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**Research Report**

## European comparison of trends in labour and unit labour costs in 2015: German labour costs in stabilising

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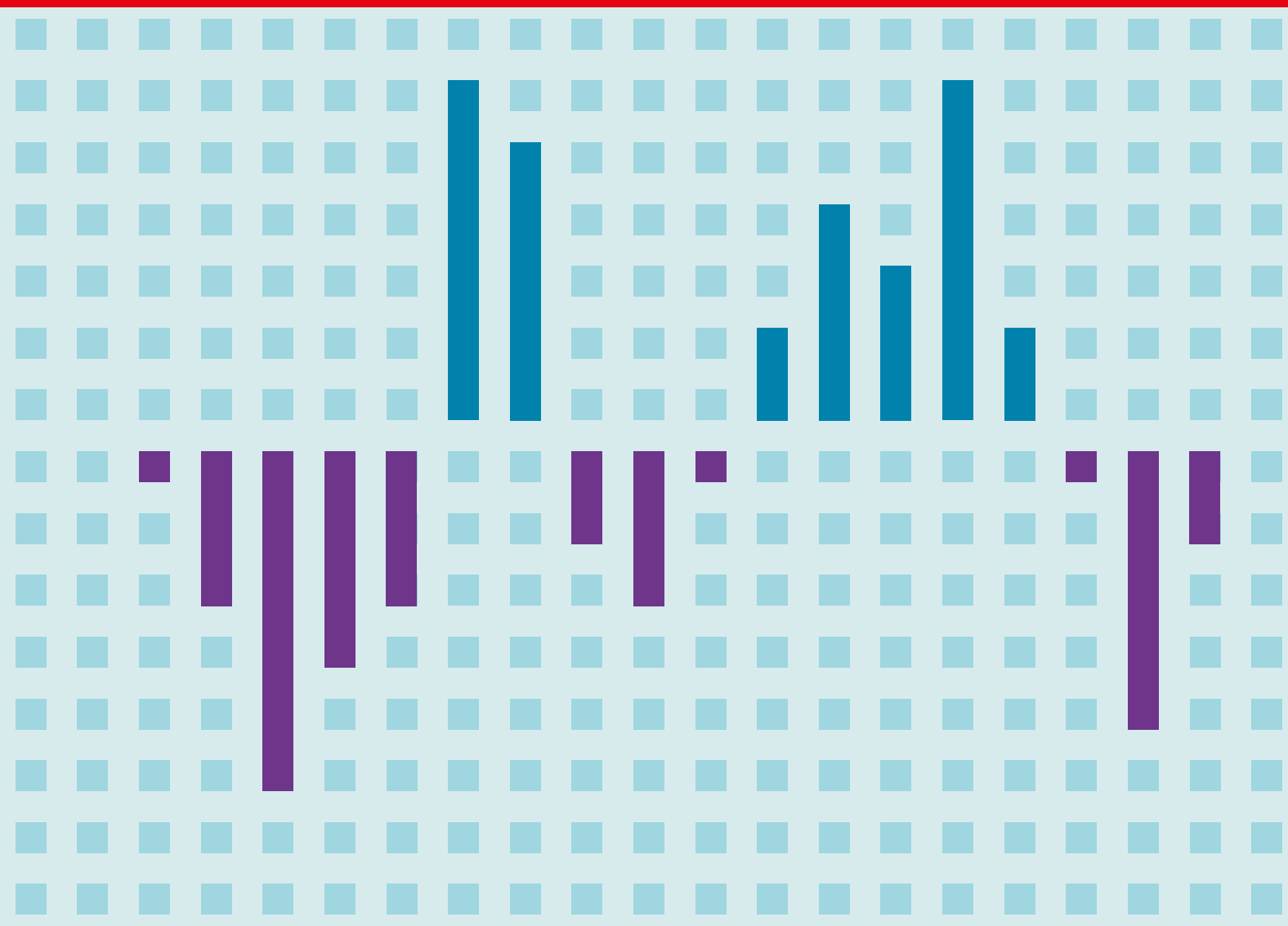
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# POLICY BRIEF

