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COMMISSION COMMUNICATION TO THE COUNCIL
ON THE PRINCIPLES OF INDEXATION IN THE COMMUNITY

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Commission communication on the
principles of indexation in the Community

1. In its Annual Report on the economic situation, the Commission proposed to the Council that mechanisms for indexing nominal incomes should be "used with sufficient flexibility or limitations to avoid passing on, into wages, unavoidable terms of trade losses, and to allow other necessary adjustments in income distribution or tax structure without causing extra inflation."

The Council adopted this text in its Decision of 15 December 1980.

2. The European Council discussed the question during its meeting at Maastricht on 23 and 24 March 1981. The Presidency concluded as follows: "High and divergent inflation rates are a threat both to the prospects of growth and to the economic and monetary cohesion of the Community. In this context the European Council also discussed the effects caused by rigid systems of indexation of incomes and expressed the opinion that an adjustment of such mechanisms should be considered."

3. Beginning from these discussions and guidelines, the Commission presents below various elements and conclusions aimed at preparing the discussions.

4. Firstly, the analysis should be considered in the light of two general remarks:

- the first concerns the way in which existing indexation mechanisms in various Member States contribute to the settlement of pay issues. This suggests that any changes in these systems should be made only with caution and with a full understanding of its implications. Thus the essential objective should be to adjusted existing mechanisms so as to remedy their main disadvantages.

- the second concerns the fact that in practice, the consequences of an indexation system greatly depend on how the mechanism in question operates: how general it is, the definition and content of the price index used, the degree and frequency of compensation, what categories of prices and incomes are indexed.

5. An automatic or semi-automatic link between the cost of living and wages or other prices or incomes - which exists at present in a number of Member States - may form a serious obstacle to efforts to correct an underlying balance of payments disequilibrium, to improve the production structure of an economy or to measures designed lastingly to reduce inflation. In particular:

- where the economy in question suffers an inflationary shock which has nothing to do with the relative shares of wages and profits - such as a rise in the price of oil - automatic indexation extends the inflationary process and blocks adjustments required by changes in relative prices;

- where the exchange rate is modified to correct an external imbalance, an automatic link gravely hampers the adjustment process and thus tends to keep the economy in its position of imbalance;

- where, for budget policy reasons, the authorities wish to increase taxes or social security contributions (with a short-term effect on prices) automatic indexation pushes up wage costs, at the same time fuelling domestic inflation and damaging competitiveness.

Thus, by making adaptations in cost and price structures more difficult, an automatic link between prices and wages can endanger the viability of existing jobs as well as increase obstacles to the creation of new jobs.

6. Furthermore, indexation mechanisms represent a considerable danger that divergences within the European Monetary System will be prolonged since such mechanisms may help to preserve inflation differentials and distort relative costs. In a country seeking - by the use of budgetary and monetary policy measures - to keep the exchange rate within margins of fluctuation, unlimited indexation also results in purchasing power compensation, thus weakening the ability of economic policy to tackle the necessary adjustments.

7. At present, Belgium, Luxembourg and Italy are the only Member States to have a very developed and rapid system of linking a consumer price index on the one hand to hourly wages (and other prices) on the other. In Denmark, indexation is semi-annual on the basis of a special index which excludes the effects of rises in indirect taxes and the price of energy

products. In the Netherlands indexation is also semi-annual on the basis of a special index which excludes indirect tax increases and gives a reduced weight to medical services. In the other Member States, to the extent that it exists at all, automatic indexation is limited. In France, automatic indexation applies only to the statutory minimum wage (SMIC), but this is principally a low income protection measure; in Germany, indexation is illegal. However, in Greece and Ireland the last collective wage agreements provide for compensation should the rise in consumer prices go above a certain threshold (20% and 10% respectively).

8. In view of the need to improve employment prospects in the Community by strengthening competitiveness, making a flexible adjustment to the new economic situation, substantially slowing down inflation and reducing the extent to which prices and costs diverge, and in view also of the need to reduce budget deficits and balance of payments disequilibria, the Commission suggests that the Council adopt a recommendation relating to indexation practices:

- (i) in the Member States in which the principle of wage indexation is accepted, the basis for indexation should be a price index adapted in such a way as to prevent price increase factors outside corporate control from working through to wage costs; the regulation index ought thus to exclude the impact of any changes in indirect taxes and certain public service prices such as public transport and medical service charges; where the rise in prices is attributable to a deterioration in the terms of trade due, for example, to a rise in important raw material prices or to a depreciation of the currency, the impact of these factors ought to be excluded from indexation;
- (ii) in order to prevent temporary fluctuations in consumer prices from being permanently incorporated into wage costs, giving a further boost to the prices and incomes spiral, wage adjustments should be implemented with a delay and should number no more than two a year;
- (iii) where the inflation rate is appreciably above the Community average and the indexation principle widely applied, the aim should be to limit the degree of indexation to an agreed rate, for example the Community average inflation rate, so that the upward movement of prices and costs is gradually slowed down and exchange rates become more stable.

(iv) a simple and temporary technique for adapting to an inflationary shock could be to forego entirely a certain number of indexation adjustments.

9. These principles should also apply to other types of income such as the fees of the liberal professions and rents, where they are indexed to consumer prices.

10. The recommendation ought to be addressed to the social partners in the Member States concerned so that they can undertake negotiations with a view to making rapid changes in the existing indexation mechanisms.

11. Looking ahead to the institutional phase of the European Monetary System, the Commission considers it vital for the Community to clarify the monetary principles of the European economy. In this regard, the European economy must move towards a system which adopts as its basic objective the defence of the nominal value of money for its use in contracts and transactions and for the denomination of monetary and financial assets.

12. In the light of the discussions which will take place on the basis of this communication, the Commission will present a draft recommendation implementing the principles set out in paragraphs 8 and 9.