Firm-level agreements are the right solution

Costas Meghir and Dimitri Vayanos[1]

There has been much discussion recently on whether labour negotiations should be carried out at the country- or industry-level, or whether they should be done at the firm level. Under the current system, firm-level agreements are feasible only if they improve the terms that country- and industry-level agreements offer to workers. The memorandum that Greece has signed with the EU/IMF requires changing this system towards one where firm-level agreements prevail. This change has been opposed strongly by union leaders, representatives of employer bodies, and the Ministry of Labour. We believe, however, that firm-level agreements are the right solution.

A key advantage of firm-level agreements is that they take into account the conditions specific to each firm, and especially the productivity of its workers. Moreover, while industry- or country-level agreements could in principle take into account important economic variables such as unemployment and competitiveness, this often does not happen in practice. Industry- and country-level agreements are influenced by the interests of union leaders, which differ from those of a large fraction of the labour force---especially the unemployed and those who risk losing their jobs.

Firms differ vastly in productivity, either because they operate in different markets, or because they use different technologies, or because of the composition of their workforce in terms of qualifications and training. Therefore, wage increases cannot be common to all of them.

Let us take the hypothetical example of an industry sector with two types of firms: low-productivity ones that barely cover their costs, and high-productivity ones that are very profitable. A wage increase that corresponds to the sector's average productivity will push the low-productivity firms into financial distress and possibly bankruptcy, thus increasing the level of unemployment. On the other hand, the workers in the high-productivity firms will be able to negotiate higher wage increases.

Some believe that the current system establishes a link between wages and productivity. Their argument is that high-productivity firms are able, through firm-level agreements, to offer wage increases above and beyond those agreed at the industry and country level.

This argument would have been correct if the wage increases agreed at the industry and country level were suitable for low-productivity firms, i.e., low. This is not true in practice: industry- and country-level agreements often yield wage increases above average productivity, and do not take into account the level of unemployment. For example, unemployment in Greece was 7.7% in 2008 and rose to 9.5% in 2009. Unit Labour Cost (total compensation of workers over real GDP) rose by 3.9% in 2008 and 5.3% in 2009. The corresponding numbers in the EU were 7.0% and 8.9% for unemployment, and 3.4% and 3.6% for labour costs.[2] Thus, while unemployment in Greece increased in 2009 by approximately the same amount as in the EU, labour costs increased by much more---and hence the Greek economy became less competitive.

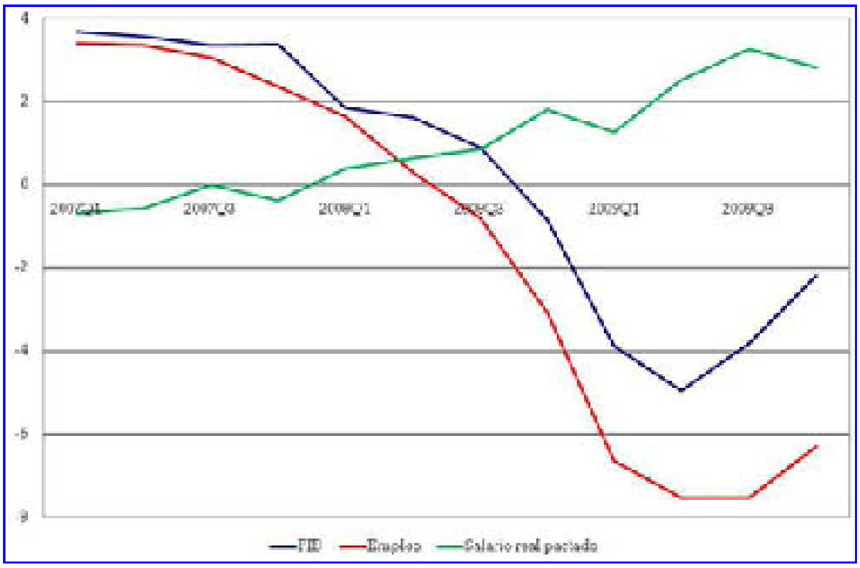
Greece's situation has close similarities with that of Spain. Labour negotiations in Spain take place at the industry and country level. The following graph shows Spain's average real wage, employment level, and GDP.[3] During the second half of 2008 and all of 2009, employment (red line)

[1] Costas Meghir is Professor of Economics at Yale and University College London. Dimitri Vayanos is Professor of Finance at the London School of Economics. A more detailed exposition of some of the arguments in this article can be found in the article "The economic crisis in Greece: a time of reform and opportunity", available at www.greekeconomistsforreform.com.

[2] The data are from the OECD (OECD Main Economic Indicators).

