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Wage policy today

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International Labour Office

GLU

Wage Policy Today

Hansjörg Herr, Gustav A.Horn

GLOBAL LABOUR UNIVERSITY

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Wage Policy Today

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SUMMARY

Macroeconomically oriented wage policies had largely gone out of fashion. Instead, the prevailing view was that wage setting is just another market process comparable to market processes in goods markets. However, these theoretical approaches ignore some fundamental aspects of wage setting. For example, no account at all is taken of the overall economic dimension of wages. And yet, through its impacts on income and distribution, wage setting has a direct influence on domestic demand and price levels.

Since the launch of European Monetary Union (EMU), a further significant macroeconomic aspect has been added. The abolition of exchange rates has raised the problem of structural trade imbalances as a result of different competitive conditions in the national economies of the individual Member States. Wages are a major factor here. The following paper develops a wage policy concept that takes account of all these elements.

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1. INTRODUCTION

Macroeconomically oriented wage *policy* had largely gone out of fashion - at least up to the onset of the deep recession after the start of the financial crisis in 2007. Instead, the prevailing view was that wage setting is just another market process comparable with market processes in goods' markets. This implies that wage setting should be as competitive and decentralized as possible and should take place in deregulated labour markets. Under these conditions, it is argued that the interaction of supply and demand would automatically lead toan equilibrium wage and full employment. For market-governed wage setting of this kind, trade unions and employers' federations are just as disruptive as are overly strong welfare state safety nets. Seen from this perspective, which has characterized the labour market policies of the past decades, all of these elements lead to unemployment.

So in Germany too, recent decades have been marked by policies opposed to trade unions and to coordinated wage bargaining systems. Other hallmarks have been the dismantling of state transfer payments and the deregulation of labour markets. The massive widening of wage gaps and the creation of precarious employment relationships have been actively promoted.

However, these theoretical approaches ignore some fundamental aspects of wage setting. For example, its macroeconomic dimension is completely overlooked. And yet, through its impact on incomes and costs, wage setting has an influence on domestic demand and prices. Especially through its distributive effects and, more particularly its effect on lower incomes, it has a bearing on domestic demand, due to the high propensity to consume that is associated with lower incomes. Wage developments are also a key factor in the maintenance of price stability. Very high wage settlements can lead to inflationary wage-price spirals, while unduly low settlements can trigger a downward spiral towards deflation. Decentralized wage setting takes no account of either of these dangers. It also ignores the different market positions of employees and enterprises. An unregulated labour market is not a perfect market in which each participant, in principle, has the same amount of power. Especially when they are easily replaceable, job seekers who need to earn an income have little chance of achieving their wage demands through individual negotiation. They usually have to take what they are offered. This too has macroeconomic effects on demand and distribution. Since the launch of European Monetary Union (EMU), a further significant macroeconomic aspect has been added. Exchange rates have been abolished but at the same time, extensive national sovereignty has been maintained, for example by abstaining from a fiscal union and the introduction of Europe-wide transfer systems, and defending national wage bargaining institutions and traditions. This raises the problem of structural trade imbalances resulting from different competitive conditions in the individual Member States. Wages are a major factor here. And this means that, one way or another, there has to be coordination among the very heterogeneous wage setting systems in the

Member States. On the one hand, this must help to prevent and overcome external economic imbalances within the EMU, but on the other, it must not be misused as a pretext for State restrictions on the freedom to set wages.

As of all of this suggests, it is high time we reminded ourselves of the macroeconomic role played by wages. The kind of wage determination process that would be ideal from a macroeconomic, European perspective – one that promotes growth, employment, price stability and external economic stability – cannot be achieved through the conventional market model. It needs additional institutions and mechanisms to ensure that macroeconomic goals are not jeopardized.

