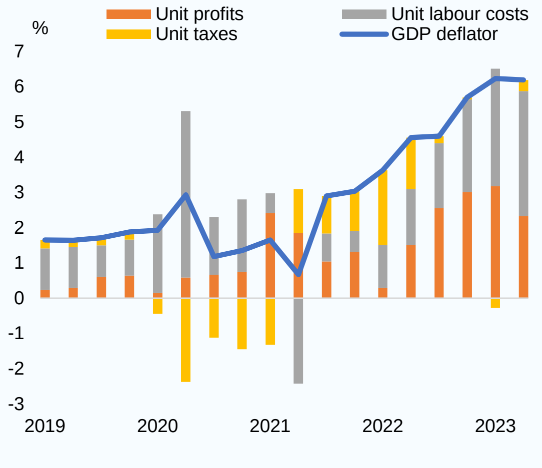
Box 3.1: **The increase in unit profits is a temporary phenomenon reflecting high inflation**

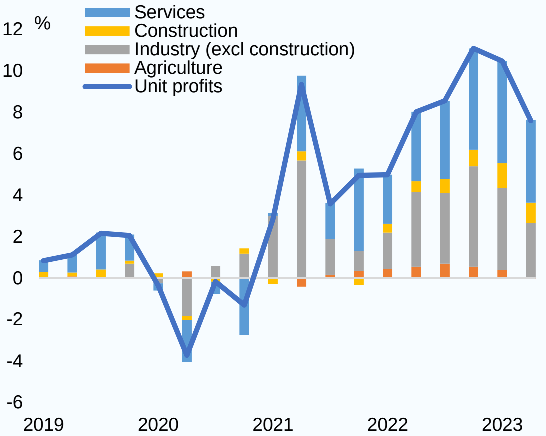
High inflation has put the distribution of value added between profit, compensation of employees and taxes under the spotlight. A number of empirical studies ([1]) have highlighted the increase in unit profits that has accompanied the increase in inflation in 2022. Based on a decomposition of the GDP deflator, unit profits appear to have increased steadily in 2022, growing at a record 9.3% (year-on-year) in Q1 2023 before decreasing slightly in Q2 (**Graph 1a**). ([2]) Unit profits have increased across all euro area countries and sectors, albeit with wide variations. In 2021, the increase in unit profit was led by industry, including manufacturing, energy and utilities, as well as mining, but other sectors, including services, caught up in 2022 (**Graph 1b**). The mirror image of the rise in profit has been a lower share of value added going to labour income. Accordingly, concerns that the rise in inflation may translate into extraordinary profits in some sectors, to the detriment of workers, led some European governments to take policy action. A number of Member States announced windfall taxes on sectors including banks (e.g. Spain and Italy) and food distributors (in Portugal).

Graph 1a: **Decomposition of GDP deflator**



Source: Eurostat and author's calculations.

Graph 1b: **Decomposition of unit profts and sectoral contributions**



Note: Analysis based on sectoral accounts. Unit profit growth is calculated based on sectoral value added (i.e. profits=value added minus compensation of employees).
Source: Eurostat and author's calculations.

A higher inflation does not point to weak competition, nor does a higher level of competition necessarily translate in lower inflation. In fact, in the short run, the relationship between competition and inflation depends on the nature of the shock. An increase in input costs will typically result in higher inflation in more competitive environments, as firms cannot absorb costs inflation through lower margin (OECD, 2022). Second, market power affects the absolute price level rather than the price changes. Still, in a high-cost inflation environment, consumers may have more understanding for a firm increasing its prices and are less likely to punish a firm by switching to a competitor if price increase. Altogether, this suggests that, while increasing competition may reduce prices in the long-term, competition policy cannot be a prominent short-term anti-inflation tool.

Empirical studies confirm that the increase in unit profits mainly reflects the rapid pass-through of higher input cost into selling prices and the comparatively slower adjustment in wages. When input prices rise, and assuming that the ratio between selling price and production costs – the mark-up - remains constant, the nominal profit per unit produced will also increase by the same proportion. Accordingly, the observed increase in unit profits does not necessarily entail higher profit margins. Recent evidence for Belgium and Italy indeed suggests that mark-ups played no role in the recent increase in profits (Colonna et al., 2023). Meanwhile, wages are generally set contractually or renegotiated at fixed intervals and hence adjust more slowly to shocks than prices. The rising contribution of ULC and other wage indicators from 2022 onwards points to a lagged reaction of labour compensation and suggest that the increase in unit profits may be temporary (Graph A). This is consistent with evidence from the US which suggests that higher unit profits could be a by-product of strong demand in markets where firms are price-takers and prices have risen to match demand to limited supply or margins could have increased temporarily in anticipation of future cost increases (Glover et al., 2023).

([1]) See for example E. and E. Hahn (2023) and Hansen et al. (2023).
([2]) Unit labour costs are compensation of employees per unit of real GDP and unit profits are gross operating surplus over real GDP.