Why the Directive on Adequate Minimum Wages is the right approach in a time of inflation

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A frequent argument made by employers and other opponents of the Directive on Adequate Minimum Wages is that wage increases and in particular substantial minimum wage hikes are a key driver of inflation and bad for the economic recovery. It is, therefore, so the argument goes, the wrong time to adopt the minimum wage directive whose explicit objective is to ensure the adequacy of minimum wages and to strengthen collective bargaining. The aim of this briefing note is to show the exact opposite: the Directive on Adequate Minimum Wages is the exact right tool at the exact right time to ensure a socially adequate economic recovery.
In order to do so, this briefing note will proceed in three steps. It will, firstly, show that in 2021 wages were not the main driver of inflation. It will, secondly, show that the effect of minimum wage hikes on inflation is negligible. And it will, thirdly, illustrate that minimum wage increases and strong collective bargaining should be essential parts of the economic recovery.

1) Why wages did not drive inflation

The current high inflation is mainly caused by temporary one-off factors whose influence will either ease during 2022 or which will not be part of the year-on-year calculation of inflation at all. These factors include:

a) Base effects

To some extent the high inflation is the result of statistical effects. Inflation is usually calculated on a year-on-year comparison; i.e. prices on 2021 are compared with prices on 2020. The high inflation in 2021 is therefore also the result of the pandemic-induced extraordinary low inflation in the EU of only 0.7% in 2020. If one includes 2019 in the comparison, the two-year average inflation is below 2% which according to the ECB is the value needed to keep prices under control while at the same time avoiding deflationary pressures.

b) Production and delivery bottlenecks

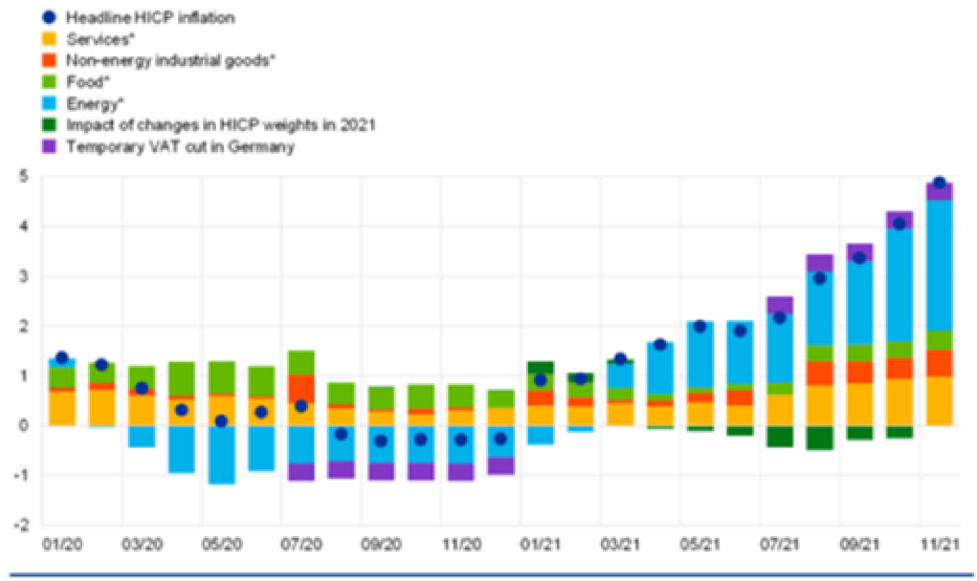
Another explanation for the temporary increase in inflation is the simultaneous effect of increased demand due to the re-opening of the economy and supply shortages which increased prices. The showcase example for this dynamic is the electronics industry in which the production of important components such as semi-conductors from Asia is still disrupted by flaring Corona outbreaks, while at the same time demand has risen significantly compared to pre-crisis levels. The demand for electronic devices for home office, home-schooling and private use continues unabated, and the pandemic-induced acceleration of structural change towards automation and smart technology, as well as electric vehicles has increased the demand for electronic components and certain raw materials significantly. Further delivery bottlenecks resulted from disruptions of the handling of goods in ports. While there is the general expectation that these bottlenecks will ease over time, they may persist into the second half of 2022.

c) Developments in energy prices

The large increase in energy prices - especially for oil, gas and electricity – account for approximately half of overall inflation. Thus, the so-called 'core inflation' in the EU, which excludes extremely volatile elements such as energy, alcohol, food and tobacco, stood at 2.4% in October 2021 compared to headline inflation at 5.0%. The increase of energy prices is partly also due to strong base effects, because energy prices in 2020 were extraordinarily low due to the price slump in crude oil. This base effect will not be part of the inflation calculation in 2022. However, because oil prices are expected to remain above the pre-crisis level, government intervention to protect consumers and businesses from high energy prices through measures such as emergency income support for energy-poor consumers are an essential element in mediating the long-term impact of increasing energy prices.