2. A SHORT HISTORY OF WAGE POLICY

In the 1950s, responding to the issues raised above, Viktor Agartz (1953), the chief economist of the German trade unions at that time, called for a productivity-oriented wage policy. He dubbed it a "dynamic" wage policy, and it proved very popular with the German trade unions. Nominal wage increases in line with macroeconomic productivity developments are indeed of great importance for overall economic stability. The reason is that productivity increases, which are the source of affluence, bring down nominal unit costs. Falling unit costs lead to price reductions in competitive markets. But in oligopolistic markets too, lower prices may be expected when unit costs decrease. At least, that will be the case if the demand for goods does not exceed their supply at full capacity. Otherwise, firms will have opportunities to avoid cutting prices and even to increase them. Empirically, there is a medium-term connection between trends in nominal unit wage costs and trends in price levels (cf. Ameco 2012). Clearly, firms are generally able to reflect higher costs in their prices – whether those extra costs are oil price rises, value-added tax increases or, indeed, higher unit wage costs. If that is the case, then productivity-oriented wage developments are of great macroeconomic importance. For if nominal wages stay unchanged at a time of rising productivity, the result will be falling price levels. And deflationary developments are just about the worst possible news for positive economic development. Among the world's central banks, even those that are strictest about monetary policy are explicitly opposed to deflationary trends. Not least because, as they cannot set interest rates below zero, they have only limited means of combating deflation. Even if it resorts to unconventional monetary policy measures, such as flooding the markets with liquidity, a central bank will have only very gradual success in this respect. That is why the European Central Bank (ECB) has an inflation target of almost, but not quite, two per cent. So there is also a lower limit to the inflation rate. Deflation increases the debt burden of enterprises, private households and the State. At the same time, investment and consumer demand will hold back in expectation of price decreases. So from a macroeconomic point of view, productivity-oriented wage development, i.e. nominal wage increases in line with productivity development, is absolutely essential in order to protect an economy against deflationary developments.

It should, however, be borne in mind that the statistically measured increase in productivity will show very strong cyclical variations. So allowing pay to be guided by the productivity values prevailing at any given moment would result in procyclical wage developments, thus further strengthening the cyclical swings. To that extent, it would be preferable from the trade unions' point of view that wages should be aligned on the cyclically adjusted productivity trend. The latter would reflect medium-term technical progress, change in skills, and changing natural conditions for production. A productivity-oriented wage development would result in a more stable economic development, and fiscal policy would be relieved of stabilization tasks.

But is productivity-oriented wage development sufficient? To answer that question, we may draw on the arguments of Helmut Meinhold. As a mediator in the metalworking industry, he proposed, in the mid-1960s, that as well as being guided by progress on productivity in the economy as a whole, wage increases should also shadow price increases, and so should be higher than the overall increase in productivity. Meinhold's reasoning is close to that of John Maynard Keynes (1930), who put forward similar arguments in his wrongly disregarded *Treatise on Money.* If price levels rise due to high demand for goods then, Meinhold argues, it is grossly unjust for wages to rise solely in line with progress on productivity. For such cases, he discusses a theoretical upper and lower limit to macroeconomic wage development. The lower limit "below which there should really be no discussion at all" is "the limit formed by the increase in productivity" (Meinhold 1965, p. 16). However, as has been emphasized, this would be unjust, as the entire burden of the price level increase would be borne by labour income. So it would mean a permanent redistribution away from labour income. The upper limit would be reached if "an inflation allowance were added to the productivity-oriented wage increase, and this allowance both incorporated the price increases expected over the coming year and took account of any lag between nominal wages and the average rise in the national product over the previous year, but without factoring in any visible trends that would foster a reduction in the rate of price level increases" (Meinhold 1965, p. 16). However, if this upper limit were attained, wage development would not in any way contribute to reducing inflationary developments. Rather, it would further fuel the inflation process, and this would not be macroeconomically desirable either.

Both Meinhold and Keynes assume a unit labour cost/price level spiral. However, this is typically not driven by wages. Both authors regard excess demand in the goods market as a source of inflation that faces the trade unions with a serious dilemma. If wages stay at the lower limit defined by Meinhold, this will lead to unjustified real wage losses for the workers. But if wages rise in line with the upper limit, the inflation process will escalate. In this latter case, the central bank will sooner or later step in with a restrictive monetary policy to combat the inflationary developments. Wage-earners will then still be paying a high price, in the form of reduced growth and rising unemployment.

Meinhold's line of argument is a very modern one, as an exclusively productivity-oriented wage development would indeed be insufficient. For if nominal wages were, in the medium term, to rise purely in line with macroeconomic productivity, then the increase in unit wage costs, and thus the inflation rate, would in the long run be brought down almost to zero. But an inflation rate of almost zero runs counter to the ECB's inflation target. Moreover, zero inflation must be regarded as highly dangerous. A negative demand shock, a currency revaluation or other influences could, in these circumstances, quickly plunge the economy into deflation. As far as wage development is concerned, this means that it should be guided by medium-term macroeconomic productivity progress plus the target inflation rate. In that case, wages will be perfectly compatible with price stability as defined by the central bank and monetary policy will be relieved of a

