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# **Wage Moderation and Rising Unemployment**

## **A Report on Union Motivation**

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An IMF Country report (01/2003) concluded that “wage moderation” played a more important role than reductions in employers’ social security contributions and replacement rates of unemployment compensation or the deregulation of labor markets in generating the increased employment intensity that characterized the expansion and the fall in unemployment in France, Italy and Spain in the second half of the 1990’s. The analysis proceeds in two steps. First, the fact that the increases in employment that occurred were accompanied by reductions (rather than increases) in real effective wages was interpreted as a downward shift in the wage curves (with nominal wages adjusted for productivity as well as consumer prices). Accordingly, the major part of these wage curve shifts was accounted for by changes in the preferences of workers and their union representatives as they placed increased emphasis on “job preservation and creation”. Consequently (and this was the second part of the argument) the incentive for employers to substitute capital for labor was reduced: the elasticity of labor with respect to capital was increased in a “job-rich expansion”. The conclusion: “...wage moderation does work...With unemployment rates in all four countries (including Germany) at historically high levels, wage moderation needs to continue.”

But while unions may “need” to continue to bargain with undiminished restraint as long as unemployment remains high, recent experience in Germany suggests that they might not always be willing to do so if aggregate demand declines, unemployment rises, and moderation no longer appears to work. German experience, it is true, might not provide too relevant an example since Germany is the only country in the study in which real effective product wages, adjusted for unemployment, increased instead of moderating after the early Eighties; and it is the only country in which growth failed to become more labor-intensive in the Nineties (IMF 2002: 104, 115 and 86). This exceptional wage and employment behavior was attributed to the impact of the shock to the economy administered by national reunification at the beginning of the Nineties (obviously a uniquely German phenomenon).

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But in the second half of that decade, real effective wages, both unadjusted and adjusted, did not increase, while unemployment declined significantly from 11.7 to 9.5 percent. (IMF 2002: Fig. III.2). This slowdown in real wage growth (which indeed turned fractionally negative) was attributed to the earlier climb in wage and nonwage labor costs and a consequent reduction in international competitiveness, which was translated into increased employer bargaining pressure (OECD 2002: 24). That downward pressure, however, was complemented by a set of supply-side policies called the Alliance for Jobs which was introduced in 1998 by a new government led by the Social Democrats. It was designed to reduce relative unit labor costs and boost international competitiveness through a variety of measures, including “employment oriented collective bargaining”. Indeed, insofar as employment stopped falling and even rose while real wages declined, especially after adjustment for unemployment, collective bargaining could be described as having become a bit more employment-oriented towards the end of the 1990’s.

The absence of major strikes during this period should also be noted. If a combination of wage moderation and declining unemployment reflected some reorientation of union policies and membership attitudes, it might be expected to have occurred in the context of peaceful industrial relations. In 2002, however, after unemployment had stopped declining (while still at the unsatisfactorily high level of 10.1 per cent) and began to rise again, some fifty thousand auto workers walked out on the Alliance for Jobs as well as on their employers in a series of short “rolling strikes” which ended with contractual increases that were generally regarded as excessive.

Increased union militancy when unemployment began to rise may have been consistent with union moderation when unemployment had been falling. Nevertheless, the question was raised: why should the union have abandoned a policy calling for bargaining restraint when the need for restraint was arguably greater than it had been before the downturn in demand that began in 2001?

Several German union officials discussed this problem with colleagues from Japan and the U.S. at a small informal conference on union policies and unemployment held in Berlin in 2002 (Report 2002). At one point in the proceedings, the participants were informed (or reminded) of a survey of companies in 2000 according to which 34 to 42 percent of the entrepreneurs declared that their employees were willing to take pay cuts in order to save their own jobs while only 3 to 7 percent would do so for the provision of additional jobs (Franz/Pfeiffer 2003: 35). These results are consistent with the “insider-outsider” theory of unemployment, adhered to by many academic economists, according to which “rational” unions seek to establish wage levels that are

low enough to preclude loss of employment within their own jurisdiction but too high to permit employment therein to expand. The theory implies that unions would voluntarily moderate their wages when- but only when- their own jobs are threatened, e.g. by some adverse development in demand or relative costs. This implication was partly confirmed by the German discussants when they reported that they “listen to” the employers and may moderate their demands during slack periods when profits have been reduced (and when the employers’ willingness to take strikes has increased). They also reported that their sectoral agreements had increasingly contained “opening clauses” under which smaller and less cost-efficient establishments, when supported by their works councils, might receive dispensation from the trade unions and employer associations (the parties to collective bargaining) concerned to pay wages below the sectoral contract scale, although usually for only a limited period of time.

