Austerity and the alternatives

Briefing #3: The Fairy Tale of Structural Reforms

APRIL 2014

forum

A NEW PATH FOR
EUROPE

The Fairy Tale of Structural Reforms

Austerity, as experienced by millions of workers across Europe, is not just about a frontal attack on public services and social security systems. It is also about shifting the responsibility for the crisis from the banks to workers, their wages and the labour market institutions that protect their working conditions.

The lack of regulation of financial markets that triggered a profound market failure is being forgotten and gets transformed and translated into excessive deregulation of labour markets. Thus, the Masters of Austerity are also the Masters of Deregulation.

In this third part of our series on austerity and the alternatives, we focus on the main arguments used by the Masters of Deregulation to shift the blame for the crisis to wages and wage formation institutions.

The next briefing will debunk the arguments of the deregulators about other labour market institutions that protect workers, such as job protection systems and dual labour markets.

Since the beginning of the crisis EPSU has been consistent in calling for measures to boost the European economy. It argued for real wage growth to maintain demand and increased public investment to support jobs and the long-term competitiveness of the European economy. For more on EPSU's policy see page 24.

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Soaring capital costs are the problem, not “excessive” wages

Advocates of austerity claim that the crisis is caused by excessively high wages. In their view, wage increases outpaced productivity growth and that resulted in high output prices destroying competitiveness.

In recent years, the debate about price and cost competitiveness across Europe has focused exclusively on wages. Statistics on wages, labour productivity and unit wage costs are being closely watched and adopted as key indicators for policy in the European economic governance process and its procedure on excessive macro-economic imbalances. In these processes the European Commission has been handed the power to intervene in economies, mostly with a view of pushing wages down.

It is striking to observe that the other side of the equation, the cost of capital, is hardly being mentioned.

However, the same indicators that are being used to discipline labour costs can also be applied to the cost of capital. Indeed, unit capital costs can be calculated in the same way as unit labour costs. (Technically, this is done by dividing the change in profits by the change in the volume of output).

A striking picture emerges. Over the last decade, unit profit costs have exploded and increased substantially more than unit labour costs. Whereas, from 1998 to 2011, unit labour costs went up by 20% in the EU 27, unit profit costs soared by 30% (see chart 1).

A further step is to recalculate these changes in labour and capital costs in terms of their respective contribution to inflation (see chart 2). The remarkable conclusion is that, although the absolute share of profits in GDP is still lower than the share of labour, between 1998 and 2008 the expansion of profits contributed nearly as much to inflation as wage costs.

So, the question is why wages are being blamed for inflation and losses in competitiveness while the evolution in unit profit costs has been much more pronounced? Why ‘discipline’ wages if it is highly likely that a substantial part of workers’ efforts to moderate wages will be used by business not to keep prices down but to increase profit margins?

Unit profit costs have increased much more than unit labour costs

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Chart 1. Change in the components of unit costs, 1995-2011 (1998=100)

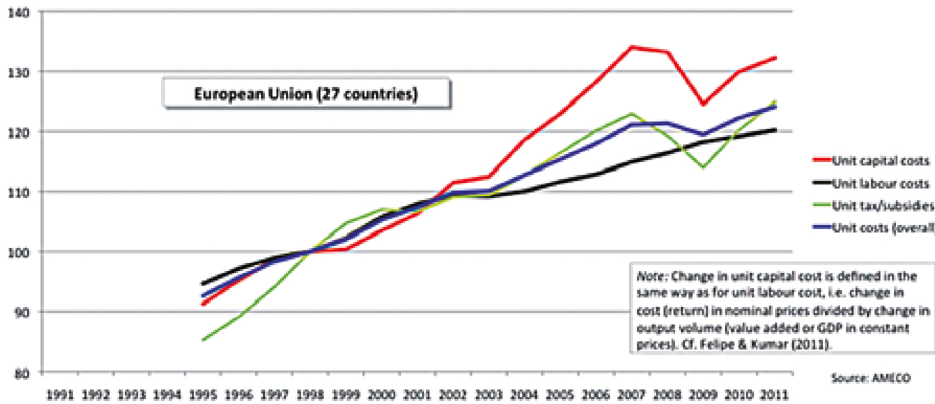
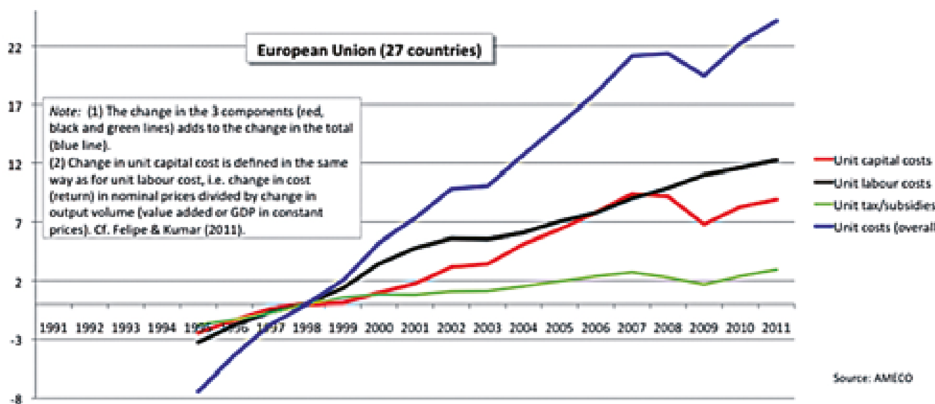