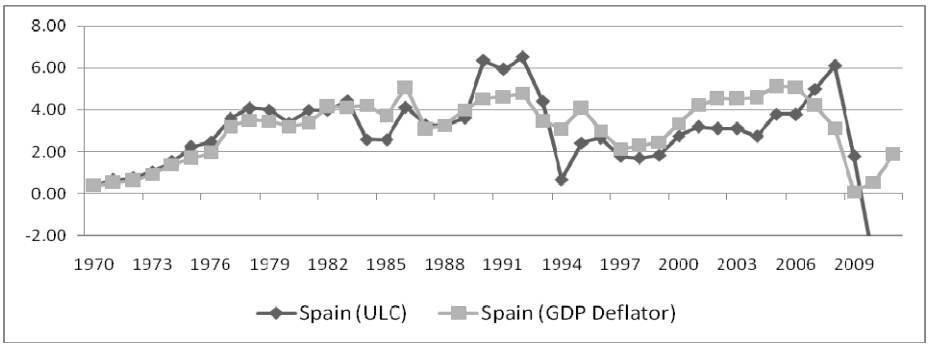
considerable burden. If macroeconomic productivity rises by 2% and the central bank's target inflation rate is also 2%, then the nominal wage level should increase by 4%. That is the modern variant of the Meinhold formula.

The upshot of the Meinhold-Keynes reasoning is that the level of real wages within a country can, in the longer term, be increased only by raising productivity. Certainly, a wage increase may lead to reduced profits in a sector that is exposed to strong international competition, as it will not be possible to raise prices. But in the long run, it is unlikely that unit wage cost increases could not be passed on in prices. Diagram 1 shows annual percentage changes of nominal unit labour costs and of the price level for a selection of EMU-countries.[1] Given that many additional factors influence the price level like exchange rate movements, tax changes, changes of prices of natural resources and food, demand inflation, the business cycle, etc. the correlation between nominal unit labour costs and the price level is surprisingly close. This supports that nominal unit labour costs are the anchor of the price level.

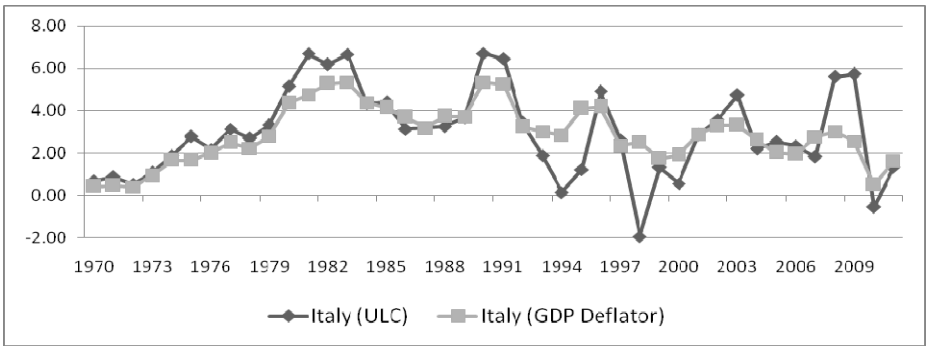
[1] For the price level changes of the GDP deflator is used. This is a better indicator for inflationary or deflationary developments than the consumer price index which gives a higher weight to more "exogenous" items such as the costs of renting a flat.

Diagram 1: Nominal unit labour costs and price level changes (GDP deflator) for selected EMU-countries, 1970-2011