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## EUROPEAN COMPARISON OF TRENDS IN LABOUR AND UNIT LABOUR COSTS IN 2015: GERMAN LABOUR COSTS STABILISING<sup>1</sup>

Alexander Herzog-Stein, Camille Logeay<sup>2</sup>, Ulrike Stein, Rudolf Zwiener

### ABSTRACT

Based on Eurostat data the Macroeconomic Policy Institute (IMK) regularly analyses the development of labour costs and unit labour costs in Europe. This report presents labour cost trends in the private sector, disaggregated for private as well as public services, and in manufacturing industry, for a selection of European countries, the Euro Area and the European Union. A special focus is put on the effects of the statutory minimum wage of € 8.50 per hour, introduced at the beginning of 2015 in Germany, on the increase in labour costs. Subsequently, the report examines the development of unit labor costs in Europe and its impact on price competitiveness.

In 2015 hourly labour cost in the German private sector averaged 32.7 Euros. The German economy is in eighth position in the ranking of EU countries, as in the previous year. With an annual rate of change of 2.7 %, the rise in labour costs in the German private sector was above the European average. In most of the so-called European crisis countries hourly labour costs decreased or stagnated again. Hourly labour costs in German manufacturing and in private services rose at the same rate (2.7 %). Consequently, the percentage difference in labour costs between the two sectors still exceeds 21 %. This is the largest intersectoral wage gap of all the EU countries.

The adjustment process in the European crisis countries continued in 2015. Such that the average rate of change in unit hourly labour cost in the Eurozone of 1.0 % was significantly below the ECB's inflation target of slightly below 2 % per annum. Therefore, the development of unit labour costs in the Euro Area as a whole does not comply with the ECB's inflation target. In Germany unit labour costs rose by 2.0 %. Overall, since the start of the currency union the rate of growth of unit labour costs in Germany has been substantially below the ECB's inflation target. Therefore, wages in Germany should grow at a substantially above average rate for several years to support the adjustment process in the European crisis countries.

<sup>1</sup> See also the in-depth analysis in Herzog-Stein, A. et al. (2016).

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# European comparison of trends in labour and unit labour costs in 2015: German labour costs stabilising

## Development of labour costs in the EU

For more than ten years, the Macroeconomic Policy Institute (IMK) has carried out regular comparisons of German hourly labour costs with those in other European countries (starting with Dütthmann et al. 2006, and most recently Herzog-Stein et al. 2016). The calculations of hourly labour costs are based on the publicly available data in the Eurostat Online Database.

As in previous years, private sector wage and labour costs in Germany were close to the average for Western Europe – at the end of 2015, Germany remained in eighth position among the EU countries. The 2.7 percent nominal increase in German labour costs in 2015 was above both the EU average of 2.2 percent and the very low eurozone average of 1.6 percent. Although it is not possible to identify a clear-cut impact of the statutory minimum wage on labour cost trends for the economy as a whole, positive wage effects can be seen in certain service industries. Despite the slightly higher than average rise, Germany has yet to make up the ground that it has lost over many years in terms of wage, labour cost and unit labour cost increases. This was a contributing factor to Germany once again posting a record current account surplus equivalent to 8.5 percent of GDP.

Throughout the 2000s, private sector labour costs in Germany rose at a rate well below the EU average. Since 2011, however, the trend for Germany seems to have gradually started to return to normal. This labour cost trend reflects the stronger wages growth that has recently played a key role in helping to overcome the prolonged weakness in private demand. The fact that the German economy is achieving good growth rates in a difficult international environment is primarily down to this normalisation. In these times of weak growth in emerging economies, Brexit and ongoing repercussions from the eurozone crisis, Germany would have struggled to stay afloat with its former one-sidedly export-led growth model.

