IFO VIEWPOINTS

August 9, 2022

°239

The Government Should Stay out of Wage Policy — Supply-Side Reforms Make More Sense in the Fight against Inflation

How can inflation be contained in Germany? Wages are currently playing a major role in this discussion. Trade unions point out that the current inflation rate of more than 8 percent is reducing employees' real incomes. Accordingly, IG Metall is calling for an 8 percent wage increase in the upcoming round of collective bargaining. Critics warn that wage agreements at this level could lead to a wage-price spiral and make inflation even worse.

In this situation, calls for the "concerted action" get louder last seen in the 1960s and 1970s. This refers to nationwide negotiations between the collective bargaining parties and politicians to prevent wage increases that are harmful to the economy as a whole. An initial meeting has already taken place at the invitation of Chancellor Olaf Scholz (SPD). This approach may sound good, but in the current situation it has little chance of success.

At its core, collective bargaining is about how a company's earnings are divided between employees and company owners. Unions want high wages, but also have an interest in not endangering the jobs of their members. Therefore, they should take care not to overreach regarding their demands.

Collective Wage Agreements Have Far-Reaching Consequences

Employers, on the other hand, want to reduce wage costs in order to increase their profits – but they know that if wages are too low, employee turnover ll increase, and productive workers in particular will quit or not even take the job in the first place. Therefore, when it comes to wage development, it's in employers' own interest to ensure that employees feel they are being treated fairly. Given this background, there is much to be said for collective bargaining autonomy and against government attempts to influence collective bargaining.

However, the collective bargaining partners bear a great deal of responsibility: wage agreements have consequences not only for those sitting at the negotiating table, but also for the rest of the economy. In times of weak overall economic demand and low inflation, low wage agreements can weaken purchasing power and exacerbate economic crises. On the other hand, excessively rising wage costs can increase unemployment – and the resulting financing burdens must then be borne by the community of tax and contribution payers. Moreover, when inflation is high, rising wages can force monetary policy to intervene with harsh measures – possibly triggering a stabilization recession.

Who Bears the Burden of Current Inflation?

How are wages currently developing in Germany? According to recent surveys by the ifo Institute, HR managers expect wages to increase by an average of 4.7 percent in 2022. In this case, employees would have to accept a significant decline in their real incomes. This lowers overall economic demand – but this is more of an advantage, at least with a view to high inflation.

One could also argue that it is unfair if falling real wages mean that the burden of containing inflation falls solely on employees. But this is true only if inflation arises from companies raising their prices and earning greater profits. If inflation is caused primarily by more expensive energy, raw materials, and other imported goods, the domestic economy is poorer than before. Falling real wages are then accompanied by falling real profits. Given these interrelationships, does it make sense to call for concerted action? Several reasons argue against it.

Concerted Action Will not Reach the Goal

First, employers would have to contribute, too. But agreeing to keep sales prices down is hardly feasible and does not fit in with a competitive economy. Second, it is unclear what the government could contribute in concrete terms. The idea of making one time payments by employers tax-free, for example, is not very effective. This tax relief would initially fuel inflation further. And it is unclear whether one-off payments really lead to more moderate agreements.

Currently, the government can achieve more by focusing on improving the supply conditions in the economy. Starting points are reforms to the tax and transfer system that improve incentives to work more, especially for people with low incomes. If more people are working, the supply of goods increases, and prices fall. Regarding energy policy, longer operating times for nuclear power plants, an accelerated expansion of renewable energies, and the approval of fracking for domestic natural gas production could help lower energy prices.

Conclusion: Even in the high inflation phase of the 1970s, concerted action was not very successful. Things would not be any better today.

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Published under the title "Warum uns eine konzertierte Aktion nicht weiterhilft", WirtschaftsWoche, July 29, 2022