However, German unionists were less ready to accept wage restraint as an instrument of sectorwide collective bargaining; whether out of uncertainty that it would effectively reduce unemployment, or because they believed that unemployment could be reduced more effectively by other instruments, or both. Thus the German conferees dismissed a proposal by their Japanese colleagues that wage demands should be moderated in order to increase the competitiveness of currently viable firms. They were certain that their members would not support a policy that presupposed a more direct causal linkage between wages and employment and that did not offer more definite assurance of a satisfactory quid pro quo. As one of the German unionists put it (in a subsequent interview):

This means that the union makes a prior concession and (agrees) to reduce wages and assumes that this wage concession will not get lost in a diffuse process...But you cannot expect the employees and union members to accept the vague assertion that this is a process which goes in the right direction that would mean that the unions and the members have to bear the burden (wage reduction) and conversely have to accept a vague promise...

Work-sharing, or negotiating reductions in the standard work week with compensatory increases in basic rates, has offered a contrasting approach to the reduction of unemployment which was pursued more vigorously in Germany than elsewhere in the Eighties and Nineties. It offers direct linkage between wages and employment because it involves negotiating over wages and hours of work together (“in the same bargaining package”). And, by maintaining the weekly income of the employed members while increasing the amount of leisure time of their disposal, it is supposed to increase the welfare of both employed and currently unemployed workers. However, it resulted in cost increases, which the employer side sought to offset by insisting on the insertion of “opening clauses” in the collective agreements under

which individual firms could gain (with the consent of their works councils) greater flexibility in the assignment of work and scheduling of hours so as to reduce recourse to overtime at premium rates. But this meant reduced opportunity to work overtime when the desire to do so - especially among younger workers - might well have been increased by the reduction in the basic work week. Many felt obliged to take extra part-time jobs at lower wages. Hence the German unionists (at a previous conference) ruled out further reduction in hours, not because it would be ineffective in reducing unemployment (cf. Hunt 1999), but because it was no longer generally acceptable to their members. This approach did not lose its appeal to the more militant leaders in the IG Metall, however: in 2003 they led a strike to reduce the work week in the auto industry in East Germany to levels prevailing in the West. But that strike was lost when members of IG Metall crossed their own union's picket lines. (Financial Times, 06/27/2003 and 07/01/2003).

Meanwhile at the 2003 conference (and in a subsequent interview), the representative of one of the industrial unions put the case for the Schroeder Government's Alliance for Jobs. Unlike the policies discussed above, the Alliance called for wage restraint under Germany's intersectoral system of collective bargaining. It was supposed to reduce, not raise, unit costs; it was supposed to apply generally and not just in exceptional cases; and it was supposed to prevail during upswings in employment as well as in hard times. Its effectiveness was predicated on the existence of a broad social and tripartite consensus on the paramount importance of full employment as a policy objective. It implied that union policymakers would recognize the existence of some tradeoff between wages and employment. They should be willing to bargain over wages with restraint and thus strike a balance between the interests of their employed members and unemployed workers because (as one of union representatives put it) they should feel obliged to regard both employed trade unionists and unemployed workers as members of an all-embracing labor movement. And if a global agreement on wages could be paralleled by one calling for improved and enlarged apprenticeship programs, the average employed member would find that wage restraint paid off in a sense of heightened job security.

Unfortunately, things did not work out that way. Neither side could actually refuse to attend the Alliance meetings called by the new Government, but neither side gave evidence of a serious intent to negotiate. The employers hung back, waiting for the unions to open discussions by indicating their willingness "to correct the mistakes of the past" (apparently by offering wage policies that would reduce relative cost levels). And when the unions countered by proposing additional training slots for apprentices

(“the lowest common denominator”), as a topic for discussion, the employers were reluctant to explore this possible instrument.