Viewed from a longer-term perspective, however, there is still room for improvement. Between 2000 and 2015, private sector labour costs rose by an average of 2.8 percent a year across the EU as a whole and by 2.5 percent in the eurozone. Over the same period, they grew by an average of just 2.0 percent a year in Germany, the third-lowest figure in the EU after Greece (0.5 percent) and Portugal (1.8 percent), two countries where labour costs

have either stagnated or even fallen at some points in recent years as a result of the economic crisis.

It is currently unclear whether this labour cost realignment will continue this year. It is true that the Federal Statistical Office reported a rise of 3.3 percent for the first quarter of 2016. However, the quarterly figures are affected by key dates on which e.g. collective agreements or legislative changes come into force and past experience has shown them to be prone to major fluctuations within any given year. Closer scrutiny of the quarterly trends for the past 15 years reveals that in every year where labour costs rose by at least three percent during the first quarter, the final average for the year as a whole ended up below this figure. A similar outcome can be expected this year.

## **Unit labour cost development in Germany: 12 percent below the eurozone average (excluding Germany)**

Rather than using labour costs alone, price competitiveness should be assessed on the basis of unit labour costs, i.e. the ratio of labour costs to labour productivity. However, competitiveness will always be a relative concept – ultimately, what matters is how the price competitiveness of one country's economy changes in relation to that of other countries over a given period. Accordingly, this section compares the unit labour cost trend for Germany against several other European countries with which Germany has close trade links.

It is also important to choose the right baseline for analysing changes in price competitiveness. This requires the use of an additional indicator. A country's current account balance or net exports can provide a means of establishing when its international competitiveness position was more or less neutral. 2001 serves as a good starting point for Germany, since in this year it had positive net exports and only a very small negative current account balance of -6.8 billion euros. Since this time, Germany has recorded current account surpluses that have grown almost every year, with the most recent figure reaching 265.2 billion euros when the figure for the entire eurozone was just 377.3 billion.

The Centre for European Policy Studies stresses the huge importance of choosing the right baseline year (Gros 2015, p.19). It argues that 2003 is the year with the least divergence between countries. However, this only holds true if you choose not to treat Ireland as an outlier and also ignore the fact that the eurozone countries' current account surpluses and deficits were at their lowest in 2001, not 2003. Otherwise, according to their own calculations, the best baseline point would be the beginning of 2002 rather than 2003 (Gros 2015, Figure 1). In any case, 2001 remains the most suitable year in terms of providing a neutral baseline for Germany's competitiveness.

Unit labour costs also experienced only modest increases in Germany over the period between 2000 and the first quarter of 2016. Despite once again showing somewhat stronger growth in the last few years, German unit labour costs have risen by significantly less since the start of monetary union than all the other eurozone countries in the study except for Ireland. This slow rate of growth is incompatible with the ECB's inflation target. The latest figure for cumulative growth in German unit labour costs was still fully 12 percent below the average for the eurozone, excluding Germany. This extremely weak growth in German unit labour costs over the course of several years has contributed to the pronounced economic imbalances within the eurozone.

A long-term, "stability-oriented" growth rate, on the other hand, would be in the region of two percent a year, more or less in line with the ECB's target inflation rate. Germany actually achieved this rate in 2015 at a time when the overall rate for the eurozone was extremely low, at just 1.2 percent. However, the longer-term average since 2000 shows an annual increase in German unit labour costs of just one percent. This indicates that Germany still has room for improvement, with much catching up to do in terms of strengthening domestic demand. Germany's exports have more than doubled in real terms since the beginning of 2000, whereas domestic demand grew by just 11 percent or so in real terms over the same period.

