Key Factors for Determining a Salary Increase Budget

Background – What is a salary increase budget

Each year, most organizations budget for higher salaries in the subsequent fiscal year. A salary increase budget is the pool of money set aside for salary increases. Salary increase budgets are often expressed as a percentage: the proportion by which the organization is growing its salary pool from one year to the next. Note that the increases individual employees receive will vary based on individual factors such as performance and equity.

Factors for determining a salary increase budget

Organizations consider the following when setting salary increase budgets:

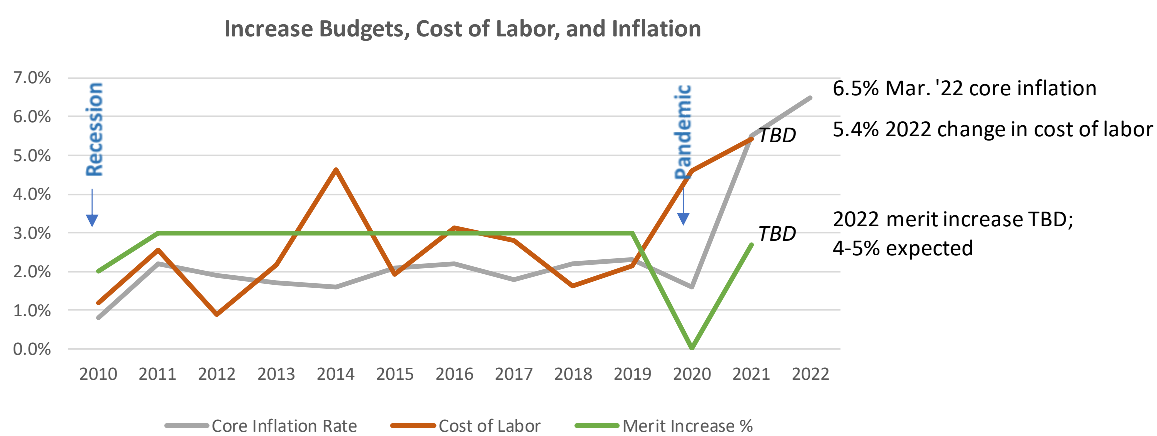
- Organizational finances – A key driver since the organization needs to fund the increases
- Changes to cost of labor – The cost of labor reflects an organization's compensation costs. Changes to the cost of labor are determined by supply and demand, which are influenced by the competitiveness of the labor market (organizations raise salaries when having difficulty attracting or retaining employees), technological advances or growth in productivity (which lower labor costs by reducing need for human labor), as well as a number of other economic inputs. While periods of high inflation often coincide with periods of larger increases to the cost of labor, they are driven by different factors and are rarely identical.
- Organization's prior competitiveness of salaries and desired future level of competitiveness – If an organization's pay practices are less competitive relative to the market, a higher increase budget will help it catch up
- Peer organizations' practices – Organizations will often benchmark themselves against the organizations most like them, since they compete for similar talent

The labor market, not overall inflation, is the primary driver of salary increase budgets

The current tight labor market directly affects cost of labor, pushing organizations to raise salary increase budgets as they compete to hire/retain employees. Inflation measures the change in the cost of a basket of goods over time. Indirectly, inflation can put upward pressure on salaries as employees look for higher-paying jobs to offset lower purchasing power due to inflation; however, high inflation may not push employers to budget more for salaries if the cost of labor rises at a slower pace.

Increase Budgets, Cost of Labor, and Inflation

As illustrated in the chart below, increase budgets track cost of labor[1] and, loosely, inflation. Prior to 2019, compensation consistently rose more quickly than inflation, with organizations budgeting around 3% annually while inflation averaged around 2%. Given the current tight labor market, organizations are budgeting more, with projections of 4-5% budgeted increases for 2022. However, individual organizations' increases will vary, based on the factors mentioned above.



[1] Cost of labor measured by percent change year to year in Q4 Bureau of Labor Statistics employment cost index for wages and salaries.