Overall, Figure 1 illustrates that the current increase of inflation can primarily be attributed to pandemic-related temporary factors and will therefore slowly return to normal levels around the ECB target inflation.

Figure 1: Headline inflation and its components (annual percentage changes, percentage point contributions)



Sources: Eurostat, ECB staff calculations and the Narrow Inflation Projection Exercise.
Notes: Components highlighted with * exclude both the impact of the changes in HICP weights in 2021 and the temporary reduction in VAT in Germany in 2020. The impact of the changes in HICP weights is estimated by the ECB and the impact in November may change depending on Eurostat's full release for that month. The latest observations are for November 2021 (flash estimates).

d) Wages did NOT drive inflation

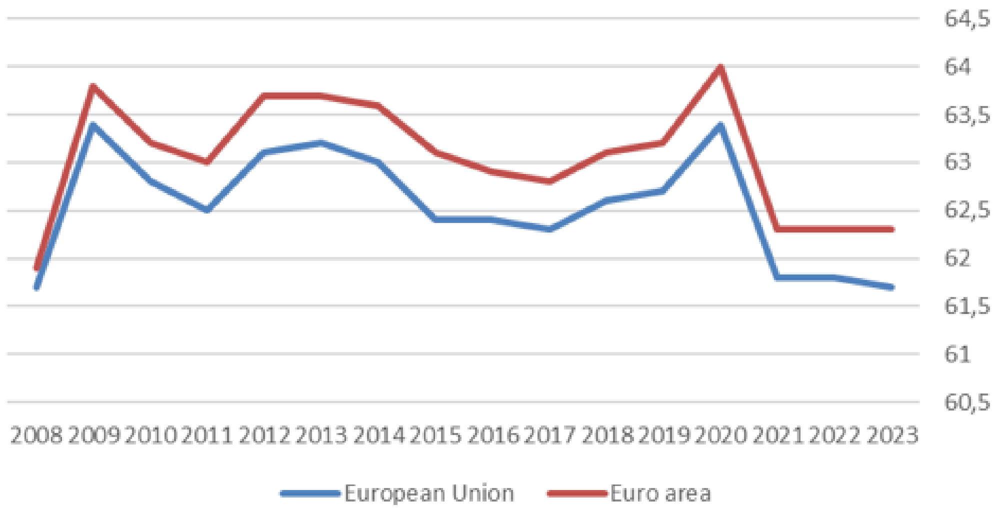
Figure 2 illustrating the development of negotiated wages shows that in 2020 and in the first three quarters of 2021 negotiated wages stayed persistently below the ECB target inflation of 2%. Data on negotiated wages provide a more accurate picture of underlying wage developments during the pandemic because they are not influenced by developments in the hours worked and policy measures. In particular the former plays an important role because the frequent use of job retention schemes during the pandemic distorts the wage data. This is because employees as a rule only receive a part of their original wage for the time not worked while being enrolled in the job retention scheme. This, however, means that the frequent use of job retention schemes tends to lower nominal compensation per employee. In any case, the data provided by the ECB illustrates that in the light of the moderate increase of negotiated wages there is no danger of inflationary pressures through a so-called 'wage-price spiral'.

Figure 2: Development of negotiated wages (Euro area)

Source: European Central Bank
(https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=132.STS.Q.I8.N.INWR.000000.3.ANR)

As a matter of fact, **Figure 3** illustrating the development of the wage share – measured as the share of national income accounted for by labour compensation in the form of wages, salaries and other benefits – demonstrates that wage earners have been the losers of the pandemic. Because the wage share depends on GDP developments which dropped in 2020, the wage share actually increased during the crisis in 2020. However, during the recovery in 2021 the wage share fell even below pre-pandemic levels and, according to forecasts, it is not expected to increase in 2022 and 2023. On the contrary, because its level is expected to stay below the pre-pandemic level, the forecast actually supports demands for stronger wage increases and measures that support this objective like the Directive on Adequate Minimum Wages that aims at adequate minimum wages and the strengthening of collective bargaining.