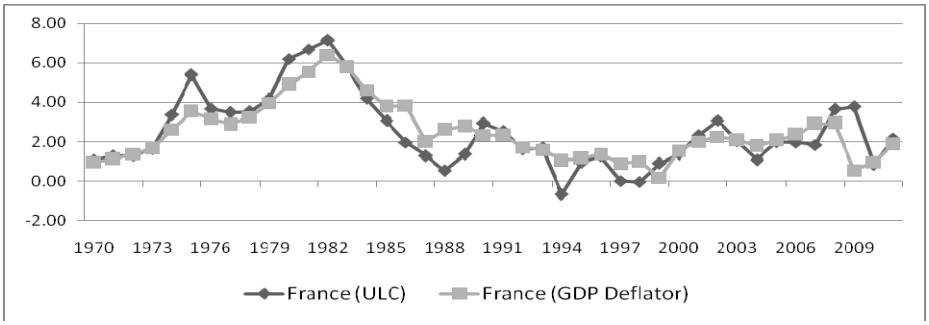
Spain



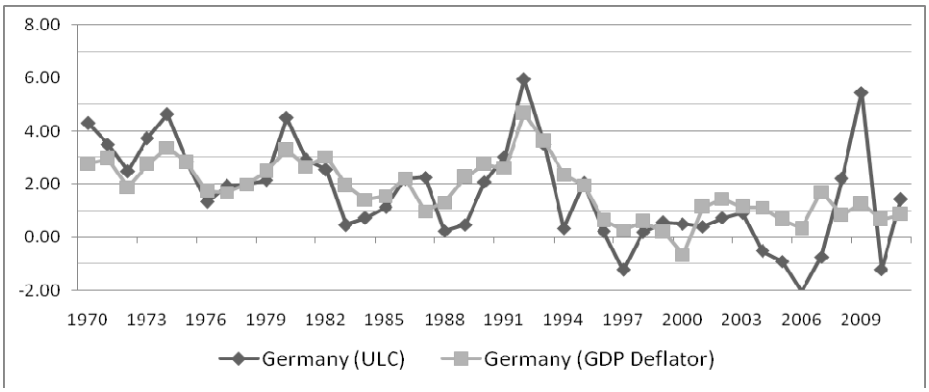
Italy



France



Germany



Source: AMECO Online (2012)

One consequence of the above analysis is that the functional division of income between wages and profits cannot be changed by raising nominal wage levels. This is because radical attempts to increase the wage quota will lead to inflation, not to redistribution. After all, if wages rise, the enterprises still have the upper hand and can pass the higher costs on. This does not

mean that functional income distribution cannot be altered. It just means that wage policy is not the right instrument for this task. The explanation for rising profit mark-ups and a rising profit ratio should be sought first and foremost in managements' radical shareholder value orientation and the increased power of the financial markets (Hein 2011; Onaran/Stockhammer/Grafl 2011).

If price levels increase due to "exogenous" cost factors such as rising prices for raw materials and food, real income will fall as a result. In this case, there is no realistic possibility of compensating for the drop in real wages. Because, to stick to the same example, if oil becomes scarcer and its price changes relative to those of other goods, then this ought to be accepted or, to put it another way, wage increases should not diverge from the modern variant of the Meinhold formula. Central banks and trade unions alike should therefore let such cost factors "work their way through" and should not react to them.

An *individual* trade union can increase its members' real wages if it raises pay by more than the average within society, but this will be at other people's expense. If air traffic controllers, ground staff or engine drivers secure very significant pay increases while the rest of the workers do not, air and rail travel will become somewhat more expensive for everybody, whereas for these particular employee groups, real wages will have risen.

3. MACROECONOMIC PRODUCTIVITY AS A YARDSTICK

In their wage policy ideas, Agartz and Meinhold emphasize the general importance of *macroeconomic* productivity development. Not only is macroeconomic productivity to be the guiding hand behind average wage development, but also average productivity development is to underlie *all* wage settlements as a matter of principle, regardless of the sector and the firm – unless the deliberate aim is to change the wage structure.

If sectoral productivity development were to be used as the yardstick for sectoral wage development, some sectors would be systematically delinked from wage development. To take an example: in elderly care and nursing, productivity cannot and should not be raised in the same way as in the auto industry. The wage differential between employees in the caring professions and the auto industry would constantly increase if it were based on sector-specific productivity, and this would lead to an unjust and socially intolerable pay gap. If wages in the caring professions increase by the same percentage as in the auto industry, then the relative prices will shift in such a way that cars will become relatively cheaper in relation to care services. And that is how it should be.[2]

The neoclassical model argues against this, on the grounds that wage structure is dependent on labour productivity structure.[3] If a gardener, a nurse or a hairdresser earn very low wages, it's because of their lousy productivity and if we want high employment then, so the argument goes, we just have to accept those kinds of wages.

But technology, or productivity levels in the different sectors, together with the wage structure as governed by institutions such as minimum wages, the existence and strength of trade unions etc. determines the structure of prices. The volume of production and employment then depends on the national demand for goods, regardless of the price structure. Of course, the cost structure will have feedback effects on the technology, but that does not affect the basic argument. The upshot of that argument is that the wage structure can be radically altered in the medium term without this giving rise to negative employment effects. Of course, changes in employment depend on percentage changes of demand and volume of production minus percentage changes in productivity. However, between wage structure and macroeconomic productivity developments there is hardly a clear relationship. And sufficient aggregate demand can always compensate for high productivity increases. High productivity increases also opens the possibility to reduce working time without reducing real wages.

