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Inflation and Cost-of-Living Adjustment Clauses

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Inflation and Cost-of-Living Adjustment Clauses

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Inflation has played a major role during the past few years in determining the substance and form of collective bargaining agreements. This **Economic Commentary** *examines the influences of inflation on negotiated settlements, with special emphasis on cost-of-living adjustment clauses.*

Wage-rate increases among unionized employees have generally been larger in the past few years than increases among nonunionized employees. As measured by the Employment Cost Index, for example, wage rates of union workers increased 40.1 percent between September 1975 and December 1979, while nonunion wage rates rose 34.9 percent.[1] Effective wage-rate adjustments in major collective bargaining units averaged 8.1 percent per year during the 1972–1979 period, whereas average hourly earnings in the private nonfarm economy (excluding overtime in manufacturing) rose 7.6 percent per year.[2]

An important component of wage-rate increases for union workers is the portion due to cost-of-living adjustment (COLA) clauses in negotiated agreements. In 1972, about 10 percent of the total effective wage-rate adjustments in major bargaining units resulted from COLAs. During the 1973–1977 period, COLAs contributed from 19 to 25 percent of the effective change. Most recently, COLAs provided about 30 percent of the 1978 adjustments and 34 percent of those in 1979 (see table 1).

COLA clauses are often considered as an insurance policy against unanticipated inflation, but benefits to employees having this inflation insurance are not uniformly distributed throughout the union sector.[3] Settlements in the construction industry, for example, typically do not provide COLAs, whereas those in the automobile industry usually do. In 1979, 9.3 million employees were subject to major bargaining agreements, and about 60 percent had COLA clause protection.[4]

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1. The Employment Cost Index measures changes in straight-time average hourly earnings of most private nonfarm employees. For more details see *BLS Handbook of Methods for Survey and Studies,* U.S. Bureau of Labor Statistics, Bulletin 1910, 1976.

2. Effective adjustments in major collective bargaining units refer to agreements covering 1,000 or more workers. Adjustments are due to current and prior settlements and cost-of-living agreements. Average hourly earnings figures refer to changes in the Hourly Earnings Index from January to January. See *BLS Handbook of Methods for Survey and Study* for information about series construction.

3. While it is possible to design a contract mechanism that lowers wage rates when the price level declines, few—if any—COLA clauses in operation are so designed.

4. In 1979, about 72 million people were employed in the private nonfarm sector of the U.S. economy.

Table 1 Average Percent Change in Effective Wage-Rate Adjustments

	1972	1973	1974	1975	1976	1977	1978	1979
Total effective adjustment[a]	6.6	7.0	9.4	8.7	8.1	8.0	8.2	8.8
Due to:								
Current settlement	1.7	3.0	4.8	2.8	3.2	3.0	2.0	2.8
Prior settlement	4.2	2.6	2.6	3.7	3.2	3.2	3.7	3.0
Escalator provision	0.7	1.3	1.9	2.2	1.6	1.7	2.4	3.0
Escalator provision as a percent of total	10.6	18.6	20.2	25.3	19.8	21.3	29.3	34.1

a. During 1979, 8.9 million workers in major bargaining units actually received wage increases averaging 9.2 percent. Wage adjustments were due to current settlements, deferred increases paid from previously negotiated contracts, or COLA increases. When prorated over the 9.3 million employees under major agreements, the average wage increase put into effect was 8.8 percent.

SOURCE: Bureau of Labor Statistics.

If all unions enjoyed equal bargaining power and their employers faced similar market conditions, some analysts argue, the inclusion of a COLA clause in a negotiated agreement should be irrelevant to the wages of the employees in the long run. These analysts would argue that only the timing of wage increases would differ among employees with and without COLA insurance, as those without COLAs would get large "catch-up" increases in the first year of their new contracts. Comparing the experience of both employee groups, however, indicates that those groups with COLAs fare better, on average, in every year examined (see table 2).

First-year settlements with COLA clauses called for wage-rate adjustments that averaged 8.5 percent from 1973 to 1978 before the clause itself was triggered (see table 2, column 1). When the actual wage-rate adjustments due to the COLAs themselves were combined, the wage-rate adjustments averaged 10.8 percent (column 2). The average inflation rate for the period was 8.1 percent; on average, employees with COLA protection improved their real wages in the first settlement year. Employees without COLAs received first-year settlements averaging 8.2 percent (column 3), about the same as the inflation rate.

The discrepancy between COLA and non-COLA-related wage increases may be due to temporary circumstances in the labor and product markets. It is more likely, however, that some unions enjoy a continuing advantage over other unions in their abilities to negotiate wage increases. Since a COLA clause is basically an inflation-insurance policy, it might best be thought of as a form of fringe benefit. Unions with more leverage in their bargaining situations can procure better fringe benefits.

