation is, to use Mr Bailey's terminology, already seemingly "out of control"?

Graham claims a two-thirds success rate in securing higher wage deals, including a 13% award for British Airways cabin crew and baggage handlers and the same for Stagecoach bus drivers in August; and 11% (5.5% on basic rates and two cost-of-living lump sum payments) for workers at Heinz.

Without any labour unrest, food retailer Lidl similarly recently announced their second pay award this year, totalling between 10% and 15% for its employees, reflecting on the more than 100,000 unfilled vacancies in their sector. Lidl was an early adopter of the Living Wage Foundation's real living wage level floor and, as well as rewarding 'the ongoing commitment and dedication of our workers', its chief executive explained the scale of increase by the fact that "our business simply would not run without them". Perhaps he needs to speak to Mr Bailey.

Though the context and exact economic figures varied across Europe, the same core dilemma was evident for all of the participants in our European HR director circle. Powerful German labour union IG Metall has demanded an 8% wage hike for around 3.8 million workers in the metal and electric industry amid spiking inflation. In France a national strike of mostly public sector workers began in October and at the oil company Total, employees agreed to return to work after winning an inflation-matching pay increase of 7% plus a cash bonus.

Why higher pay isn't driving a return to 1970s-style pay/price 'stagflation'

This is exactly why governments, central bankers and employers say they are worried about and intervening to prevent high pay awards, for fear of further fuelling price inflation. Governments in the UK and France are proposing to ban strike action for various groups of public sector employees.

Andrew Bailey said restricting wage growth was vital for "keeping a grip on inflation", telling the *Today* programme it would help to stabilise the economy after the turbulence of Covid-19. Otherwise, we risk a return to the chaotic low productivity 'stagflation 'economy of the 1970s.

Except that someone needs to tell Mr Bailey that in terms of productivity growth we are already there. Worse in fact. Asking if "the UK's (2010s) productivity slowdown is unprecedented", Craft and Mills' (National Institute Economic Review) detailed analysis of historical trends leads them to answer in the affirmative:

"We find that the current slowdown has resulted in productivity being 19.7% below the pre-2008 trend path in 2018. This is nearly double the previous worst productivity shortfall 10 years after the start of a downturn in the 1970s."

Slower growth means less money for pay. By 2026, the IFS estimate is that average household earnings will be £30,800, almost £13,000 below what they would be paid if they earnings had risen at the same pace as in the two decades before the banking crisis. So austerity-driven economic orthodoxy since the financial crash of 2008, to hold interest rates, inflation and pay increases down has, it appears, been bad for national productivity and even worse for employee pay.

There are a number of other problems with this 'pay austerity 'train of thinking by employers and HR leaders, even if it very much reflects economic orthodoxy and was supported by western government policies since the financial crash of 2008.

The classical market economics I learned at London Business School in the 1980s said to us budding business leaders that if labour is short then you have to put the price of it up, that is, pay employees

more to recruit and retain them. And correspondingly increase your prices to consumers (which is happening in many sectors at the moment, big time, and bigger on the prices than the pay).

Large employers on both sides of the Atlantic, despite their warnings of impending recession around the negotiating table, seem to have been ‘easily ’increasing their prices, profits and shareholder returns since the pandemic, according to the *Wall Street Journal s* analysis.

In fact, since the turn of the millennium, analysis by John Van Reenan at LSE confirms that the historic association between the rates of productivity and wage growth has been broken, they have become ‘decoupled’, with wages increasing even slower than rates of productivity growth.

Or at least that is for low and averagely paid workers. The earnings of higher paid employees have steamed ahead at much faster rates of growth than the overall economy and general rates of earnings movement. By 39%, for example, for the chief executives of our largest FTSE 100 companies over the past 12 months, according to the High Pay Centre's latest annual survey.

As a result, we are the now the most unequal society in Europe. In 1970, a UK chief executive earned around 20 times the average earnings level of their employees. Now its up to well over 100 times.