Chart 2. Contribution of change in its components to overall increase of unit costs (1998=0)



The graphs above show the trend for the European Union 27. However, this trend of accelerating profits pushing up prices can be observed in many individual member states, in particular in those countries hit by financial turmoil. The case of Spain is particularly illuminating. Whereas unit wage costs there increased by 40% from 1998 to 2008, unit profit costs soared by one and a half times that much, by 60%. And whereas the upward trend in unit labour costs substantially reversed after the 2009 crisis, unit profit costs increased even more sharply than before. In 2011, unit profit rates were at 170% of their 1998 level.

In Spain profit costs have risen one and a half times faster than wage costs

Chart 3. Spain - change in the components of unit costs 1995-2011 (1998=100)

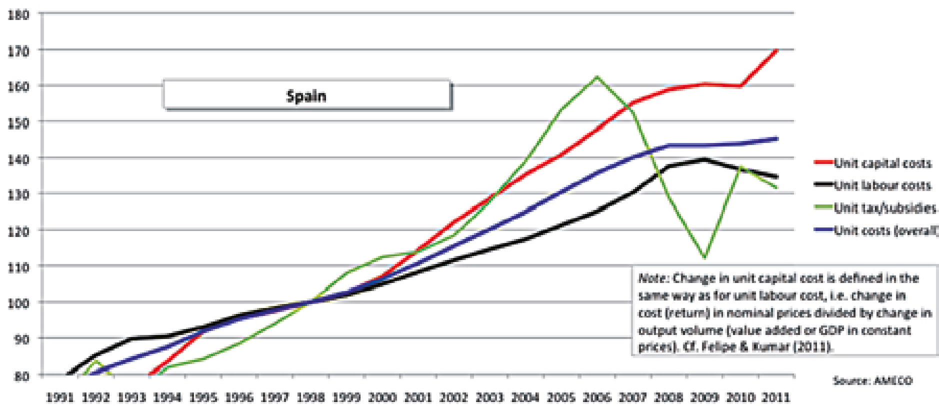
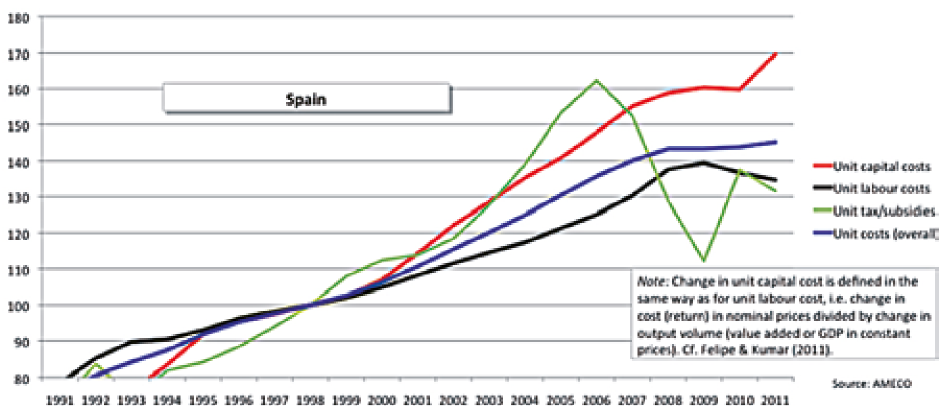


Chart 4. Spain – contribution of change in its components to overall increase of unit costs (1998=0)



What these statistics show is that the usual debate on 'competitiveness' is a smokescreen to hide an underlying trend of rising inequalities. With little or no attention given to capital costs and booming profit margins, the redistribution of income from labour to capital and the role of rising profits in deteriorating inflation and price competitiveness is simply going unnoticed.

