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Research Report

Salary cuts and competitiveness

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Salary Cuts and Competitiveness

Policy Letter Series No. 1

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Salary Cuts and Competitiveness

By Michael Haliassos

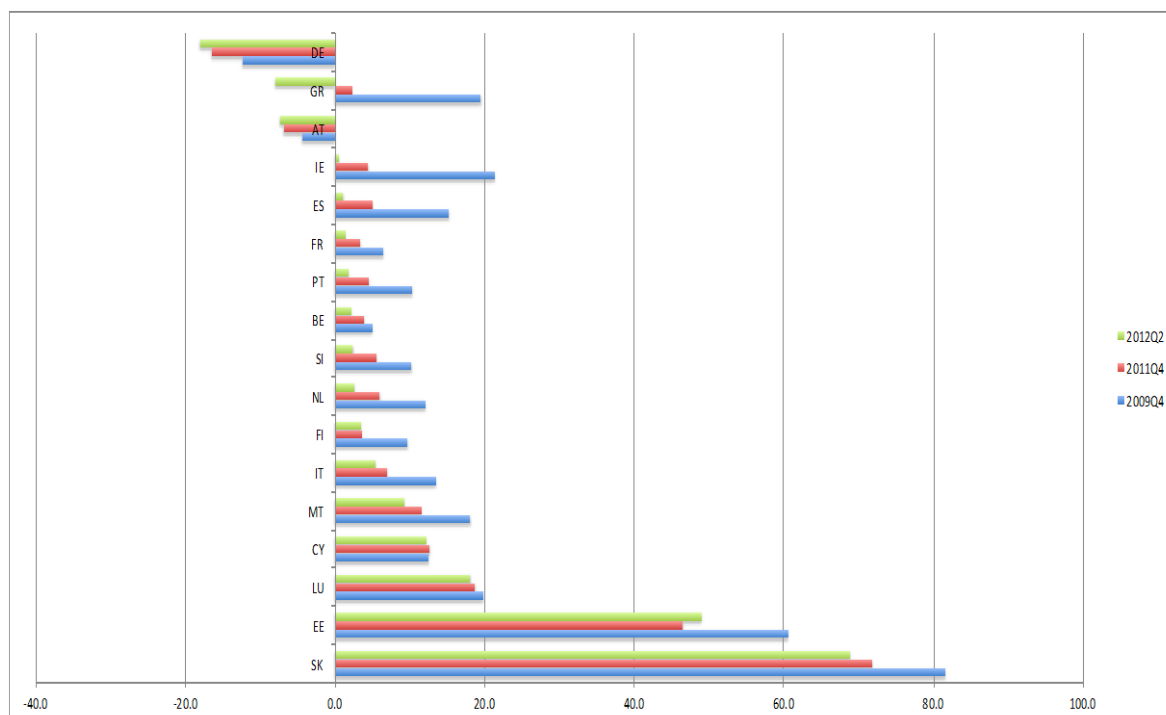
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Promotion of competitiveness in the international market for goods and services, especially for fiscally troubled countries, is both an objective of European Union policies and a prerequisite for the longer-run viability and repayment of public debt. Massive horizontal salary cuts appear, at first, to promote competitiveness by reducing unit labor costs and to reduce fiscal deficits by reducing the wage bill of the public sector. Upon closer look, however, horizontal salary cuts have been much greater than needed for Greek competitiveness, providing an alibi vis a vis the Troika for reforms that are still to be implemented, but at the same time undermining both competitiveness and the potential to reduce public debt through sustainable development.

There is a prevalent view outside Greece that promotion of competitiveness is tantamount with price reductions for Greek goods and services. Unit labor costs are the ratio of wage levels to productivity. In view of the long delays and limited willingness to implement reforms in Greece, foreign debtors promote and accept drastic salary reductions as a means of boosting productivity and reducing public spending. Multiple reductions, however, are hard to attribute to restoration of competitiveness. Based on the Harmonized Competitiveness Index of the ECB with reference to unit labor costs, Greece was one of only three Eurozone countries to improve competitiveness relative to the first quarter of 1999, second only to Germany (Figure 1). Already by the end of 2011, it stood in the middle of Eurozone countries in terms of the change in the index, without the further wage cuts implemented in 2012. Figure 1 shows the change in competitiveness since the first quarter of 1999 for every Eurozone country, in three different quarters: 2009Q4, when the Greek crisis broke out, in 2011Q4, and in 2012Q2.

Figure 1
Change in ECB Harmonized Competitiveness Index since 1999Q1
Eurozone Countries, Based on Unit Labor Costs
In three quarters: 2009Q4, 2011Q4, 2012Q2

