What Comes First, the Chicken or the Egg? Minimum Wage and VAT Pass-Through*

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Abstract

The spillover effect of nominal adjustments across wages and prices is fundamental to the conduct of monetary policy. Exploiting two separate shocks in Mexico— a minimum wage increase (MW) and a VAT hike, we implement a difference-in-difference style analysis in a selection model to causally identify the price-wage setting direction. We uncover two main findings. First, increasing wages (MW) affects the extensive margin of price changes, but not the intensive margin. Second, price inflation (VAT) has negligible effects on wage adjustments. Since MW increases are seeing as an anti-poverty policy and VAT remains a key instrument for fiscal policy, this paper shows that detractors overemphasise the inflationary side effects of these policies.

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