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You're getting a 2.9% raise next year

How to make the most of (even slightly) larger paychecks

By Jonnelle Marte

There are roughly three stages to getting a raise: 1. Joy: "More money for me." 2. Disappointment: "After taxes and divided over 26 pay periods, it's really not that much more money for me." And finally, 3. Amnesia: "Where did the extra money go?"

Though it's easy to squander a few extra dollars, even a modest raise can be put to good use, advisers say.

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A study by PayScale, a provider of compensation data and software, found that 57% of companies surveyed gave raises to the majority of their workforce in 2012, up from 35% in 2011. And that number is expected to grow, with some 85% of companies planning to give employees raises this year, says Katie Bardaro, a lead economist for PayScale.

Raises are making a comeback as companies look for ways to retain and engage employees. "When you do a good job, you expect to be rewarded for it," says Margaret-Ann Cole, a consulting practice leader for Right Management, a talent and outplacement firm headquartered in Milwaukee.

But for many workers, the increases will be mild: The average rise in base pay is expected to be 2.9% in 2014, up slightly from the average 2.7% raise seen in both 2012 and 2011, according to a survey by human resources consulting firm Mercer. Performance-based increases often tend to be more generous, with the average raise for top performers being closer to 5%, compared with 2.6% for average performers and 0.2% for the lowest performers, according to Mercer.

So short of going on a spending spree, what should you do after getting a raise? Advisers suggest several steps employees can take to get the most out of a raise without socking all the cash away for a rainy day. Workers who adjust their savings, charitable contributions and spending as soon as they get a raise can get closer to meeting their financial goals, and won't feel much of the pinch, advisers say. Here is a look at some recommended strategies.

Boost retirement savings.

With the arrival of a bigger paycheck, some people may be more tempted to splurge than to save, but a new study shows that even minor increases to savings rates can lead to notable differences when retirement rolls around. Boosting monthly retirement savings by just 1%, or roughly $50 a month for a 35-year-old making $60,000, could lead to an additional $270 in monthly income in retirement, according to a Fidelity study released last month. (The study assumes a 7% rate of return and a retirement age of 67.) That means that even a person getting a mild 3% raise could increase their retirement savings in a meaningful way while still having some extra spending money, says Jeanne Thompson, vice president of thought leadership for Fidelity. Most changes to contribution rates for retirement accounts tend to be incremental: One in five employees increased their allocation rates over the past year, by an average of 3.5%, she says. Of course, someone getting a larger raise can bump up their savings rate more dramatically, says Thompson, who recommends workers save close to 10% of their income in their twenties and 15% of their earnings in their thirties.

Give to charity.

Workers who feel they're better off after a raise may also want to share their newfound wealth. This could be a good time to set up an automatic, monthly contribution to a charity of one's choice, says Michael Chadwick, a certified financial planner based in Unionville, Conn. "If you do it simultaneously, you won't feel it at all," he says. Chadwick recommends people typically split their pay increases into three purposes: savings, charity and spending. Since charitable contributions are also tax deductible, making bigger donations after a raise could also lead to a smaller tax bill at the end of the year, says Chadwick, who recommends people generally donate no more than 10% of their annual income. But Chadwick cautions that most workers should consider increasing their charitable donations only if they have enough cash set aside for emergencies and feel confident about their savings for retirement and other important causes. "I tell people to do that after they've got their own financial situation in order," he says.

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Increase FSA contributions.

Many companies tend to issue raises shortly before starting their open enrollment periods for health insurance and other employee benefits, says Chadwick, making it a good time for workers to re-evaluate their benefits. Some employees who are expecting health care expenses to grow may want to funnel some of their raise into health-related accounts, such as a flexible spending account, which lets workers stash away pre-tax dollars for qualified medical expenses, or a health savings account, a tax-exempt account typically available for people who have high-deductible health plans. (The funds in an FSA must be used up each year while HSAs can be carried over from year to year.)

Treat yourself.

Companies often use merit pay increases as a way to improve employee retention, compensation experts say. So workers who receive them and have most of their main financial goals in order should feel okay spending a portion of their fatter checks, advisers say. Some of the cash can go toward a larger purchase a person may have been planning for, like a new car or home appliance. But workers should be careful not to overextend their spending by reaching for high end goods that could lead them to become overwhelmed by with larger monthly bills. "Being a good shopper is just as important as, if not more important than, earning a bigger income," says Chadwick.

Plan for Uncle Sam.

Some workers seeing a surge in income (imagine a young doctor who goes from earning $50,000 as a medical resident to a six figure salary as a practicing physician) may feel like they're sharing the raise with the tax man if they get pushed into a much higher tax bracket. It could be a good time to start making pre-tax contributions to a tax-deferred retirement account like a 401(k) or an IRA instead of putting post-tax income into a Roth IRA, says Montanaro. Some workers may find they now make too much to qualify for certain deductions and credits and may be better off using other strategies to lower their tax bills, by investing in tax-exempt municipal bonds or making charitable contributions. "Don't forget that Uncle Sam is standing on the sideline with his hand out," says Joseph Montanaro, a financial adviser with USAA in San Antonio.

Fund your future.

Even a significant raise can feel like a wash for those who don't take a moment to think about how the added income can move them closer to meeting some of their goals. "Clearly a big promotion represents a watershed event in someone's career," says Montanaro. "The key is to make it into a financial watershed and not solely an opportunity for more quality of life." One way to "capture" the money early is to set up automatic deposits to an emergency savings account or college savings fund, he says. For some families, that might mean taking the opportunity to open up a college savings fund or finally making the down payment for a new home. (And that should be after any credit card debt or student loans are taken care of — a move that could also increase a worker's cash flow by reducing interest charges and eliminating some monthly bills, he says.)

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