## **Labour costs in Germany in 2015: 32.70 euros an hour**

In addition to gross wages, labour costs also include employers' social security contributions, spending on employee training and development and taxes regarded as labour costs. In 2015, an hour's work cost German employers in the private sector (industry and private services) an average of 32.70 euros (see also Table 1 in the appendix). Seven countries have higher labour costs than Germany: in Denmark, Belgium, Sweden, Luxembourg, France, Finland and the Netherlands, the cost of an hour's work ranges from 43 to 33.30 euros. Labour costs in Austria are virtually the same as in Germany (32.60 euros), while the eurozone average is 29.50 euros. Countries where the rate is fractionally below this average include the UK, where the figure for 2015 stood at 29.10 euros, Ireland (28.70) and Italy (27.30). In the other southern European countries, average labour costs ranged from 21.10 euros in Spain to 12.50 euros in Malta. Greece and Portugal, two of the "older" EU members, now have lower labour costs than EU newcomers Slovenia where the average is 15.80 euros an hour. In Estonia, Slovakia, the Czech Republic, Croatia, Poland, Hungary and Latvia, the hourly rates range from 10.80 to 7.50 euros. However, labour costs in these countries enjoyed above-average growth rates of up to 7.4 percent last year, whereas the rate barely went up at all in most of the (former) crisis countries, as well as Belgium and the

Netherlands. Romania and Bulgaria come bottom of the table, with labour costs of 5 and 4.10 euros an hour respectively.

## **The gap between manufacturing and services has not grown since the introduction of the minimum wage**

In 2015, the cost of labour in German manufacturing industry stood at 38 euros an hour. As in 2014, Germany had the fourth highest rate among the EU countries, forming part of a wider group of industrialised nations that sit well above the eurozone average of 32 euros. This group includes Belgium, where the hourly cost of labour in manufacturing industry is 43.30 euros, Denmark (42.40 euros), Sweden (41.10 euros), France (37 euros), Finland (36.80 euros), the Netherlands (34.80 euros) and Austria (35.20 euros). These figures overlook the fact that German manufacturing industry benefits more than any other EU country from cheaper upstream input from the services sector (see next section). Labour costs for manufacturing in Germany rose by 2.7 percent in 2015, compared to an EU average of 2.0 percent and a eurozone average of 1.8 percent.

In 2014, the cost of labour in Germany's private services sector stood at 29.90 euros, once again putting it in ninth place behind the Nordic EU member states, the Benelux countries, France and Austria. Denmark had the highest rate of 43.60 euros, while the averages for the eurozone and the EU as a whole were 28.50 euros and 25.60 euros respectively. Labour costs in Germany's services sector rose by 2.7 percent in 2015, which was above the EU average of 2.2 percent and the eurozone average of 1.5 percent.

The fact that – in contrast to most of the previous years – the increase in Germany's services sector was not lower than the increase in manufacturing industry can be put down to the introduction of the statutory minimum wage. Although it is not possible to identify a clear-cut impact of the minimum wage for the economy as a whole, distinct wage effects can be detected in various service industries where large numbers of people were working for less than 8.50 euros an hour prior to its introduction. It can therefore be concluded that the minimum wage had a positive influence on labour cost trends in the private sector and in particular the services sector in 2015.

## **Upstream input is cheaper for German manufacturing industry**

Notwithstanding the above, the gap between labour costs in manufacturing industry and the services sector remains wider than in any other EU country – at the end of 2015, it stood at more than 21 percent. Industrial enterprises that acquire upstream input from the German

services sector benefit from its relatively low labour costs – manufacturing industry achieves an eight to ten percent labour cost saving in this way, equivalent to approximately 3 euros an hour (Ludwig 2013). While in Germany the services sector reduces the costs for manufacturing industry, the reverse is true in the countries of Central and Eastern Europe in particular.