[2] As one industry's output is another industry's input, the changes in relative prices would generally be difficult to predict.
[3] More precisely, wage structure is determined by the marginal productivity of the various employees.

Usually, the law of one price applies to markets. At least, in functioning markets, it is supposed to. This law is broken if different wages are paid for the same occupations within a sector. This is particularly problematic if, within a sector, those enterprises that have relatively low productivity and poor management skills pay lower wages than those with better productivity and management skills. That is deeply innovation-hostile. Because relatively low wages are then subsidizing the sector's "lame ducks". This is not to rule out the possibility of temporary variations in order to tide firms over during an emergency. But the longer-term expectation of both firms and employees must be that wages will develop in line with macroeconomic productivity. Permanent "wage subsidies" must not become a strategy. Otherwise, innovation will be less rewarding.

4. WAGE POLICY IN THE EMU

The considerations outlined above represent a viable concept for a macroeconomically oriented wage policy. The Federal Republic of Germany, among others, was a showcase for such a wage policy. It was used in practice until well into the 1980s, albeit with a pinch of salt. However, this type of coordinated wage policy has come under pressure not only from economic theory but also from the fundamental political and economic changes of the past two decades. In many countries more market based wage bargaining systems developed leading to wages increases below *and* above wage increases, according to medium-term macroeconomic productivity progress, plus the target inflation rate. Germany can again serve as an example. German unification opened up a serious gap in collective agreement coverage, particularly in the service sectors, and that gap has still not been filled to this day. So wage setting on the basis of macroeconomic goals has become an illusion here. This has also had knock-on effects in the old federal territory, as firms there have consequently come under wage-related competitive pressure from those in the new federal states. Economic policy in Germany did not stop the development of a dual labour market with a large sector which is not covered by collective bargaining. It did the opposite as it has been rejecting statutory minimum wages in Germany until today, and deregulated labour markets.

A major change was the advent of the EMU. This altered the macroeconomic parameters for all counties joining the EMU. Economically countries such as Spain, France, or Germany are now regions in a large monetary area. Consequently, wage increases according to medium-term macroeconomic productivity plus the target inflation rate must hold for *each* region in the entire Eurozone. Otherwise, there is a danger of real devaluations and revaluations, ultimately leading to trade imbalances the consequences of which have been seen. Economists have already early pointed out that an EMU without a minimum of wage coordination is not able to survive in the long-term (see for example Fritsche/Horn/Scheremet/Zwiener 1999; Herr/Kazandziska 2007).

Given the many and varied wage setting systems, ranging from decentralized bargaining structures at the enterprise level (Spain, Italy) to national index-linking (Belgium), it would be illusory to think that any wage determination system on an EMU level could be established in the foreseeable future which is comparable with established national wage bargaining systems. There are no relevant supranational union federations and no supranational employers' federations which directly could negotiate wages on an EMU level. An additional problem is that EMU regional productivity development is not identical in all regions and the same nominal wage increases in all EMU countries would be dysfunctional for regional coherence. Just as unlikely, in either the short or the long term, is the establishment of transfer systems between the Member States in order to compensate for possible large and permanent current account imbalances. Against that backdrop, the only available option is for wage setting in each

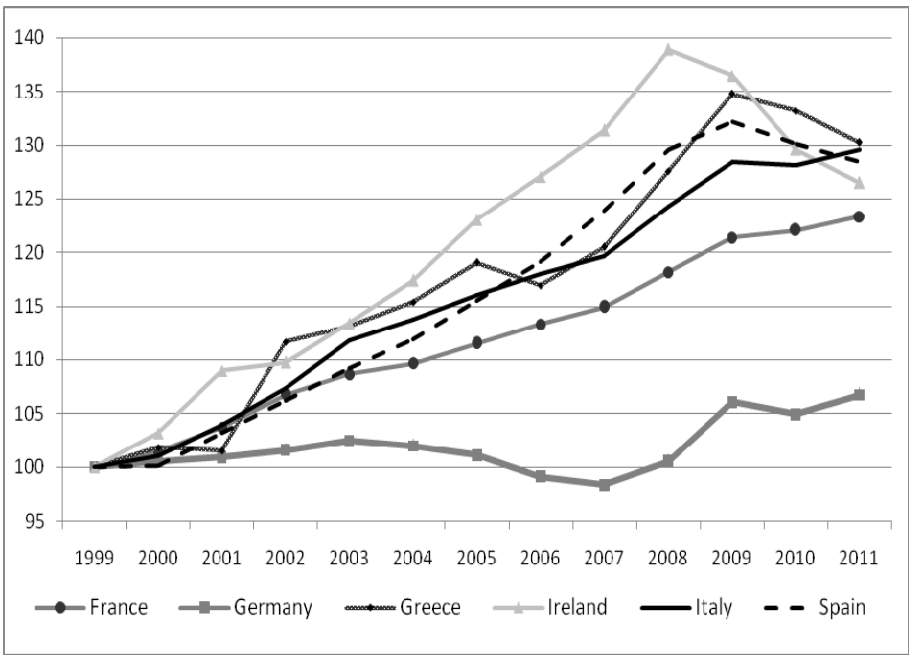
individual Member State to be guided by the national economic fundamentals and the ECB's inflation target. So nominal wages should rise in line with the *regional* macroeconomic productivity trend and the ECB's inflation target. According to such a rule nominal and real wages, for example in Spain or Greece, would increase faster than in Germany when these countries close the productivity gap to Germany. However, the heterogeneity of the European wage setting systems makes it doubtful that this way of proceeding will be kept to at all times in every country. The more market-based wage development is in the EMU region, the less likely a functional wage development in the EMU becomes.