On the other side, the representatives of IG Metall (the leading union) complained that wages had really been under restraint since the early Nineties and that their members’ incomes had been reduced relative to productivity and profits. As Figure 1 indicates, the sum of increase in productivity and prices, or “the margin,” rose by about 39.2 per cent while gross wages and salaries increased by only 31.4 per cent between 1991 and 1998; indeed, wages and salaries lagged behind the cost-neutral margin in every year after 1992. Collective bargaining outcome previously had been very close to this “margin of distribution” (Verteilungsspielraum), which the unions accepted as a norm of fairness in the spirit of the “social market economy” and which called for equal sharing in the growth of wealth (see Table 1). However, the adverse distributional changes that occurred in the Nineties, it was claimed, led workers to feel that they had been treated unfairly (even when real wages were increasing in absolute terms); and a cumulation of small changes could touch off increased bargaining militancy and demands that the union negotiators “catch up” with uncompensated increases in prices and productivity. (In fact, an increased share of the growth in prices and productivity was claimed by employer contributions to social security, but it was believed that individual union members were concerned primarily with the level and growth of their take-home pay.) Hence in 1999 – after only a year’s experience with the Alliance for Jobs under the new Schroeder government – the unions called for a “U-turn” and “an end to modesty in collective bargaining” – and that year the “margin” was fully “used up” with wage increases. In the following two years, however, the wage settlements fell short again; and in 2002 the first major outbreak of strikes occurred since 1995.

The German unionists also believed that they suffered injustice at the hands of the fiscal and monetary authorities. They shared with their colleagues from Japan and the U.S. the belief that unemployment results (at least in good part) from insufficient demand and that it is the responsibility of the government of the day or the central bank, as providers of last resort, to maintain employment at satisfactorily high levels. Hence, after the export boom associated with the strong growth in the U.S. economy in the Nineties had subsided and unemployment in Germany reversed course and began to increase again in 2000, the unions supported the Keynesian view that it was up to the authorities to adopt more expansionist monetary/fiscal policies. At the opening session of the conference, however, the Secretary of the Federal Ministry of Economics and Technology tossed the ball back into the unions’ court. He bluntly told the participants that his government was tightly constrained by the limits placed on public deficits and spending by the European Union’s Stability and Growth Pact, and

he reminded them that the European Central Bank was even more insulated and removed from governmental influence than the old Bundesbank had been. Hence the level of demand-related unemployment is essentially determined by the outcomes of collective bargaining which, he implied, should be moderated. His comments were received with a marked lack of enthusiasm, but they provided his audience with material for attempted rebuttal for the rest of the conference. The European Bank was criticized for administering one-size-fits-all-countries interest rates which penalized low-inflation countries like Germany, for excessive aversion to the risk of inflation, and even for allegedly tightening monetary policy in advance of wage settlements which it anticipated would be excessive. As for the Government, if it “brought nothing to the table” (as one of the Americans put it) that the union leaders could offer their membership by way of direct linkage between wages and employment, how could the former be expected to support wage moderation after unemployment had begun to rise? (If the authorities wish wage curves to be shifted downwards, demand curves must be shifted outwards as well - as happen to be illustrated in IMF par. 92.)

But if the authorities had no fiscal or monetary carrots to offer the unions, a stick – in the form of structural decentralization of Germany’s system of sectoral bargaining – was being brandished increasingly by the conservative political opposition and in employer circles as an alternative to wage moderation. The union representatives were, unsurprisingly, opposed. They might have tolerated the use of opening clauses in sectoral contracts, but only to the extent required to halt the erosion of the sectoral bargaining structures and to protect their negotiated levels of compensation and membership density. On the other hand, some of the union negotiators warned that the relocation of formal bargaining from the sectoral level to the firm or establishment could have unintended consequences. They maintained that leaders of sector-wide unions have been in a position to moderate the demands of their more myopic constituents at the local level; and while it was being claimed that more moderation was required than had indeed been forthcoming, the results could be worse if collective bargaining had to be exclusively a local affair. (Some of the Americans warned that what the employers might have really had in mind was the outright elimination of collective bargaining, rather than its decentralization, and its replacement by a U.S.-style “union free environment”; but this alternative to bargaining moderation was not discussed by the Germans.)

