Employee Share Schemes: The Impact of Inflation and the Cost-of-Living Crisis

David Craddock is a recognised authority in the UK and worldwide on employee share schemes and cash profit-sharing schemes and is the author of Tolley's Guide to Employee Share Schemes. In this article, David Craddock offers a prescription for the British Government on how to tackle the cost-of-living crisis through the application of employee share ownership economics.

The Cost-of-Living Crisis

The practical manifestation of the seriously harmful effects of inflation is the cost-of-living crisis that increasingly dominates the news cycle and, at the present time, shows little sign of abating. This focus from the television and radio stations in a democracy is fully justified, given the impact of inflation on people's everyday lives, taking the equivalent form of a regressive tax by consuming a higher proportion of the income of poorer people who are forced to make stark choices, even to the point in some cases of "eating or heating". The resort of many is to be forced either to draw on hard-earned savings or to take out debt or to go into arrears, with the mental trauma that any of those responses has the acute propensity to create for the individual. At the extreme, the consequences can be homelessness or hospitalisation or even death – yes, it is that serious! The impact of inflation is truly uneven, not only hitting low-income families the worst, but affecting public sector employees disproportionately more than private sector employees to whom companies typically award higher wage rate increases than do government bodies to their employees. By contrast to the plight of the poorer people, for the wealthy, capital asset values increase with inflation, and the debt taken out by the wealthy to fund capital projects reduces in value. Furthermore, the conundrum of how to cure the UK economy from the impact of inflation is compounded by the fact that the costs of food, home energy and vehicle fuel – all absolute necessities for living – seem to be outside the control of government.

The Response of the Bank of England

A sure indication of concern within the Western economies came in June with the latest increase in interest rates, notably for the UK on 16th June 2022 with the Bank of England increasing the Bank Rate from 1% to 1.25%, presumably a response to the initiative of the US Federal Reserve the day before to increase its rate by 0.75%. For the Bank of England, the gravity of the issue is best illustrated in the comparison between the target inflation rate as measured by the Consumer Price Index of 9%, expected to reach 11% by the autumn, and the Bank of England's own target rate of 2%, a level estimated to keep the economy buoyant and avoid the recession-inducing effects of deflation.

The assumption must be that the Bank of England, with its interest rate increase, is seeking to stabilise sterling in the exchange rate markets and keep the demand for sterling high to lower the cost of imports. The converse effect, though, is to increase the cost of exports, with a stifling effect on export-led growth and contributing to the fears of a recession.

The Economic Lessons of the 1970s

The inevitable question to ask is this: Are we witnessing a return to the 1970s when inflation in the UK reached 25%, with interest rates reaching 17% in valiant attempts to break the inflationary price-wage spiral? That was a time when expectations had spiralled out of control with trade union demands for ever-increasing wage hikes to maintain purchasing power, chasing to keep up with price increases as businesses sought to maintain their profit margins. Therefore, the key in the current economic crisis is to learn from the 1970s that expectations of further price increases must be kept under control and that requires cooperation from all decision-makers at the macroeconomic level, i.e., governments, banks, employers, and trade unions. If the combination of: (1) fiscal policy from the British Government, (2) monetary policy from the Bank of England, (3) the management of industrial relations by company employers and (4) restraint from the trade unions cannot control expectations, then further interest rate rises will almost certainly follow. However, the difference from the 1970s is that the evidence indicates that the UK economy is slowing down with 0% growth projected for the 2022 calendar year, in which case the slow-down in the economy may do the job that the massive hikes in interest rates in the 1970s were intended to do at the time. The point is that somehow inflation must be squeezed out of the economy.