## **Benefits of a macroeconomically-oriented wage policy and problems with its implementation**

A macroeconomically-oriented wage policy that makes full use of the macroeconomic scope for income redistribution arising from the trend in productivity growth and the ECB's inflation target allows wages to increase in line with economic productivity without damaging the supply side.<sup>1</sup> Moreover, it ensures that employees – and, indirectly, transfer income recipients – also benefit from productivity gains. The increase in productivity thus translates into greater purchasing power which in turn results in stronger demand. As such, it creates a wage policy environment that favours balanced growth. Basing wage increases on productivity growth trends results in a medium-term perspective that prevents them from having a procyclical effect on the economy. Furthermore, using the ECB's target inflation rate as a guide means that wage trends contribute to macroeconomic price stability, since their influence is neither deflationary nor inflationary.

A macroeconomically-oriented wage policy also helps to avert displacement effects with regard to relative competitiveness. It will normally help to prevent situations where prices in one country rise consistently faster or slower than in another country. This would otherwise result in an external imbalance, with wealth accumulating in the country where prices are rising more slowly and debt accumulating in the country where they are rising faster. The eurozone crisis that began in autumn 2009 provided dramatic proof of just how unsustainable such a situation is.

Moreover, in a European context, it is not enough only to use current wage and labour cost trends as a yardstick. Past trends must also be taken into account, for example in order to correct a long-term devaluation and return the real exchange rate to a level consistent with the stability requirements of Europe as a whole.

It has evidently been many years since the price effects of wage trends in Germany – that are an expression of unit labour costs – were on a course compatible with the requirements of a single currency area. Whilst it is true that, since 2011, there have been signs that

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<sup>1</sup> The following observations are based on Horn (2016) and Herzog-Stein and Horn (2016) and the references cited by them.

Germany has returned to a macroeconomically-oriented wage policy, significantly higher wage increases over a period of several years will be necessary if the external imbalance with regard to the other eurozone economies is to be corrected. However, this conclusion raises a key question: is wage policy capable of addressing all these different macroeconomic challenges?

Collective wage agreements are always a negotiated settlement between the trade unions and employers' organisations. Moreover, the wage trend for the economy as a whole is strongly influenced by the current labour market situation. When unemployment is high, the trade unions' bargaining position is weak. In these situations, fiscal policy measures are required in order to prevent internal and external imbalances.

However, there are still structural tendencies within Germany's industrial relations system that hinder a macroeconomically-oriented wage policy. Not all wages in Germany are determined by collective bargaining – indeed, collective bargaining coverage has been falling for several years. In 2015, 58% of all employees in Germany still worked for companies covered by collective agreements and just 48% were covered by a sectoral agreement (Ellguth and Kohaut 2016, Table 4).

Transferring the macroeconomically-oriented wage policy concept to the European level is an altogether more complex challenge. The different national pay bargaining systems are heterogeneous in nature and the European coordination mechanisms are extremely weak. While Germany at least to some extent possesses the institutional framework for macroeconomic wage formation, the national collective pay bargaining systems in the crisis countries have been dismantled on ideological grounds in favour of company-level wage settlements and individual contracts with employees (Schulten and Müller 2013). Under the current circumstances, it would therefore be extremely difficult to introduce a wage formation system that follows common rules.