The ‘Trussonomics ’promised during Liz Truss's 44-day prime ministerial reign, with its emphasis on economic growth over distribution, would ironically have most likely made things worse for both GDP and pay, removing constraints for top earners and protections for the low paid.

While the planned removal of the EU cap on short-term banker bonuses of 200% of pay will most likely be a casualty of Truss's demise , along with the lowering of the top income tax rate to 40%, with a swift return to traditional economic orthodoxy under new Chancellor Jeremy Hunt, I wouldn't feel too sorry for those bankers. My client work has highlighted their actual paid bonuses have on average doubled since the financial crash and rates of base pay increase been similarly high.

A study commissioned by the TUC confirms both of these trends towards higher earnings inequality and a lower share of productivity gains going to workers over the past decade and a half. They found that payments to shareholders have increased three times faster than workers' pay since the 2008 Crash, with dividends and total shareholder returns up by a total £440bn above inflation since 2008, while wages have fallen in real terms by £510bn below inflation.

“Too many businesses are lining shareholders' pockets without giving workers a fair deal,” said Frances O'Grady, TUC general secretary preparing for its annual conference this week: “It's time to get back to solid above-inflation wage growth and sustainable economic growth that everyone in the UK can share in.”

Many of you, like me, probably instinctively recoil at seeing, in a low-paying sector in the current climate, the reported £100 million bonus opportunity given to Mike Murray, Sports Direct founder Mike Ashley's son-in-law and chief executive of the Fraser Group,. Even shareholder adviser Glass Lewis said it had “serious reservations” about the plan, both due to the potential for huge “windfall gains” and its fundamental unfairness relative to the pay of thousands of their other hard-working employees.

A similar trend, perhaps more surprisingly, is evident throughout Europe, with shareholder payouts rising seven times faster than wages so far this year, according to the ETUC.

How has this happened? Well, this is very obviously not the 1970s environment that we face replicated today, whatever Mr Bailey's worries. Trade union bargaining for example, covers fewer than nine in 10 private sector workers in the UK now, compared with half in 1973, with levels of

cover particularly low in the poorest paid jobs that have been at the heart of the employment growth in the 2010s.

Strike days, as *The Times* economics editor David Smith highlights, are running at less than 1% of their 1979 peak of almost 30 million. This leads him to conclude that "Britain has many economic problems but this" (strikes and resulting high pay awards) "is not one of them".

More than two million more employees are now in low-skilled, insecure jobs paid at the national minimum rate and almost five million at less than they need for a real living wage. Most of the millions of children living in poverty today have a working parent. According to the Joseph Rowntree Foundation, with such high rates of price inflation, low-income families are living through a "frightening year of financial fear".

So will employers paying their low and average earning workers more really make things worse, are our European HR director groups really doing the "wrong thing" and stoking inflation and economic instability?

Another big difference with the 1970s are the estimates that more than half of the increase in inflation today is explained by the 'shock 'to power supplies and prices, and the wider economy still dependant on fossil fuels, caused by the war in Ukraine. It's nothing to do with high UK pay awards.

In fact, if you look at the patterns of increase this year, wage awards have significantly lagged price escalation in terms of both timing and scale. XpertHR reports "a summer of stability in pay awards" (if nothing else). Average base pay increases have plateaued at 4% over the past five months across all of the employers on their database. Any higher awards they find to be largely explained by self-funding performance-related and recruitment/retention-driven bonuses. Hardly governor Bailey's "out of control" pay awards driving inflation and risking the UK's macro-economic stability.

Liz Truss's government's attempt to challenge this low pay/low interest rate/low inflation prevailing UK economic and political consensus, with its no-holds-barred, growth-at-any-cost (including labour regulation and protection) 'Trussonomics 'barely lasted a month before "economic orthodoxy bites back" and forced her removal.

But the results of its application and return of 'Hunt-enomics 'in terms of achieving the high productivity/high pay economy that her predecessor Boris Johnson regularly talked about have been, as already described, less than spectacular.