The redistribution of income from capital to labour is going unnoticed

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the speculators
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NO TO CUTS
in public spending
priorité à l'emploi
et à la croissance
ARE FIGHTING FOR
OUR EUROPE
SOCIAL JUSTICE • PUBLIC SERVICES • JOBS FOR ALL

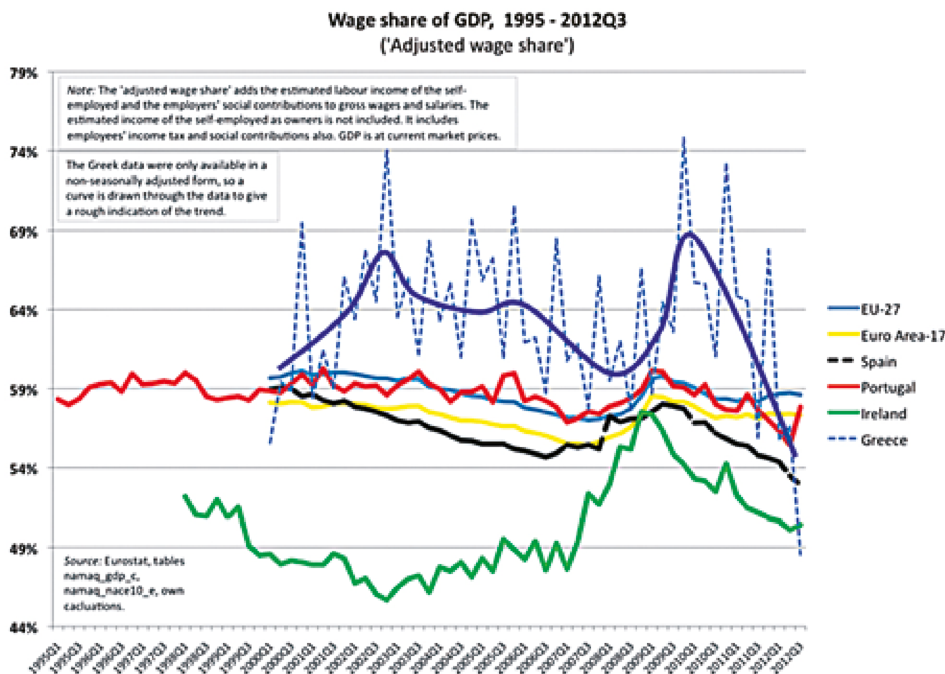
Profits up, investment down

The claim is that soaring profits, even if this means price competitiveness is not improved, are still a desirable thing. Today's wage cuts are supposed to be the profits and investments of tomorrow.

Squeezed wages are certainly reflected in a falling share of labour in GDP, as can be seen in particular in the financially distressed countries (see chart 5).

In Spain, Portugal and Ireland, wage shares have fallen by 5%-6% of GDP while Greece has seen an even sharper drop of 14%.

Chart 5. Wage share of GDP, 1995-2012 (Quarter 3)
(Adjusted wage share)