Figure 3: Development of wage share



2) Why minimum wage hikes do not drive inflation

Even if opponents of the Directive on Adequate Minimum Wages accept that wages are not a driver of the current surge of inflation, another common argument is that the minimum wage increases following the adoption of the directive will certainly drive inflation. This assertion is not borne out by recent research. An analysis of the impact of minimum wage increases on inflation in the USA found that a 10% minimum wage increase leads to an increase in inflation of 0.36%. This result is confirmed by a recent analysis of the situation in Germany estimating the inflationary impact of the increase of the minimum wage to €12 as announced by the new government. The study found that the 15% increase of the minimum wage would increase inflation by approximately 0.25%. To put this into perspective: The reversal of the Covid-induced VAT reduction in July 2020 for the second half of 2020 accounted for approximately 1% of inflation in 2021 on a year-to-year basis. The impact of minimum wage increases on inflation is not only negligible but also temporary in nature because the increases in prices are concentrated in the months following the minimum wage increase and ease off over time.

The limited impact of minimum wage increases on inflation can be explained by two main factors:

First, the impact of minimum wages on inflation depends on whether employers pass-through the minimum wage increase to prices. Research as shown that in many cases employers find different ways to deal with minimum wage increases. They accept a lower profit margin and decrease dividend and bonus payments (global dividends increased by more than 15% in 2021 and are expected to grow again by 5% in 2022), they compress the wage structure which means that they compensate the increase at the lower end of the wage scale with more moderate increases for employees higher up the wage scale and, finally, minimum wage increases usually lead to higher productivity which offsets at least parts of the pressure to increase prices.

Second, minimum wage increases mainly affect classical low-wage sectors, primarily in private services. Thus, even if companies see the need to increase prices the impact on the economy as a whole will be limited because any price increases linked to an increase in the minimum wage will be limited to these sectors.

3) Why the Directive on Adequate Minimum Wages is the right tool also in a time of inflation

Rather than arguing that the adoption of the Directive on Adequate Minimum Wages will drive inflation, the real impact of the directive is the other way round. An increase in inflation hits low-wage workers much more seriously than employees with higher wages. An increase of minimum wages is therefore important to protect the purchasing power of low wage earners which also has a positive demand effect for the economy as a whole. By the same token, high collective bargaining coverage ensures a higher overall wage level through the wage premium secured by collective agreements. Recent research by the ETUI found that if the current average coverage rate in the EU of around 60% returned to the level of more than 70% at which it was in 2002, the pay premium would be more than 3% higher than it currently is.

Adequate minimum wages and strong collective bargaining are the most effective shields against the negative impact of inflation to ensure that in particular low-wage earners can still afford essential items. In doing so, an adequate minimum wage and strong collective bargaining also contribute to fighting the various forms of wage inequality which increased during the pandemic. By ensuring an adequate minimum wage and strong collective bargaining the Directive, should contribute to increasing the wage share and, thus, to ensuring that those workers who kept the economies and societies going through the pandemic receive their fair share of productivity increases during the demand-driven recovery.

Another macro-economic consequence of the Directive on Adequate Minimum Wages is its positive effect on state finances – in two respects. First, it puts an end to a business model that relies on paying inadequate and unfair wages which shifts the responsibility of ensuring that a worker can make a living to the state which has to top up salaries through tax credits or in-work benefits. Companies pursuing such a business model externalize the costs of paying inadequate wages to the state and the society as whole and put a further strain on public budgets – in particular during an economic crisis. Second, by boosting domestic demand fair minimum wages and strong collective bargaining furthermore help the state to generate more revenue through increased taxes and higher social security contributions. Thus, the state budget benefits not only by reducing expenditure but also by increasing revenue.

It is important not to repeat the mistakes of the management of the crisis in 2008-2009 when austerity, internal devaluation, the freezing or even cutting of minimum wages and the dismantling of collective bargaining systems prolonged the crisis with sometimes dramatic social consequences. It should have become clear that in addition to all the moral reasons, there are compelling macro-economic reasons why the Directive on Adequate Minimum Wages is an important element of a paradigm shift in managing the current crisis. It, therefore, is the right tool at the right time to fend off the negative consequences of inflation and to ensure a socially adequate economic recovery.