The Dangers of Stagflation in 2022

Ultimately, the danger is that inflation, if left unchecked in any given nation's economy, will reduce demand through lower purchasing power, with a consequential downward spiral of the economy into recession. The hidden danger in 2022 is that further successive increases in interest rates, if that becomes the policy adopted by the Bank of England, may fail to reduce inflation. Why? The answer is that the conditions that have created the inflation may remain unaffected by a monetary policy that revolves around rises in interest rates. In summary, those conditions are: (1) the massive increase in the country's money supply to fund the Covid-19 lockdowns, (2) the food shortages through the war in Ukraine, (3) the restrictions in the supply of fossil-based fuel supplies through the resolve to combat climate change, (4) the supply chain bottlenecks from China, and (5) the shortage of labour arising from lifestyle changes in response to the pandemic. The absence of any policy to address these supply-side distortions in the market combined with the rises in interest rates represents a recipe that could create the conditions for stagflation, i.e., stagnant growth

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combined with rampant inflation. The path away from this outcome must be navigated carefully. The point is that even if demand is strong, the failure to address the supply-side issues contaminates the demand-side within the quest to bring demand and supply into equilibrium at a place that creates a healthy economic outcome.

The Economic Evolution from the 2000s to the Present Day

The received wisdom in the 2000s among the economist elite was that through globalisation lower prices were assured through the organisation of supply from low-cost countries in relation to the world's food supplies, pharmaceuticals, component parts, etc. and that there was ample supply of oil and gas available to the Western world – problem solved! However, the realization slowly dawned among the Western nations that supply chains should not be entrusted to non-democratic nations that were not natural geopolitical allies of the West, coming to a head in 2020 with the Covid-19 pandemic emanating from China and in 2022 with the war in Ukraine arising from the unprovoked aggression from Russia. The process of deglobalisation had begun, though, prior to the pandemic with the trend to organise world economics into regional areas and the UK going to the extreme in this process through Brexit. What has come together at the same present time are two key factors: (1) the response to Covid-19 that has seen a massive increase in the money supply, devaluing the currency and creating excessive liquidity in the market, both of which have caused prices to rise through demand-pull inflation, and, (2) a contraction in the supply of goods and services from previously reliable supply sources with a reduction in productivity both at home and overseas. It is also important to note that the increase in the money supply in 2020/2021 has landed directly into people's bank accounts, unlike the quantitative easing in response to the 2008 financial crisis when the newly created money went to store up the banks' balance sheets and stayed there with minimal recycling into the economy as a whole.

The Search for a Solution for the Present Day

How, then, can inflation be combated in 2022? Is it the case that there are only two alternatives: either for the government to allow the economy to drift into recession and use that brutal technique to eliminate inflation out of the economic system, or for the government to reduce taxes with a view to keeping the economy operating while the issue of productivity is properly addressed, and responsibility and efficiency are re-introduced into the economic system? The approach of reducing taxes was taken by President Ronald Reagan in the USA in the 1980s while, at the same time, Prime Minister Margaret Thatcher pursued a similar strategy in the UK. Such an approach recognises

that inflation is a symptom of a deeper malaise relating to productivity, and that to appeal to the motivational and incentive instincts of the human condition is the basis for navigating a path to recovery. For the UK, the approach of reducing taxes, combined with the introduction of incentive, finds its natural ally in employee share schemes, working with its natural sister policies of profit-sharing, training and development, devolved decision-taking and a strong emphasis on purposeful goal setting.

The Unique Features and Characteristics of Stocks and Shares

An employee share scheme links employee incentive to the growth in the share price, a concept that is predicated on the properties, features and characteristics that are embodied in a share, fundamentally the capacity in a market economy to capture value that is generated as a result of genuine human endeavour and purpose. The testimony of economic history is that the shares of a company whose underlying foundations are strong will ultimately rise in value and deliver gains. How short-sighted it is, therefore, to take the view that cash holdings subject to, say, a permanent 9% inflation erosion represent a hedge against, say, a temporary 20% reduction in share values! Volatility at varying degrees of severity is part of the behaviour of how stocks and shares work when tossed around on stormy seas but if the ship is built of sturdy material, then it will in time once again find a safe harbour laden with new gains for those who put their faith in its mission. The way to hedge, therefore, is the other way round, i.e., a carefully chosen portfolio of stocks and shares is a hedge longer-term against how the vicissitudes of inflation seek to attack cash reserves by inflicting permanent damage on cash values. Remember that confidence in the stocks and shares of your choice is a good reason for staying in the market and indeed, also benefiting from new share investment through the wonders of pound cost averaging. Stocks and shares are like people who grow as human beings when subject to the trials and tribulations of life and, ultimately, are better people for the experience.