COLA Limitations

A common misunderstanding about COLAs centers around the degree of inflation protection that they offer. From the information in table 2, it is evident that in a

Table 2 Comparison of Average First-Year Wage-Rate Settlements before and after Escalator Adjustments

Percent changes

Year	Settlements			Consumer Price Index[b]
	With Escalator		First-Year Settlement without Escalator	
	First-Year Settlement	Settlement plus Realized COLA[a]		
1973	5.7	9.9	5.8	8.8
1974	9.5	12.2	10.2	12.2
1975	12.2	12.8	9.1	7.0
1976	8.4	10.8	8.3	4.8
1977	8.0	9.7	7.6	6.8
1978[c]	6.9	9.4	8.0	9.0

a. Four quarters of escalation are included in data.
b. Percent change, December to December.
c. Preliminary figures.

SOURCE: Bureau of Labor Statistics, *Current Wage Developments* (monthly publication).

year with relatively low inflation, such as in 1976, the percentage of total wage-rate adjustments due to COLAs can be larger than the COLA percentage adjustments in a year with a higher inflation rate, such as in 1975. The characteristics of the COLA clauses and the numbers of employees affected are different in these two years, explaining the discrepancy in inflation protection.[5]

In 1979 escalator clauses, or COLAs, increased wage rates an average of 6.7 percent under contracts negotiated in that year or earlier. Since the Consumer Price Index rose by 13.4 percent during 1979, the COLAs "recovered" 50 percent of the inflation rate.[6] During the 1972–1979 period, these recovery rates ranged from 47 percent in 1973 to 73 percent in 1976 (see chart 1 and table 3). The inverse relationship between inflation and recovery rates is apparent from chart 1. The current recovery rate is not much greater than the rate in a similar inflationary period, namely 1974.

5. These characteristics include the type of COLA formula, the timing of the wage-rate adjustments, and possible "caps" (limits) on the size of COLA increases permitted.

6. The Consumer Price Index for Urban Wage and Clerical Workers is used in computing recovery rates.

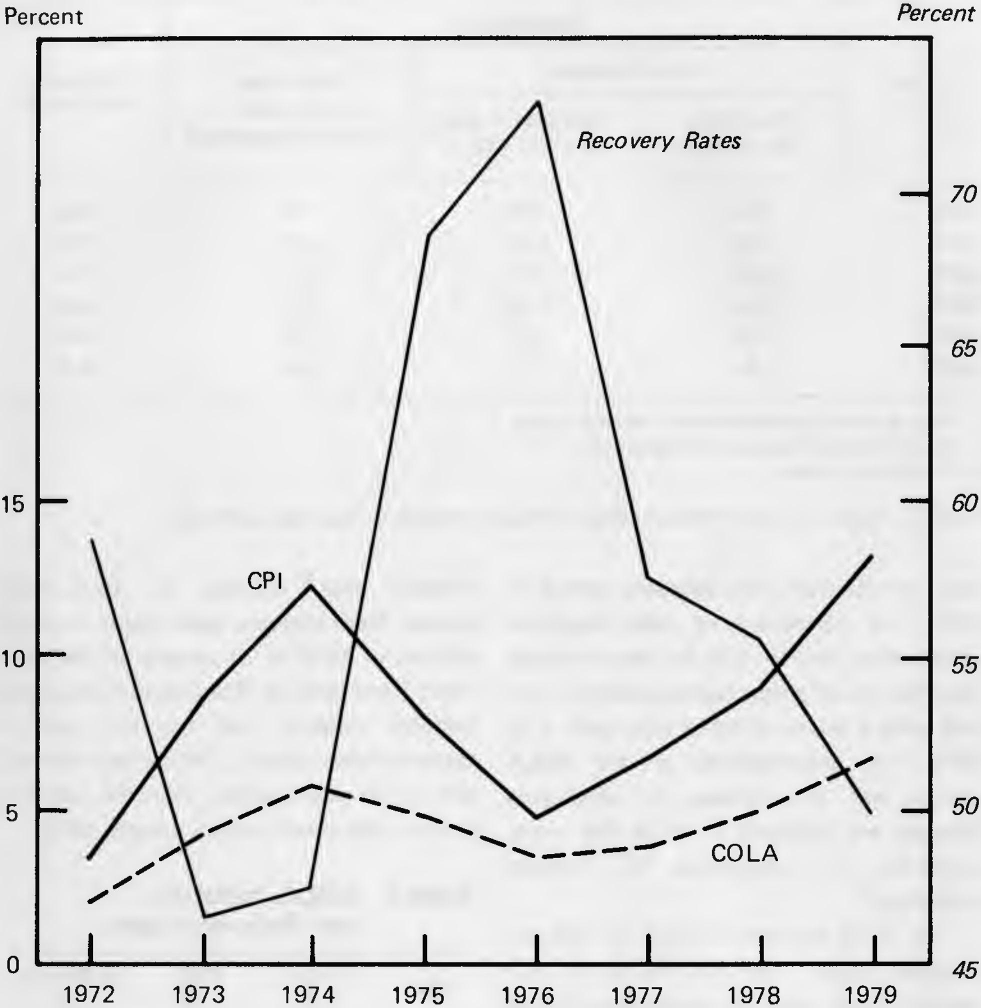
Table 3 COLA, Inflation, and Recovery Rates