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## Appendix

**Table 1: Labour costs per hour worked in euros by kind of economic activity in 2015**

	Private sector <sup>1</sup>				Private service sector <sup>2</sup>				Manufacturing <sup>3</sup>			
	LC/ hour	position	% in Euro <sup>4</sup>	% in LCU <sup>4</sup>	LC/ hour	position	% in Euro <sup>4</sup>	% in LCU <sup>4</sup>	LC/ hour	position	% in Euro <sup>4</sup>	% in LCU <sup>4</sup>
Denmark	43.0	1	1.8	1.8	43.6	1	1.6	1.7	42.4	2	1.6	1.7
Belgium	41.2	2	0.1	0.1	40.6	2	0.1	0.1	43.3	1	0.2	0.2
Sweden	40.0	3	-0.3	2.5	39.4	3	-0.5	2.3	41.1	3	-0.1	2.7
Luxembourg	36.0	4	0.4	0.4	39.1	4	0.6	0.6	31.2	9	-0.8	-0.8
France	35.7	5	1.1	1.1	35.6	5	1.1	1.1	37.0	5	1.5	1.5
Finland	33.5	6	1.5	1.5	31.8	7	1.3	1.3	36.8	6	2.1	2.1
Netherlands	33.3	7	0.6	0.6	32.6	6	0.7	0.7	34.8	8	0.5	0.5
Germany	32.7	8	2.7	2.7	29.9	9	2.7	2.7	38.0	4	2.7	2.7
Austria	32.6	9	3.3	3.3	31.2	8	3.7	3.7	35.2	7	2.4	2.4
UK	29.1	10	15.5	3.9	29.0	10	15.4	4.0	28.3	11	14.1	2.8
Ireland	28.7	11	1.0	1.0	27.7	11	1.7	1.7	30.6	10	-1.2	-1.2
Italy	27.3	12	0.0	0.0	27.1	12	0.1	0.1	27.6	12	0.5	0.5
Spain	21.1	13	0.2	0.2	20.3	13	0.6	0.6	22.7	13	-0.5	-0.5
Slovenia	15.8	14	1.4	1.4	16.5	14	2.2	2.2	15.4	14	0.5	0.5
Cyprus	15.5	15	-0.8	-0.8	15.9	15	-0.6	-0.6	12.8	16	-0.9	-0.9
Greece	13.6	16	/	/	13.4	17	/	/	14.3	15	/	/
Portugal	13.0	17	2.8	2.8	14.3	16	2.2	2.2	11.1	17	4.2	4.2
Malta	12.5	18	1.7	1.7	12.9	18	1.2	1.2	/	/	4.0	4.0
Estonia	10.8	19	5.4	5.4	10.9	19	5.2	5.2	10.0	19	6.1	6.1
Slovakia	10.4	20	4.0	4.0	10.5	20	3.3	3.3	10.2	18	4.5	4.5
Czech Republic	10.1	21	4.8	3.8	10.3	21	5.5	4.4	9.8	20	4.4	3.4
Croatia	9.5	22	2.0	1.7	10.2	22	1.7	1.4	8.3	21	2.2	2.0
Poland	8.4	23	3.9	4.0	8.5	23	4.5	4.5	7.7	22	3.8	3.8
Hungary	8.1	24	3.4	3.8	8.3	24	3.3	3.7	7.6	23	3.5	4.0
Latvia	7.5	25	7.4	7.4	7.8	25	7.0	7.0	6.7	24	8.7	8.7
Lithuania	6.9	26	5.5	5.5	7.1	26	5.3	5.3	6.5	25	7.4	7.4
Romania	5.0	27	7.5	7.6	5.4	27	8.0	8.1	4.5	26	8.7	8.7
Bulgaria	4.1	28	7.3	7.3	4.3	28	7.4	7.4	3.4	27	8.3	8.3
EA	29.5		1.6	1.6	28.5		1.5	1.5	32.0		1.8	1.8
EU28	25.6		2.2	2.2	25.6		2.2	2.2	26.2		2.0	2.0

/ = data not available.

<sup>1</sup> Economic activities B to N (NACE Rev. 2); B-F: Industry and construction; G-N: Services of the business economy.

<sup>2</sup> Economic activities G to N; G: Wholesale and retail trade; repair of motor vehicles and motorcycles; H: Transportation and storage; I: Accommodation and food service activities; J: Information and communication; K: Financial and insurance activities; L: Real estate activities; M: Professional, scientific and technical activities; N: Administrative and support service activities.

<sup>3</sup> Economic activity C: Manufacturing.

<sup>4</sup> Rate of change in percent compared to the previous year in euros or local currency, respectively.

Notes: Calculations are based on the labour cost survey 2012. The labour costs of Greece for 2015 are estimated on the basis of the first two quarters.

Sources: Eurostat; Deutsche Bundesbank; IMK calculations (data as of 20.06.2016).

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