Poland Economics View

What does minimum wage mean for inflation?

- In this note we present estimates of the impact of a higher minimum wage for overall wage growth and inflation in Poland.
- We try to take into account a likely increase in incidence of non-compliance with minimum wage regulation as well as widespread use of 'envelope payments' among small sized companies.
- We estimate that after the 33% increase in minimum wage in 2020 overall wage growth in the enterprise sector could reach 9.6% (versus 6.5% in our baseline scenario).
- Due to higher wage growth we see a risk that the decline in inflation in 2020 and 2021 is less visible and the inflation path is 0.3-0.4% points higher compared to previous estimates.
- We don't expect any change in interest rates, at least for now.

Piotr Kalisz, CFA
+48-22-692-9633
piotr.kalisz@citi.com

Cezary Chrapek
+48-22-692-9421
cezary.chrapek@citi.com

Impact of higher minimum wage

The government's new plan to increase the statutory minimum wage by 33% in 2020 and by a total 77% within four years could potentially be a significant shock for the economy. Given the unprecedented (at least for Polish standards) scale of this change, the economic consequences are difficult to gauge. The exact impact of a higher minimum wage will depend on several factors, including: a) how many employees are affected by the change, b) the extent of non-compliance with the new regulation and c) arrangements regarding remuneration of employees.

Who will be affected?

The share of employees earning a minimum wage has been relatively stable in recent years and hovered around 13%. However, since the planned minimum wage increase is large, the group of workers affected by the regulation will be significantly larger as it will include also those earning at least 33% more than the minimum rate. Based on latest available wage distribution data[1] we estimate that approximately one quarter of all employees in the private sector will be affected in 2020 and more than 30% could be affected by 2023. This also increases the risk that changes in the statutory wage will boost wage demands of workers who fall in relatively narrow brackets between the new minimum and the median. The impact should be disproportionally felt in smaller cities and villages as well as the Eastern part of Poland, where wage levels are significantly lower than in big cities.

Risk of non-compliance

Using wage distribution data it is possible to calculate an approximate impact of the minimum wage on overall wage increases in the private sector. However, the actual impact needs to take into account also potential instances of non-compliance by firms affected by the regulation. The higher the minimum wage the more firms will be tempted to violate minimum wage laws. Empirical research shows the incidence of violations is relatively low in Poland, at least when compared to other EM countries, reaching 4-5% among full–time workers[2]. However, there seems to be a correlation between violation incidence and the minimum-to-average-wage ratio. As the latter is expected to rise in the coming years from ~0.4 towards 0.6, it makes sense to expect that non-compliance will rise as well. Based on relations for CEE economies reported by Goraus and Lewandowski (2016) we assume the share of workers earning below the minimum levels in Poland will rise by half - from 4% to 6%.

All in all, taking into account a potential increase in the number of non-complying firms, we estimate that after the 33% increase in minimum wage in 2020 overall wage growth in the enterprise sector could reach 9.6% (versus 6.5% in our baseline scenario). This implies an approximately 11% multiplier for minimum wage changes, which is comparable with results reported by the IMF[3]. Since the government is planning to continue minimum wage increases after 2020 (by another 33% until 2023), the period of higher wage growth is likely to last longer, and we believe the risks are on the side of more significant increases.

---

[1] The latest wage distribution data are for October 2016. We indexed the income brackets with average wage growth for past three years and used such a corrected distribution for our purpose.

[2] See for example: Goraus, Lewandowski, „Minimum wage violation in Central and Eastern Europe", IBS Working Paper 03/2016.

[3] "Cross Country Report on Minimum Wages", IMF Selected Issues 16/151, June 2016.

Inflation impact

From the point of view of inflation pressures, what matters is not only the reported wage growth but also the actual impact on remuneration of employees. This is where the exact form of remuneration arrangements matters a lot. Studies suggest that a significant share of small sized companies may use ‘envelope payments’ which assumes that employees officially receive the minimum wage while the remaining part of remuneration is paid ‘under the table’ in cash. This means that in the case of a minimum wage increase, the composition of remuneration could change, while the actual income of workers (and wage costs of companies) remains the same. For example in Hungary this was one of the results of minimum wage increases, leading to higher reported wages and tax revenues but had less impact on inflation and competitiveness.

The ‘envelope payment’ phenomenon can affect a large number of firms. Analysis from 2009 showed the share of employees receiving envelope wages in Poland was at 11% (vs. for example 3% in Czech Republic and 23% in Romania). Furthermore employees reporting this fact were receiving approximately half of gross income in ‘envelope payments’[4]. For our calculations we assume that 10% of employees are affected by this practice, all of them at bottom of the income distribution. With this in mind we estimate that after the 2020 minimum wage adjustment the overall increase in gross wages could reach 9% in the private sector.

Strong wage growth, especially among workers with high propensity to spend, is likely to boost consumer demand. Coupled with increased pension and child benefit transfers, this may help maintain real consumption growth around 4% YoY. The extent to which firms will be able to pass higher costs to prices will depend on the sector. We assume firms in the tradeable sector who face external competition will keep prices largely unchanged and will accept lower profits or will try to move towards less labour intensive processes, possibly by investing more. However, in the case of services the price effect may be more visible. Our calculations suggest that a 1% increase in wages usually increases services inflation by around 0.3% points but this estimate covers periods of booms and slowdowns and we expect this time – due to high capacity utilization, narrow margins and low unemployment - the actual impact could be bigger.

With this in mind we think the wage shock after the minimum wage increase in 2020 could increase services prices by around 1 percentage point, which would add 0.3-0.4 to the overall consumer price index. An additional boost would be recorded when the second wave of minimum wage hikes is delivered in 2021-2023.

Our base case without minimum wage hikes assumes the CPI would reach 4% in early 2020 and would decline gradually thereafter, reaching 2.5-3% by the end of that year. Now, with higher wage growth there is a risk the decline in inflation in 2020 will be less visible and the inflation path will be 0.3-0.4% points higher compared to previous estimates. It is possible the CPI will stay above the central bank’s target throughout both 2020-2021, though the exact shape of the CPI path will depend on the timing of the minimum wage increase.

[4] Colin C. Williams, „The Commonality of Envelope Wages in Eastern European Economies”, Eastern European Economics, vol. 47, no. 2, March-April 2009.

Monetary policy implications

These may be challenging times for the Monetary Policy Council. On the one hand, global growth continues to disappoint, and major central banks have already moved towards policy easing. On the other hand, consumption growth in Poland may stay higher than previously expected, while inflation is likely to deviate upwards from previous projections. Based on MPC decisions so far we assume the Council will prefer to stick to its neutral/dovish stance and may downplay potential inflation risks. Therefore we maintain our scenario which assumes stable rates throughout 2019 and 2020. However, the behavior of the MPC in the following years is now much more uncertain and will depend on how exactly inflation evolves.

.

.

Economics Research

Piotr Kalisz, CFA

Chief Economist

+48 (22) 692-9633

piotr.kalisz@citi.com

Cezary Chrapek

Economist

+48 (22) 692-9421

cezary.chrapek@citi.com

Citi Handlowy

Senatorska 16

00-923 Warszawa

Polska

Fax: +48 22-657-76-80