There is no doubt that wage coordination within the EMU is urgently needed. New institutions are needed to organise coordination. The Macroeconomic Dialogue could be strengthened, as well as all initiatives to establish cross-border wage bargaining in the EMU. The European trade union movement has to establish ways of establishing a coherent wage policy within the EMU, otherwise it is to be expected that unions in Europe will be weakened as neoliberal policy will try to find solutions for European regional problems at the expense of the working class. However, it would be wrong and misleading to burden unions and wage development with the only, or even main task, of creating regional coherence within the EMU. Unit labour cost development is only partly responsible for regional incoherence; growth differentials and a lack of industrial and productivity development are other important factors. German surpluses, for example, were also caused by the poor German growth performance the decade before the Great Recession. In case of regional distortions European bodies are needed that can take compensatory action. The bargaining partners cannot be saddled with the final responsibility for this, if only because of the decentralized nature of wage policy decision-making in many places. The responsibility must also be borne by governments, within the framework of the European Treaties. Fiscal and labour market policies are needed, as well as policies to guarantee certain transfers between EMU countries, and policies which increase productivity development in countries with relatively low productivity levels within the EMU.

5. IMPLICATIONS FOR THE CURRENT WAGE ROUND

To date, wage development in the EMU has by no means fulfilled the stability requirements outlined above. The Member States of the EMU, which was founded in 1999, have experienced such varied unit wage cost developments that these have become a core economic problem. From 2000 to 2008, the last year before the great economic collapse, nominal wage costs in the economy as a whole remained unchanged in Germany, whereas over the same period they rose by, for example, about 31% in Spain, about 23% in Portugal, about 26% in Italy, about 42% in Ireland and about 28% in Greece. As regards the development of nominal unit wage costs in industry, the situation was similar. Industrial unit wage costs in Germany went down by 4.7% between 1999 and 2008, while in Spain, Italy and Greece they went up, in some cases by more than 20% (cf. AMECO 2012). Diagram 2 shows how different nominal unit labour costs developed within the EMU. Germany had the lowest increases, followed by Austria. France is about in the middle of nominal unit labour cost increases. The highest increases in unit labour costs can be found in Ireland, Greece, and Spain.

