Automatic Cost of Living Adjustment (COLA)

Description

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Workers' earnings in a firm reflect the contribution of labour to the firm's output (their productivity).

Earnings are expressed in nominal terms (e.g., euros per month), and are shaped by, among other things, the price of the product (affecting the demand for labour), the purchasing power of earnings (affecting the supply of labour), and the other costs of the firm (e.g., the cost of energy used in production).

In a period of financial largesse and when product prices increase proportionally without substantial structural changes in worker productivity (a demand-pull inflation), worker compensation may also increase proportionately. In such circumstances, the institution of COLA facilitates wage adjustment. When the COLA coefficient is 100% (proportional increase in wages equal to the proportional increase in the general price level), the purchasing power of wages is fully guaranteed. However, the 100% coefficient is non-discriminating because it does not allow for a smaller (larger) increase in wages when the firm's product receives a smaller (larger) increase in its price. It is preferable for the automatic coefficient to allow for individual bargaining that reflects the specificities of the market in which a particular firm operates, thus allowing for smaller (or even larger) adjustments to its wages.

In a period where changes in product prices result from an increase in the cost of inputs (e.g., an increase in the price of energy, or problems in supply chains, i.e., a cost-push inflation), the firm in question will be negatively affected. The increase in the cost of production will tend to cause a reduction in output, in the demand for labour, and the firm's profits, additionally tending to increase the price of the product. To the extent that this picture is generally representative, an increase in workers' earnings that fully restores the purchasing power of wages may not be possible. If the COLA coefficient is very high, the general increase in wages will likely cause further problems for the competitiveness and viability of Cypriot firms, the demand for labour, unemployment, the national product, and national welfare. Vicious cycles (prices-wages-prices) may develop, with further adverse consequences.

The serious problems arising from possible difficulties in the supply of factors of production lead some societies to avoid the institution of COLA: they leave the automatic response of wages to inflation to be regulated, *as appropriate on a case-by-case basis*, by the labour market institutions (employers, trade unions, collective agreements), depending on the type of inflation ('demand-pull' or 'cost-push'). In such societies, long-term, collectively bargained, wages continue to reflect their purchasing power and labour productivity. But they also allow for temporary reductions in the purchasing power of wages when these are imposed by the nature of inflation, i.e., when this inflation results from exogenous increases in factor prices, problems in supply chains, wars, etc.

Other societies find the institution of COLA useful. In these cases, the coefficient (strength) of COLA should not be so high as to prevent reductions in real earnings when these are necessary. If this mechanism does not work as and when it should, the measures that will have to be taken at the end of the day to restore economic stability will be more painful.

Which system is preferable? This depends largely on the inflationary environment that is expected. When an economy is open and exposed to exogenous shocks, then it should expect periods of cost inflation and avoid relatively high, immediately triggered, COLA intensity. The resulting flexibility in the labour market will allow it to pursue a more rational long-run economic policy, which will benefit society as a whole. In times of adversity, the state should aim to protect its economically weaker members.

The optimal regulation of COLA also depends on the existing system of industrialrelations. It could be argued that when industrial relations operate consensually and inthe interest of society as a whole, various technically sound arrangements of COLA canlead to similar long-term outcomes.

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