The opposite in fact. Crafts and Mills conclude that "this productivity slowdown is unprecedented for the past 250 years", the same conclusion as the IFS and Resolution Foundation make about the catastrophic last decade for pay growth.

The alternative employer model: invest and pay people more

So what are the arguments for and benefits of paying workers more, an alternative pay and economic model to both traditional orthodoxy and Trussonomics? Explaining a drop in its profit forecast growth earlier this month, Tesco chief executive Kevin Murphy justified to shareholders its 20p an hour, out-of-annual-cycle pay award for store staff up to £10.30 per hour by stating the blunt requirement that "we try to ensure our colleagues don't have to go to food banks". But he also explained that it's "a key part of how we see the world", for Tesco and all responsible employers.

The alternative philosophy and approach, 'HR-onomics' perhaps, is called investing in people, their skills, their careers, their pay and progression, paying as much as you can afford rather than as little as you can get away with, to the benefit of them and their employers. It's the core philosophy of

many of us in HR and why we work in the field. But now, as speaker Perry Timms told us at the Institute for Employment Studies' (IES) own HR leaders retreat a couple of weeks earlier, with their "Covid dividend" and demonstrable impact, we need to go on the offensive, despite the economic uncertainty.

We need to get our heads above the parapet and argue forcefully for the retention and extension of the sorts of investment in employee health and wellbeing which we saw increase and extend massively during the Covid-19 pandemic, as evidenced by the CIPD's latest reward management survey. To fight back against a decade and more of government and employer pay and reward austerity.

When I led the research and policy work at CIPD 15 years ago, we researched and assembled lots of evidence from around the world demonstrating the associations between investment in people and organisation performance, ranging from employee productivity and profits per employee in the private sector to mortality rates in acute hospitals in the NHS. Combs et al (2006)'s meta-analysis for example, found more than 90 such studies globally, with the "high performance work practices", including skills-based pay and performance bonuses, linking to higher productivity.

Our subsequent work at IES on evidence-based reward management drilled down into the research evidence and experience of specific pay and reward practices linked to higher productivity and performance. These include:

- Addressing low pay, which is actually associated with higher, not lower, employer costs, through increased turnover and absenteeism and lower employee commitment. The Living Wage Foundation finds that most of its more than 10,000 member organisations report benefits from their higher minimum wage floor: 58% say it has helped to improve employee relations, 75 % report improved recruitment and retention rates and 84% that it has improved their reputation as an employer, with employees, recruits and customers.
- Fair pay practices and lower pay gaps which, as the IES detailed for the EHRC, are associated with higher levels of employee trust and engagement. Commenting on the planned removal of the gender pay reporting requirement for medium-sized employers by Business Secretary Jacob Rees-Mogg, PwC chairman Kevin Ellis said "nearly every business will still report it" for "otherwise you can't recruit people: it's the most read section of our annual report by miles".
- Skills-based pay and career progression, which as the IES's Europe-wide research project demonstrates, delivers potentially huge benefits for employers who invest in progressing the pay and careers of their low paid staff. The research concludes: "In spite of challenges in terms of market pressures and demand fluctuations, employers that support low-skilled workers report reputational benefits, improvements in service quality and reductions in employee turnover." This is especially so when they focus is on internally filling higher paid roles in such a tight external labour market through internal development and promotions, thereby delivering higher levels of staff engagement and performance.
- Collective profit sharing and employee ownership and share schemes. My recent research summation published in *Compensation and Benefits Review* demonstrated that "the literature retrieved for this study undoubtedly suggests that a greater presence and breadth of collective variable and performance pay schemes coincide with better performance across a variety of metrics, especially evident at the site level".
  Benson and Sajjadiani (2018), for example, reported that the manufacturing plants they researched that use these schemes perform better than those that do not, with gainsharing plans associated with higher productivity, greater quality and other performance

improvements. A study by Nichols in 2011 similarly found the companies studied reported a significant average 17.3% productivity gain after implementing gainsharing.
No studies of the impact of executive pay practices or the prevailing focus on individual performance pay have produced anything like as compelling evidence, with the research record mixed at best.
The Employee Ownership Association has demonstrated a similar performance premium over equivalent quoted companies, concluding that "employee ownership can improve employee engagement, rates of innovation, business sustainability and productivity". Mr Bailey should be really interested in that.