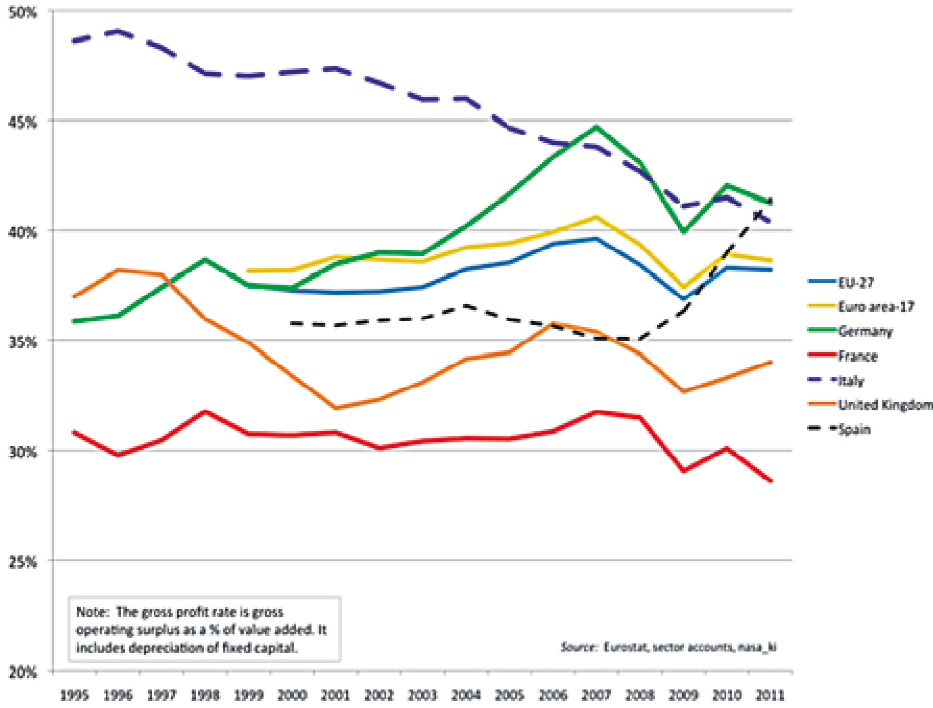


The next part in the chain of logic is also correct: squeezing wages and falling wage shares indeed turn up in rising profit shares (see also previous point).

In Spain, for example (see chart 6), at the level of non-financial companies, the rise in profit shares has been spectacular. Profits, in the midst of the crisis, have simply exploded from 35% of added value in 2009 to more than 40% in 2011. As such, Spanish non-financial companies have caught up with German companies and in matter of just a couple of years. In terms of profit shares in added value, Spanish corporations are now as profitable as German ones.

Profits in the midst of the crisis have exploded

Chart 6. Gross profit rate – non-financial corporations



Record profitability however does not result in higher business investment. Chart 7 shows the share of investment in added value of the non-financial business sector. Comparing this graph on investment with the previous graph on profit shares makes it possible to refute the claim that squeezing wages triggers a boom in investment:

- In Germany, despite a significant increase of the profit share between 2002 and 2007, non-financial business investments actually fell. They did increase at the end of this period, but only marginally so.

- Over the same period, investment performance was much better in France and this despite a stabilization in the share of profits. French investment performance even outpaced German investment from the middle of the previous decade and this positive gap has even tended to increase in recent years and up to 2011.

- In Spain, where profit shares are simply exploding and are reaching over 40% of sector added value, the share of investment has fallen to 23%. This implies that the share of profits in added value of Spanish non-financial companies is now twice as high as their investment share.

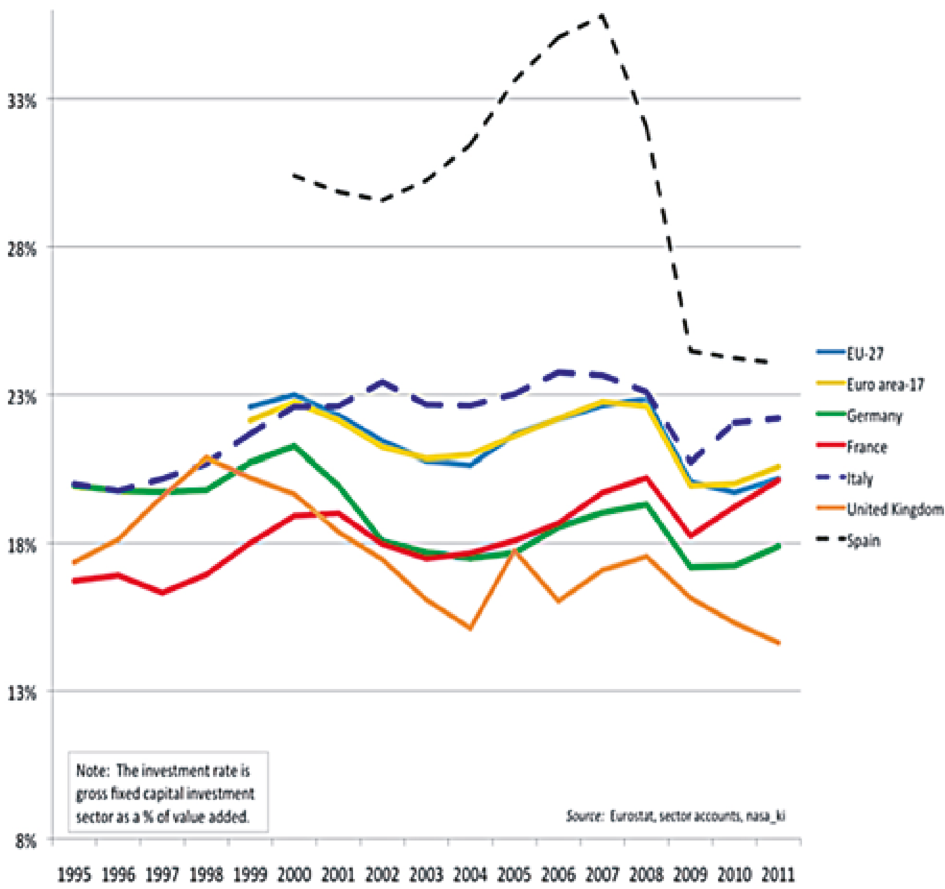
Squeezing wages doesn't lead to a boost in investment