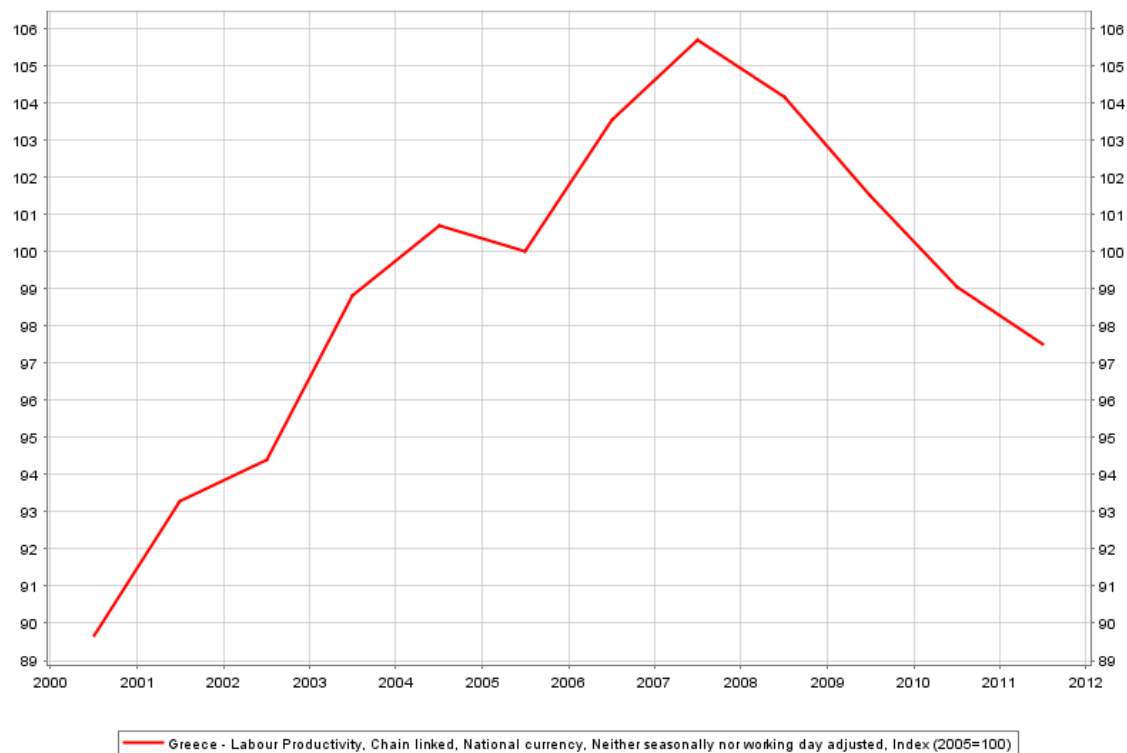


Source: European Central Bank, Statistical Data Warehouse

In countries with a broad industrial sector, a recession often leads to a process of “creative destruction”, i.e. elimination of less productive units and increase in aggregate productivity. Based on this experience, one might presume that part of the reduction in Greek unit labor costs is mechanical, due to an overall increase in productivity rather than to salary cuts. However, person-based labor productivity in Greece has been falling continuously since 2008! (Figure 2) The reduction in aggregate demand did not lead to a proportional reduction in employment, and it is worth investigating whether the reduction in aggregate productivity was aggravated by closure or relocation of high-productivity companies. In any event, salary reductions were so extensive, that they dominated even the reduction in productivity, so as to lead to an improvement in measured competitiveness.

The views of international lenders on necessary wage cuts are also influenced by the observation that Greece’s harmonized competitiveness index with reference to the Consumer Price Index continues to be lower than at the start of 1999, with Greece ranked in the middle of the Eurozone in terms of the size of the difference. However, taking into account the relatively small role of domestic producer prices in the level of the CPI (due to the limited productive base, the high share of imports, and the substantial indirect taxes), this ranking is more indicative of how attractive Greece is for locating a household rather than of how competitive the productive sector is.

Figure 2
Labor Productivity Index (person based)



Source: European Central Bank, Statistical Data Warehouse

Large horizontal salary cuts hurt productivity and the country's potential to create a broad and dynamic productive base focused on innovation and exports. Horizontal cuts lead to a reduction in expected productivity, because the best employees leave, the rest have fewer incentives to be productive, and promising new people become more difficult to attract. Current mass migration of young but also of experienced workers abroad is the result not only of unemployment but also of salary levels; it will continue as long as economic prospects remain bleak. Innovation, inventiveness, original thinking, and quality work are associated with people who have significant outside options in an increasingly globalized job market.

Could it be that salary reductions will create an influx of foreign companies or a return of Greek ones? If so, why aren't they already back? Beyond salary levels, important factors include ease of establishing and running businesses, investor protection, perceptions of public corruption, and labor relations. Greece ranks 78th in terms of the (revised) World Bank Index of Ease of Doing Business, 146th in ease of starting a business, and in 117th place in investor protection. In terms of the Perceived Corruption Index of Transparency International, Greece is ranked 94th, together with Djibouti, Colombia, and Senegal. Greek and foreign investors are unlikely to locate in Greece without sweeping reforms in public administration, labor policies, and the justice system.

Boosting Greek competitiveness requires attracting dynamic companies and productive workers. Linking pay to productivity, improvements in university and

technical education, substantial promotion of entrepreneurship, and encouragement of research and innovation should replace assaults on wages as measures to boost competitiveness. For example, R&D spending in Greece was mostly public and at around 0.5% of GDP prior to the crisis. The EU-27 average in 2009 was 2% and about two thirds of it were coming from the private sector.

Refocusing EU policy towards closing gaps in those aspects has the potential to promote economic development and repayment potential for public debt. Mindless insistence on continual horizontal salary reductions simply drains Greece from its most promising scientists, entrepreneurs, and workers.