Diagram 2: Unit Labour Cost Development in selected EMU countries, 1999-2011



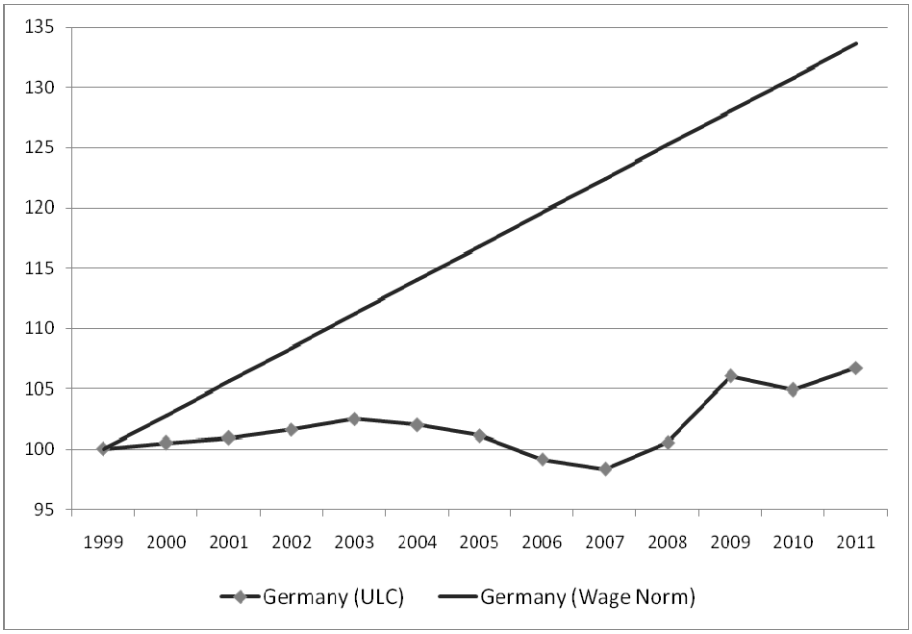
Source: AMECO Online (2012)

Looking at the country-specific wage development in more detail we can calculate a country-specific wage norm which reflects country specific medium-term productivity development plus the target inflation rate of the ECB. As the ECB "aims to maintain inflation rates below, but close to, two per cent over the medium term" (ECB 2003: 79) we took as the inflation target an annual increase of the price level of 1.8 per cent. For the trend productivity for the countries we took the average productivity increase between 1999 and 2008.[4] Diagram 3 shows to which incredible extent regional wage development was dysfunctional in the EMU. Germany, as a trade surplus country, has been in breach of the functional wage development described above, even more than Spain, Greece, Portugal, and most of the other EMU countries. From the countries shown Germany had the highest productivity increases and the lowest nominal wage increases. Wage development in France has been very much in line with EMU needs. Part of the high trade imbalances within the EMU– which are now hindering the economic stabilization of, for instance, the Mediterranean countries that are running current account deficits – is due to these unit wage cost developments.

[4] We took 2008, the last year before the Great Recession as after 2008 productivity is influenced by the volatility of GDP growth.

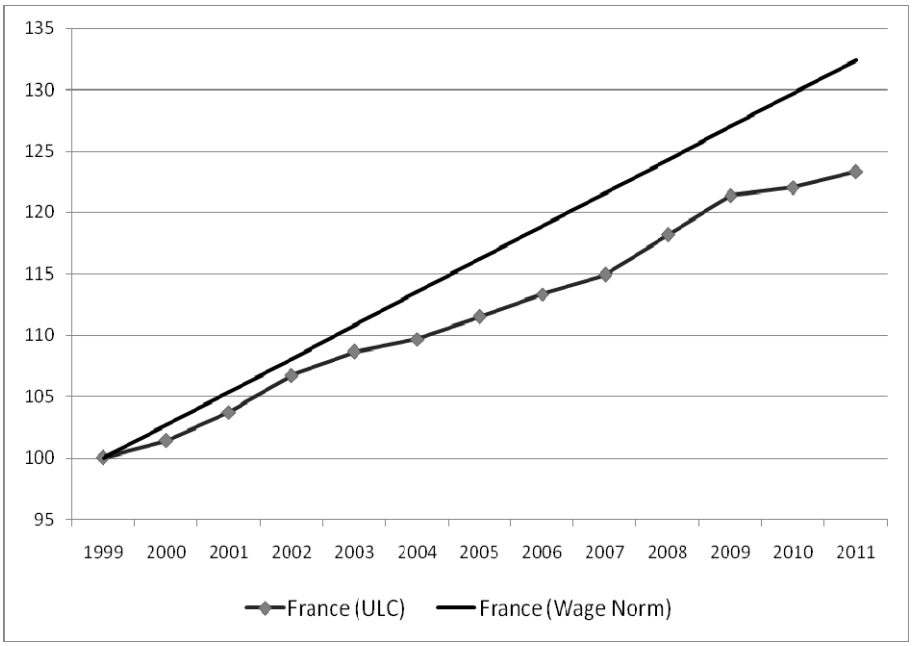
Diagram 3: Unit labour costs development and country specific age norm in Germany France, Italy and Spain, 1999-2011*

Germany



Wage norm: Target inflation rate of 1.8 % plus trend productivity growth (average between 1999 and 2008) of 1.0 %.