GEZOCHT
ECHTE
BANEN

BEZUINIGEN
IS GEEN WERK

FNV
In Beweging

Chart 7. Investment rate – non-financial corporate sector



France's investment performance outpaced that of Germany

Competitiveness is about innovation, not about wage costs

Quality and complexity explain German export performance

The advocates of austerity claim that wages, labour costs and workers' productivity are the most important determinants of an economy's competitiveness. "Do what Germany has done, cut wages and your exports will boom", or so they say.

The reality shows that things are much more complicated. Competitiveness is not about wages, not about low levels of labour costs or about imposing exhaustingly high rates of productivity. Competitiveness is not about costs, it is first and foremost about the quality of production.

Table 1 illustrates this. The second column of the table shows the average labour cost per worker in the manufacturing sector in 2009. A manufacturing worker is the most expensive in Germany, earning an annual €47000, which by far exceeds the wages paid in Spain, Portugal and Greece.

Mainstream economists will react to these wage statistics by claiming that: 'Yes, wage rates are the highest in Germany, but this is more than offset by the fact that German workers are so much more productive so that, in the end, German products are still the cheapest".

However, the figures in the table contradict this. This can be seen from the third column in the table, showing how the absolute levels of wages and productivity relate to each other. So in German manufacturing, each €100 of wage paid to a worker generates a return in terms of added value of €120.70. In the Euro Area crisis countries however, who are supposed to be totally uncompetitive, €100 paid in wages provides manufacturing business with an added value of €137 in Spain, €147 in Portugal and up to €150 in Greece. This testifies to the fact that manufacturing production in these countries is actually cheaper than in Germany. Even more stunning ratios can be observed in Central and Eastern European countries, where €100 wages translate in an added value that can be twice as high (Czech Republic, €199).

All of this raises a serious question about the mainstream view on wages and competitiveness. If wage costs including productivity are so important for competitiveness, why then is Germany, with its high labour costs, the export champion of the world? The answer to this intriguing question is that Germany is so successful, not because it is producing cheaply, but because it is producing high quality and complex products (machinery, infrastructure equipment, chemicals). These are in high demand from dynamic, emerging economies and Germany has the technical knowhow, the skills and clusters of suppliers that allow it to produce these goods. Copying the anti-labour/anti-wage policies of Germany of the early and mid-2000s (the so-called Hartz reforms) will therefore not deliver export success in other countries, certainly not when several of them would actually go for a coordinated policy and cut wages and labour cuts at the same time (see next point).

Table 1. Wage-adjusted productivity in manufacturing in selected countries, 2009

Country	Apparent labour productivity* (€1000 per employee)	Average personnel costs (€1000 per employee)	Wage-adjusted productivity (%)
EU27	46	34.5	132.1
Czech Republic	22	14.0	154.6
Hungary	23	11.7	199.6
Greece	42	28.0	150.6
Germany	57	47.2	120.7
Portugal	23	15.8	146.7
Slovakia	17	12.3	134.7
Spain	48	35.1	137.2

Source: ETUI Benchmarking Working Europe, 2013

* Apparent labour productivity is defined as value added at factor costs divided by the number of persons employed.

The wage race towards debt deflation

The argument goes that, with fiscal austerity causing domestic demand to collapse, export demand has to take over. And since members of a monetary union can no longer devalue their currency to boost exports, wages need to be devalued instead. To set the engine of export demand into motion, wages need to become very flexible and all institutions that promote or stop wages from falling such as collective bargaining systems or minimum wages need to go.

In Europe, we are not living and working on isolated islands. Our economies are integrated with each other. This implies that the policy of trying to export unemployment to other countries does not work and is dangerous. If all or many countries start to freeze and cut wages, competitive positions with European trading partners will hardly improve. At the same moment, and since one country's wages and domestic demand represent another country's exports, squeezing wages across the whole of Europe will undermine both domestic demand as well as external demand dynamics.