Higher pay at the bottom could also be married to lower pay at the top for fairer future pay and productivity outcomes, a factor leading San Francisco to introduce progressively higher taxes for local companies with excessively high and divisive internal pay ratios. Under their "Overpaid Executive Gross Receipts Tax", additional tax is levied on gross receipts or payroll expenses of any business in which the chief executive earns more than 100 times the median compensation of its employees. The tax rate reaches its maximum level when the ratio reaches 600 to 1, with a maximum tax on payroll of 2.4%.

My colleague Stephen Bevan worked with the Purposeful Company on its alternative model for executive pay, which is also supported by the High Pay Centre's research. It proposes a very different executive reward package, with base pay comprising a higher percentage of total earnings; and the current high annual executive bonuses and leveraged supposedly long-term-incentive performance (LTIP) share plans replaced by collective all-employee share and bonus schemes and long-term deferred shareholding requirements for executives. A number of companies are already moving towards this model such as The Weir Group, with deferred shares introduced to replace LTIPs at BT Group, Burberry, Lloyds Banking Group and Whitbread.

The High Pay Centre's modelling suggests that if the top 1% of UK earners took a 5% pay cut, up to nine million low income workers could have their wages boosted up to the real living wage level. And giving up one weeks' chief executive pay in a FTSE 100 company could fund an increase for 80 employees from the annual National Living Wage minimum rate up to the LWF's real living wage level.

The shift required in government/employer orthodoxy towards higher, cost-of-living-related pay

Over my career, I have regularly worked on pay with agencies and subsidiary bodies of the UN, such as UNICEF and UNESCO. Across most of these bodies the pay and rewards of professional and managerial staff are managed through the UN common system of salaries, allowances, and benefits administered by the International Civil Service Commission. The common system was established to prevent internal competition for staff and to facilitate internal mobility between these organisations.

The remuneration of staff in the professional and higher categories is made up of two main elements: a base salary and post adjustment. The post adjustment, a monthly base salary multiplier, takes account cost-of-living factors and exchange rate fluctuation as well as inflation. These staff also receive an excellent pension and benefits package.

Over recent years, Western government representatives have regularly criticised the approach for its costs and lack of consideration of individual performance and external market. Yet few other pay and benefits structures have survived more than 50 years. And the benefits it secures of staff

stability and security seem especially obvious, to these employers but also their employees at this time of high economic uncertainty and inflation.

Is inflation-related pay really such a poor model, especially when compared with the failed pay orthodoxy of individual performance and market-driven pay over the last 20 years, which has delivered widening pay differentials and unproductive pay gaps, as well as low levels of employee engagement and company and national productivity growth? Perhaps more employers, especially in the public sector, need to return to directly linking pay growth to inflation.

Politicians, as well as employers, seem at last to be recognising the failure of the low pay/low people investment model at the national as well as the employer level. Helen Thomas reports in the Financial Times that "no one (in the business community) was asking for the top rate of tax reduction(or) … ever-more drastic pledges to exorcise EU rules (on employment) from the statute book", with the government acting on "an outdated version of what companies actually want". US President Joe Biden similarly openly criticised the Truss government's plan for high earner tax cuts for its unfairness.

In the US, Biden's administration has five elements in its future economic blueprint, including returning greater power to workers to help to drive what London Business School (LBS) finance professor Alex Edmans refers to as a "bigger economic pie", as well as a bigger share once more of that pie. An early demonstration of this major change in political and economic thinking came last month, with Biden's intervention to avert a national rail strike, in marked contrast to the UK's politicians as our rail dispute smoulders on. The new US rail agreement includes an immediate 14% pay increase for rail workers after three years of pay freezes and disputes.