Year	COLA, %	CPI, %	Recovery, %
1972	2.0	3.4	58.8
1973	4.1	8.8	46.6
1974	5.8	12.2	47.5
1975	4.8	7.0	68.6
1976	3.5	4.8	72.9
1977	3.9	6.8	57.4
1978	5.0	9.0	55.6
1979[a]	6.7	13.4	50.0

a. Preliminary data.

SOURCE: Bureau of Labor Statistics.

Chart 1 Rates of Inflation, Recovery, and Cost-of-Living Adjustment: 1972–1979



Inflation and the Current Bargaining Climate

With inflation rates high and recovery rates low, it should not be surprising that many unions are interested in improving their COLA clauses. The most common COLA formula calls for a wage-rate increase of one cent per hour for each 0.3 point change in the price index. Under such a formula it may be impossible to prevent erosions in real wages. Suppose that the base wage in an industry were $5.00 per hour and that the price index were equal to 100. If prices rose 9 percent, bringing the price index to 109, the wage rate would have to rise 9 percent, or to $5.45 per hour, to keep pace. The COLA formula would only provide a wage rate of $5.30, however; to attain a rate of $5.45 would require a formula that would boost wages one cent per hour for each 0.2 point change.[7] During 1979 the United Automobile Workers and the United Rubber Workers negotiated "richer" COLA clauses than in the past. This issue should be important to other unions in the next few years.

The guidelines of the President's Council on Wage and Price Stability also encourage unions to adopt and improve their COLA protection. Under the guidelines of 1979, wage-rate adjustments due to COLAs were not counted as part of the settlement after the inflation rate reached 6 percent. This year the trigger point is 7.5 percent. The pay guidelines also encourage larger health-insurance benefit expenditures than otherwise might be the case.[8]

Another important area in which inflation affects bargaining strategy is pensions. Inflation certainly has eroded the purchasing power of pension benefits. Some large unions have pressed for price indexing of these benefits, but to no avail. Recently, the United Automobile Workers settlement provided for part of the regular COLA wage increase to be diverted into pension benefits. During 1980 and 1981, the pension issue will be critical to bargaining in the steel and coal industries. The steelworkers are relatively older than employees in other industries, averaging about 17 years of seniority. As job security continues to be threatened in the steel industry, the real value of pension benefits remains important. In the United Mine Workers union, where job security in the coal industry is also a major issue, retired union members have considerable influence on contract terms. This institutional arrangement ensures that pension benefits will be important in the 1981 coal negotiations.

Conclusion

Persistently high rates of inflation in the 1970s have encouraged a more widespread use of COLA clauses in negotiated settlements. While evidence suggests that those employees enjoying COLA protection received somewhat better wage increases than those who did not have escalator clauses, this importance of COLAs may be overstated. Despite the finding that the group of employees with COLAs experiences larger wage increases than the group without COLAs, all employees without COLAs do not necessarily receive smaller wage hikes. Likewise, many nonunion employees receive greater wage increases than union members. Furthermore, escalator clauses themselves do not guarantee wage increases greater than the rate of inflation.

While unions have learned to cope with inflation, it would be difficult to argue that they have benefited from it. In fact, inflation has probably made contract negotiations more troublesome for union leaders, who always face pressures to deliver both improved wages and pensions.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Federal Reserve System.

7. If the base wage were $10.00 per hour instead of $5.00, a "one-cent-for-0.3" formula yields $10.30, or 3 percent; a "one-cent-for-0.2" formula yields $10.45, or 4.5 percent; a "one-cent-for-0.1" formula yields $10.90, or the desired 9 percent. This example illustrates why formulas must be changed to keep real wage gains from eroding.

8. For more discussion on this point, see Mark S. Sniderman and Roseanne K. Pajka, "Collective Bargaining and Wage Standards in 1979," *Economic Commentary,* Federal Reserve Bank of Cleveland, March 12, 1979.