France

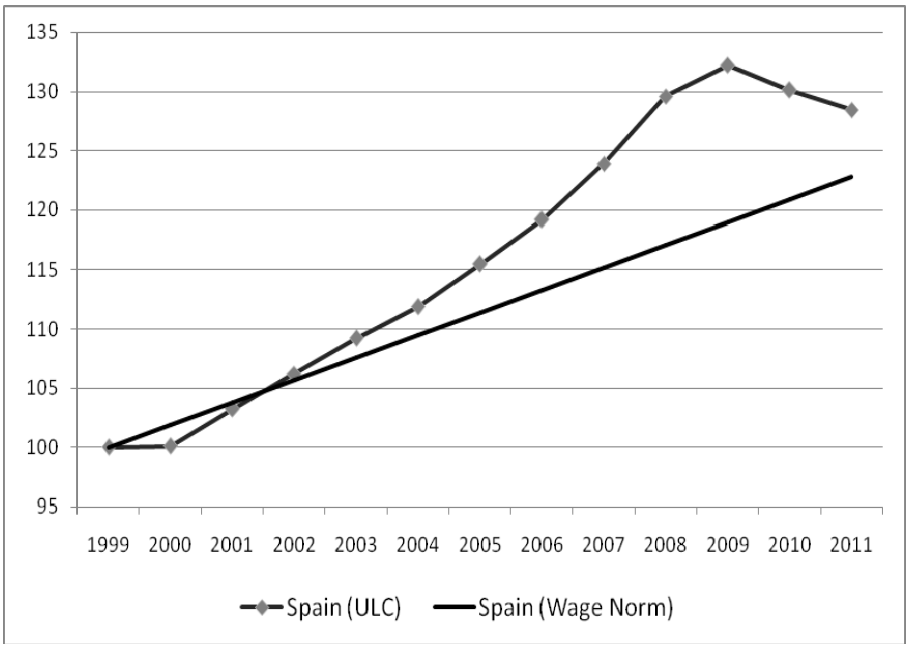


Wage norm: Target inflation rate of 1.8 % plus trend productivity growth (average between 1999 and 2008) of 0.9 %.

Italy

Wage norm: Target inflation rate of 1.8 % plus trend productivity growth (average between 1999 and 2008) of 0.0 %.

Spain



Wage norm: Target inflation rate of 1.8% plus trend productivity growth (average between 1999 and 2008) of 0.1 %.

* Trend productivity growth is calculated as average productivity growth in total economy between 1999 and 2008.

Source: AMECO Online (2012), OECD Labour Statistics (2012).

Turning to the overall economic context in 2012 (and also in years to come), wage development in Germany could make an important contribution to the stabilization of the German and European economies. The most recent wage settlements in Germany were higher than in the years before and point in that direction – they are increasing stability within the Eurozone.

In fact, given the background that has been outlined here, wage rises in Germany ought to be higher than the productivity formula would suggest. As wage development in Germany has, from a macroeconomic and European perspective, been too modest in recent years, the demand can justifiably be made (also in Meinhold's terms) that current wage rises should exceed the productivity trend and the target inflation rate. This would facilitate European stabilization and reduce the need for compensatory economic policies. The settlement in the metalworking industry is of particular importance in this regard as this industry plays the key role in the German pattern bargaining system.

In the dual German labour market only 62% of employees are still covered by collective wage agreements. The others no longer have any collective agreement protection (cf. Böckler-Impuls 2011). That the pay of some of the unprotected workers should have fallen to the basic social welfare benefits level (Hartz IV) has, given the lack of generally applicable minimum wages, come as no surprise to economists. No wage policy alleviations are to be expected from that quarter. Counterbalancing action is a matter for economic policy. Nonetheless, a high settlement in the metalworking industry and other industries with still high collective bargaining coverage could be helpful. In order to correct the incoherent wage development in the EMU, unit wage costs should, for a few years, rise faster in Germany than in the crisis-hit EMU countries. A wage development along these lines would reduce deflationary pressure in those countries and would be a form of real solidarity with the trade unions in the crisis countries. And this would have positive effects for Germany, too. The faster the EMU crisis countries recover, the greater will be their demand for German goods and the better will be developments in Germany. But if the morally repugnant and economically harmful development of income inequality in Germany is to be reversed, institutional labour market regulations will be needed, as the trade unions have long demanded. They should include declarations that collective agreements are universally binding, a universal legal minimum wage, and restrictions on temping and casual employment. Without an immediate reorientation of wage policy and prompt renewed regulation of labour markets, Germany will not emerge unscathed from the troubled economic waters of the coming decade and will not sufficiently contribute to a coherent regional development within the EMU.

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