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Why Do Workers Dislike Inflation? Wage Erosion and Conflict Costs

Based on BFI Working Paper No. 2024-117, "Why Do Workers Dislike Inflation? Wage Erosion and Conflict Costs," by Joao Guerreiro, University of California, Los Angeles; Jonathan Hazell, London School of Economics; Chen Lian, University of California, Berkeley; and Christina Patterson, University of Chicago

Why do people hate inflation? Employers do not automatically give workers raises when inflation is high. Instead, workers have to fight for raises, leading to conflict with employers. Accounting for this conflict meaningfully changes the costs of inflation to workers.

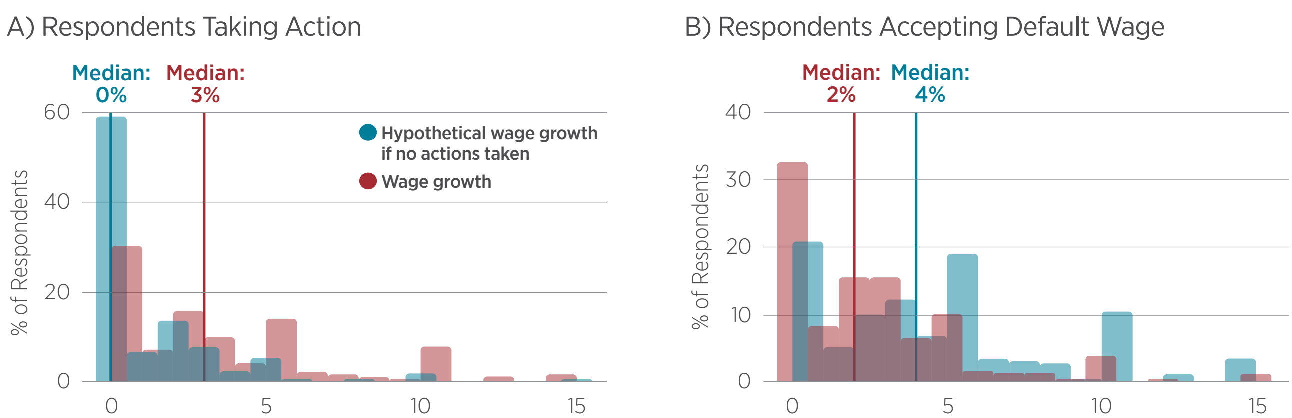
Many believe inflation is one of the worst problems facing the United States. Why? One possibility is that workers hate inflation because it causes prices to rise faster than **nominal wages**, resulting in decreased **real wages**. However, a common theory in economics argues that wages usually keep pace with prices during inflation, minimizing harm to workers.

In this paper, the authors argue that inflation imposes costs on workers beyond its impact on real wages. They show that employers do not automatically give workers raises when inflation is high; instead, workers must fight for raises. The authors create a menu-cost model that incorporates the role of conflict in determining wage growth and find that accounting for conflict costs significantly changes the costs of inflation.

The authors motivate their analysis with the following evidence about the relationship between

> **Nominal wages:** Wages measured in current dollars, without adjusting for inflation.
>
> **Real wages:** Wages adjusted for inflation, reflecting purchasing power.

Figure 1 • The Effectiveness of Conflict



Note: These graphs show the distribution of reported wage growth during 2023 (red) and the hypothetical wage growth respondents reported they would have received if no actions had been taken (left) or if actions had been taken to achieve a higher pay (right). As you can see, workers believe that engaging in conflict increases their wage growth, and true wage growth is also higher for people who engage in conflict.

conflict and inflation, taken from a survey to 3000 US workers at the start of 2024:

- Conflict is important for determining wage growth. A significant portion of workers say they took costly actions—that is, they engaged in conflict—to achieve higher wage growth than their employer offered. These actions include having tough conversations with employers about pay, partaking in union activity, or soliciting outside job offers.
- Conflict leads to higher wages. Participants who took these actions believe their wage growth would have otherwise been 3 percentage points lower. Conversely, those who did not take the costly actions believe conflict would have raised wages by 2 percentage points, suggesting that some workers avoid conflict due to sizable conflict costs that appear to offset the benefit of higher wages.
- Conflict rises with inflation. Respondents say that the costly actions were primarily motivated by wanting wages to keep up with inflation. Additionally, when asked how they would behave at different rates of inflation, respondents were more likely to engage in conflict with employers when inflation was higher. These results are consistent with observational evidence that conflict between workers and firms is more likely when inflation is higher: Between 1964 and 2022, labor market strikes were much more common in countries with higher inflation.

The authors use these results to create a "conflict cost" model to study how conflict affects the **welfare costs** of inflation. In line with survey evidence, workers in the model receive a default wage offer from their employer. Unless the offer is fully indexed to inflation, the worker's offered real wage falls when inflation rises. In response, workers choose whether to engage in conflict with employers. Conflict increases the workers' wages, but is also costly.

In the authors' model, costly conflict is more likely as inflation rises, since workers' real wages fall more and the potential gain from conflict grows. The model shows the following:

- In this setting, real wages do not necessarily reflect worker welfare. While workers may secure higher wages through more frequent conflict, the added costs of conflict can cancel out these gains. Inflation's impact on welfare is instead tied to "wage erosion"—how real wages would be affected if workers weren't adjusting their conflict in response to inflation. Even if real wages don't drop, inflation can still harm welfare because workers must engage in more costly actions to keep up with rising prices.
- The authors combine the model with their survey data to estimate the welfare costs of inflation for workers due to conflict. They find that conflict with employers is costly to workers – the median worker would sacrifice 1.75 percent of their wage to avoid conflict. They also find that workers believe that employers' wage offers are only weakly indexed to inflation. Using their survey results to fine-tune their model, the authors find that conflict costs significantly raise the welfare costs of inflation. Incorporating conflict more than doubles the overall costs of inflation to workers.

Despite hitting a three-year low, inflation remains a key concern among US voters headed into the fall election. This research provides critical new insights into why. The authors show that wages only keep up with inflation because workers are forced to take costly actions—such as demanding raises, unionizing, or soliciting outside job offers—actions that many workers dislike. Even if real wages stay in step with inflation, this research shows that rising prices can still harm workers through conflict costs, significantly amplifying inflation's economic burden.

Welfare costs: Reductions in social welfare caused by economic distortions, such as inflation.

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