According to Biden, this was "a big win for America" and he said that he was "optimistic that we can do this in other fields as well: unions and management can work together for the benefit of everyone". Bolstering inadequate state welfare and childcare support for working families is another key plank of this new, more interventionist and people-investment-oriented, economic approach. It's the opposite of the low pay/high pay differential austerity-driven approach of the 2010s and the opposite of what has been the UK's 'trickle down 'model of growth, which Biden explicitly states has "failed".

Similarly, in Europe, the European Central Bank's chief economist Philip Lane made a rare direct intervention in September, arguing for more financial support, funded by higher taxes on the most wealthy, for those most badly affected by the current "inflationary spike",. He supports such approaches by EU governments 'from the point of view of fairness, but also from a macroeconomic perspective, government should support the income and consumption of those households suffering the most".

His views echo those of Katherine Chapman of the LWF who, in explaining the record 10% increase in their real Living Wage rate last month, argued that this would provide "greater security and stability" for low paid workers and also the wider economy.

She said:

"With living costs rising so rapidly, millions are facing an awful heat or eat choice this winter – that s why a real Living Wage is more vital than ever. We know that the Living Wage is good for employers as well as workers, that s why the real Living Wage must continue to be at the heart of solutions to tackle the cost-of-living crisis."

Archbishop of York Stephen Cottrell (the Church of England says it will be making an emergency cash lump-sum cost-of-living payment to its employees in Westminster, York and Canterbury) joined her in his support on more philosophical than economic grounds:

"*During a sad and troubled period, we can take heart from this news, which will make a vital difference to the lives of many thousands of workers. With living costs rising and many families struggling, a wage that meets everyday needs is more essential than ever. Decent pay that covers living costs should be a foundational principle for business and, as we approach a difficult winter, I hope to see more employers adopt a Living Wage.*

Don't you agree Mr Bailey?

In Germany, corporate structures provide much greater involvement of and power for workers, through two-tier boards and works council. Chair of Volkswagen's council Daniela Carvallo (described as a key force in the recent ousting of chief executive Herbert Diess) dismisses, like Sharon Graham, suggestions that high pay awards will drive an inflationary spiral. She says Germany's high skill/high productivity economy meant that "in the past our labour costs were higher than in other countries, but we have still been successful".

Agreeing with President Biden and the TUC's Frances O'Grady in justifying the 8% pay claim by the IG Metall trade union, she added: "We have to make sure that employees' purchasing power remains strong, because otherwise we run into more danger of recession, because everyone is afraid to spend money". For them, business success and worker pay are not mutually exclusive, but mutually reinforcing. HR needs to make a much wider recognition of such evidence-based logic.

The Financial Times economics commentator Martin Sandbu agrees, arguing that the current central bank responses of higher interest rates to curb price and wage inflation in the UK, Europe and US, risk driving a deep economic recession. These measures, he says, are outdated for the 2020s' world of high inflation and labour shortages. Higher prices and wages will drive improved innovation, investment and productivity as "it forces managers struggling with rising input costs to find more productive ways to use staff… to up their productivity game".

Whether simply to avoid worker poverty, starvation and hypothermia, or more broadly to drive a new and more productive model of economic growth, the arguments for a higher pay model of the type Germany has used to achieve far superior growth rates than the UK, and America now aspires to, would seem a more positive, productive economic and employment model for the UK government and employers to adopt in the radically different environment of the 2020s.

Explaining their decision to increase pay and benefits and recruit 13 new apprentices in a workforce of just over 100, Chris Timmins, managing director of property developer Jessups Partnerships, says the shortages of surveyors, land managers and estimators it is facing is a long-standing, but now much worse, issue that is driving these investments in their people. It gives him and all his stakeholders the confidence that "even if there is a downturn, we expect to work just as we are now. In fact, we will grow as a company through any recession".

Far more UK companies need to follow Jessop's example. And a visit to their East Midlands HQ along with a chat with President Biden might not go amiss for governor Bailey.