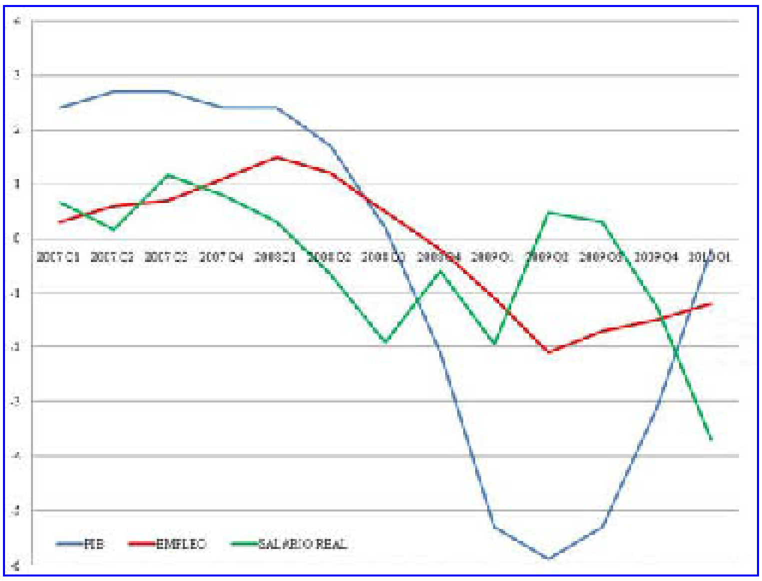
[3] This and the next graph have been constructed by Spanish economists Samuel Bentolila (CEMFI, Madrid) και Luis Garicano (London School of Economics). For more information, see http://www.fedeablogs.net/economia/?p=5085.

and GDP (blue line) decreased dramatically, as the global economic crisis hit Spain. In a well-functioning labour market, the increase in unemployment would have caused wages to decrease so that firms could survive the crisis and keep their workers. The average real wage (green line) increased, however, causing labour costs to increase and amplifying the increase in unemployment.



Average real wage, employment and GDP --- Spain 2007-9

The increase in the average real wage during a time of increasing unemployment was mainly due to the centralised nature of labour negotiations. This can be seen by contrasting Spain with the United Kingdom, where labour negotiations take place at the firm level. The graph below shows the same variables as in the previous graph, but for the UK. As in Spain, GDP (blue line) decreased significantly because of the crisis. The average real wage (green line), however, decreased slightly. And the drop in employment (red line) was much lower than in Spain.



Average real wage, employment and GDP --- United Kingdom 2007-9

Industry- and country-level agreements can fail to take into account important economic variables such as unemployment and competitiveness because they are influenced by the political interests of union leaders. For example, the representatives of workers at the industry level have every interest to insist on a high wage increase because this will bring them praise from the majority of workers in the industry. That a high wage increase can push some firms into distress or bankruptcy---and a minority of workers into unemployment---concerns them less. If the negotiation took place at the firm level, things would be different. The representatives of workers at the firm level value the praise from those they represent; yet, they also know that if the firm goes bankrupt they will lose their job.

Summarizing, the key advantage of firm-level agreements is that they link wages to productivity. This is important to avoid a further increase in unemployment and drop in competitiveness, and to bring growth. (Of course, improvements in competitiveness and productivity require additional reforms, targeting the complicated and inefficient regulatory framework, the high level of corruption, the complicated tax system, etc.)

Firm-level agreements have the additional advantage to offer firms and workers the flexibility to negotiate on a broad range of issues beyond wages. For example, a firm for which overtime is important will be able to negotiate with its workers more flexibility for overtime in exchange for higher wages. And a firm that wants to do a large investment and enter a new market will be able to negotiate no strikes for a limited time period, in exchange for higher wages. Such flexibility makes it attractive for firms to invest, and stimulates growth.

These are not simple theoretical points. The UK for example gained enormous dividends when it moved to firm-level negotiations and reformed its institutions, with new Japanese firms opening up large manufacturing establishments in the car, computer and microchip sectors. And Germany, which is considered a successful model of centralised negotiations, suffered from them following the reunification of West and East Germany. This is because the requirement that wage increases be common to the entire country caused high unemployment in East Germany, where productivity was low.

Depoliticising and decentralising wage negotiations may hurt the ambitions of union bosses but will benefit everybody else including current and prospective workers.

Labour market and competitiveness

Greece has a tightly regulated labour market. At the same time Greek competitiveness is the lowest in the EU and not improving. Stimulating growth requires measures that will improve competitiveness, and key to high competitiveness is a flexible labour market. At present there are two key sources of inflexibility: the centralised wage negotiations and the regulations that make layoffs costly to firms.

It is commonly believed that the tight regulations in the Greek labour market benefit workers: wage negotiations carried out by strong unions at the country and industry level yield high wage increases, and jobs are protected effectively if the state makes layoffs costly to firms. This belief, however, is completely wrong. First, a firm that cannot reduce its labour force during an economic downturn risks bankruptcy, in which case all its workers will lose their jobs. The same is true for a firm that must pay wages agreed at the country or industry level, and far exceeding the productivity of its workers. Second, tight regulations discourage investment and job creation because firms know that they will have difficulty surviving a downturn. This is especially important for industry sectors such as high technology, where initial investments are high---and is one of the reasons why the majority of Greek firms are small and in sectors characterised by low technology and low capital intensity. Third, tight regulations push many firms into the black economy where workers receive no protection.

We should finally note that liberalising the labour market should be accompanied with a system that will provide unemployment insurance as well as training opportunities for those that want them. Flexibility must not mean insecurity and no advanced and well run capitalist economy leaves its citizens uninsured from bad luck. Moreover, such insurance can improve productivity, by allowing workers to find a suitable new job, rather than accepting the first offer they obtain, which may not be best suited to their abilities. Unemployment insurance should, however, not burden the firms (for the reasons explained above) but the state.