The Blueprint for the Path to Recovery for the UK Economy

The path to recovery is first to recognise that inflation is the most aggressive symptom of the deeper underlying malaise of deficiencies in productivity. The credible and meaningful approach to recovery that is consistent with how the human spirit works is to combine: (1) lowering taxes with the effect of increasing private investment and releasing the growth potential in the economy, and (2) increasing wages but only in line with productivity, i.e., pay rises and business rewards only after productivity has been achieved and not before. In the execution of the latter, employee share schemes make their unique contribution. This approach represents a firm alternative to the approach currently being pursued by the US Government which has embraced increased spending and higher taxation as, surprisingly, the solution to inflation! The present US Government does not appear to have learnt the lessons of the 1970s that it is not possible to spend your way out of inflation or to high tax an economy into growth. Such an approach denies to the naturally creative human spirit the liberty that is required to maximize the benefits of human endeavour acting individually, as a business team and as a vibrant and growing nation.

The Unique Contribution of Employee Share Schemes on Productivity/Pay/Prices

The unique contribution of employee share schemes is in facilitating business reward through matching wages with productivity, and rewarding productivity once it has been achieved, after the evidence of the achievement, not before. Surely, that is consistent with best business practice, the equivalent of a trader invoicing once the job has been completed or invoicing on a step basis as the project work develops. In business terms, paying before the job has been done does not make any sense at all! The point is this: (1) once paid, wages create the demand in the economy while (2) the productivity creates the supply, and the matching occurs. The principle has to be applied first at the microeconomic level of individual companies, then extrapolated at the macroeconomic level to the economy as a whole, and in that context, employee share schemes assume a role in the management of national economies. With the wage reward as the incentive, augmented by the employee share scheme rewards, truly "The Wages of Capital" as envisaged by Louis Kelso, historically the foremost contributor to employee share scheme economics, the reward is extended for the employees to include dividends as profit share and capital gains. Furthermore, through that mechanism, the employees receive their true worth from the business. Kelso had always predicated his work on the premise that capital values rise faster than wages and, that capital values, in practice, require a fusion with the labour factor of production to truly flourish. Also, by fostering good and improved industrial relations, productivity improves, the employees enter into a deeper understanding of how businesses work through their employee share scheme involvement and, most importantly, they reap rewards – "The Wages of Capital" – to pay for goods and services at prices that are commensurate with their productivity and pay outcomes.

The Unique Contribution of Employee Share Schemes to Self-Sufficiency and Self-Regulation

The renewed capacity for efficient productivity in turn enhances the capacity for self-sufficiency for companies and for national economies, which is best achieved by the decentralisation of economic activity, lessening dependence on overseas economies, bringing the supply chains home, working with a tight labour market to enhance employment levels, and keeping wage levels buoyant but always in line with productivity. The traditional remedy for inflation is to reduce growth, but growth is at "a slow low" at the present time so how can slowing growth constitute a remedy? And in any economic circumstances, it is a negative debunked economic philosophy anyway. There is a better way but only if it is recognised that the key matter that needs to be addressed is productivity and its relationship with pay and prices. Inflation is a symptom and not the underlying cause of the economic predicament. The work of Professor Martin Weitzman, author of "The Share Economy", demonstrated that the operation of the self-regulatory mechanism of variable employee rewards through employee share ownership, potentially combined with cash profit-sharing, mitigates against fluctuating company wage bill levels over a given business cycle.

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The effect is to avoid the need for the government to introduce heavy stimulus through fiscal and monetary measures to recover from a trough recession, thereby curtailing inflationary pressures in the economy that would otherwise arise through either a cost-push and/or a demand-pull impact on prices.

The Employee Share Scheme Opportunities in the UK

UK companies have a galaxy of employee share schemes from which to choose, often including significant tax reliefs, i.e., discretionary share option schemes or all-employee share option schemes, share gifting schemes, share purchase schemes, growth share schemes, deferred share schemes, restricted share schemes, employee share trusts and employee ownership trusts. It is so important that this fine array continues to be on offer to allow companies to bespoke their share scheme arrangements to meet their own business commercial requirements and benefit from their capacity through employee motivation and incentive to improve productivity and enhance company profit margins.

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