This wage race to the bottom, thanks to the 'Masters of Deregulation' is already taking place and is contaminating more and more member states. The race has started in Greece, Spain and Portugal, where wages have already been severely compressed. In these countries, the trend of rising unit wage costs has been broken and the direction of wage costs is going sharply down (see graph).

The consequence is that the competitive ranking of countries in Europe has fundamentally changed. Up until the 2009 recession (see chart 8), Greece and Spain found themselves at one side of the extremes with unit wage costs diverging the most from the German model of prolonged wage cost stagnation. France and Belgium at that moment positioned themselves on the middle ground, with wage cost dynamics neatly between the zero line of Germany and the 30-40% wage cost increase since 2000 in Spain and Greece.

By 2014, it is not Greece and Spain but France and Belgium who are now deviating most from the German wage cost line. The pressure on trade unions in the latter countries to 'be responsible' and 'do something' is therefore increasing.

However, when this happens and wages and/or labour costs in particular in France are being seriously squeezed, competitive pressures will intensify further. Whereas Spain and Portugal will have to respond to wage squeezes in France to maintain their relative wage cost positions, other members up North (Netherlands) and South (Italy) will then be facing the fact that wage costs from France to Portugal are falling sharply. This vicious circle is closed when German business tells its workers that, given the sharp wage competition from the rest of Europe and given the collapse of European export markets for products made in Germany, there is no other choice but again to freeze or cut wages so as to preserve jobs.

Squeezing wages across Europe will undermine domestic demand

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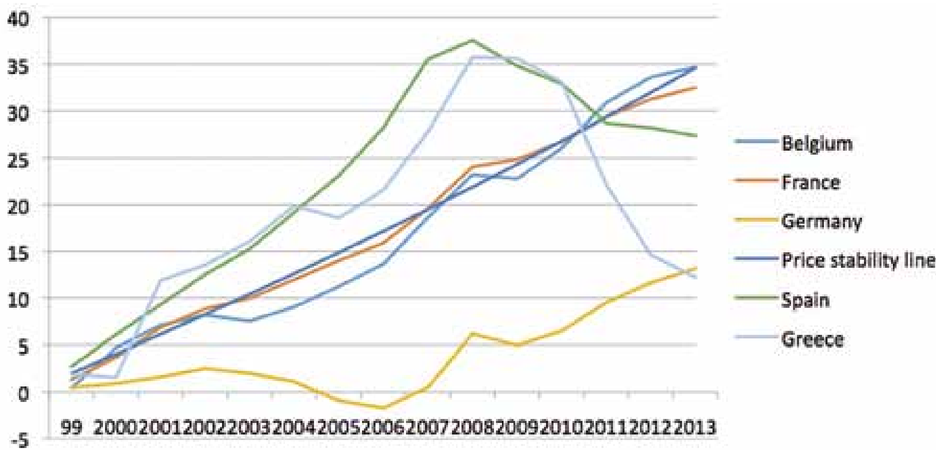
This obsession Europe has with 'wage cost competitiveness' is sheer madness. It risks driving all of us into the abyss of depression, deflation and job destruction.

Chart 8. Compounded evolution in Unit Wage Costs since 1999



Source: Commission, AMECO

EPSU POLICY

EPSU has been arguing since the earliest stages of the crisis that the European economy needed the boost of public spending and public investment and not the cuts of austerity. As long ago as May 2010, the EPSU Executive Committee agreed a statement arguing that:

"… a true, lasting end to the crisis involves boosting purchasing power, employment and public investment. Public expenditure plays a key role in this respect as stimulus and driving force in a certain number of economic sectors. In parallel, these austerity policies reduce and disrupt public services and therefore affect first and foremost the sectors of the population experiencing the greatest difficulties. In our view, the dogmatic approaches subject to the dictates of finance will do nothing but accentuate the social and economic crisis we are going through. We need a genuine, ambitious common European social contract for Europe to regain its place in the world order."

EPSU has also challenged the pay cuts and freezes imposed on millions of public sector workers that have only contributed to undermining demand across Europe and weakening the prospects for recovery. EPSU has monitored the impact of these cuts in The Wrong Target research reports published in December 2010 (www.epsu.org/a/7109) and updated in January 2012 (www.epsu.org/a/8828).

EPSU continues to call for measures to boost the European economy and provide additional sources of income for public services particularly through a financial transactions tax (www.epsu.org/r/575) and through action to recoup the €1 trillion a year lost to tax fraud and tax havens (www.epsu.org/r/640).

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AGAINST AUSTERITY

For another Europe

There are alternatives!

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