In any event, the representative from one union wondered whether the decision to abandon the Alliance for Jobs –and its norm for money wage increases not to exceed growth in prices plus productivity- had been a wise one. Following such a rule might not make up for past distributive injustice caused by a succession of wage settlements

that fell short of the “distributive margins”, but it would be an improvement over what the unions had been able to accomplish in the absence of this type of “restraint” (even when growth was increasing and unemployment was falling.) Nor could a margin-based norm that yields constant unit labor costs generate increased demand and employment in the manner that falling real effective wages and unit labor costs are alleged to have done. The former would not generate job-rich growth; however, it would tend to ensure that any growth that does occur would be noninflationary. Furthermore, by providing the fiscal and monetary authorities with incentives to adopt more expansionist macroeconomic policies, credible noninflationary wage policies might even serve as an indirect source of growth in output and employment. And so a moderate unionist challenged his colleagues:

“Are we a social movement or are we a membership organization... If we go to our membership we focus on collective bargaining for our membership. We can (then) speak (only) for the employed...” (Report 2002)

In attempting to explain why German unions pushed up labor costs when faced with rising unemployment, their representatives at the Berlin conference assigned important roles to limited rationality and to perceptions of unfairness in overriding the dictates of rational self-interest. Rationality is “bounded” by the parochial perspective of the membership, who might be willing enough to accept moderation on the recommendation of their local works council when the latter agreed that their firm was in financial difficulties or, if not, that a threat to outsource their own jobs was credible. But they were likely to reject wage moderation in the interest of employment growth in *profitable* firms even when rejections would place their own jobs in jeopardy. Nor would they be happy with sectoral negotiations (and union negotiators) that called for “a prior concession” on their part with no firm assurance that it would be rewarded by increased employment and job security for those already employed and by higher wages in the future. In part, therefore, the economic rationality of the constituents of these union officials would appear to be bounded by the degree to which the wage-setting process is effectively decentralized, by distrust generated by their limited access to information, and by their own cognitive limitations.

It was our impression that, while the union leaders at the conference may have been somewhat less subject than the average member to such bounds on economic rationality, they (or at least some of them) were more moved by feelings of unfairness or distributional inequity which could be aroused when, for any reasons, wages lagged behind the cost of living and productivity. When such an ethical deficit is associated with a policy of wage restraint, it can be interpreted as a cost of that policy. It is a cost that is an increasing function of the policy’s duration; and when it exceeds the value of the perceived gain from restraint (in the form of reduced unemployment) the unionists



abandon the policy and return to their former immoderate ways. (This could be one reason why – even in the absence of excess demand – incomes policies have tended to lead short lives and why they fell out of fashion after the Seventies.)

The German unionists' primary purpose in renouncing a policy of restraint, as they did in 2002, was redistributive – to “catch up”, or “make up” for accumulated unfairness. In this respect, this homegrown model of union motivation that emerged from the Berlin conference departs from the seminal contribution of Matthew Rabin (1993) according to which individuals (including unionists) who believe themselves to have been treated unfairly react nonrationally and to the detriment of their material interests in order to punish the alleged wrongdoers (rather than to recoup a perceived loss which they may have incurred). (Their ethic is: don't get mad; get even.)

External events also suggest that the intensity of the feelings of unfairness experienced by the German unionists depended on the (divergent) political or ideological orientations of their leaders as well as on the (negative) gaps between the growth of wages and of the “distributive margin”. The strikes in the German auto industry in 2000 and 2003 were directed against the wage policy of an incumbent social democratic government by a dominant left leaning leadership fraction within the pattern-setting IG Metall, which also opposed the government's efforts to reduce the scope and magnitude of the social security system. In contrast, the leadership of a more moderate union at least partially supported the government in both the legislative and bargaining arenas.

The view that a unionist's characteristic militancy or moderation in collective bargaining is related to his or her political orientation receives some support from a potentially important working paper by Blanchard and Philippon (2004). Their cross-country analysis finds (a) that, in each decade in the period 1965 – 2003, a country's rate of unemployment is negatively related to the “quality” (or cooperativeness) of its labor relations (as instrumented by strike activity in the 1960's): and (b) that their quality measure is strongly correlated with the number of votes received by their respective communist parties in the late Sixties. Apparently the hypothesis is that the climate of labor relations is determined by the extent to which union negotiators appreciate when it becomes advisable to moderate wages in the interest of profits, investment, and employment. Their cooperativeness/militancy reflects in turn their prior ideological or political orientation.

Our German unionists would accept the authors' assessment that “most socialist and social-democratic unions now recognize the need for firms to maintain an adequate

profit rate". (Blanchard/Philippon 2004: 17) But not even the more moderate ones (economically and politically) would willingly attempt to persuade their more bounded members at the grass roots to accept general wage restraint (relative to prices and productivity) in the absence of a guarantee to maintain or increase employment. And what they seek (and in some cases have achieved) at the company level is guaranteed performance under efficient contract bargaining under which employers have to negotiate over employment together with wages.

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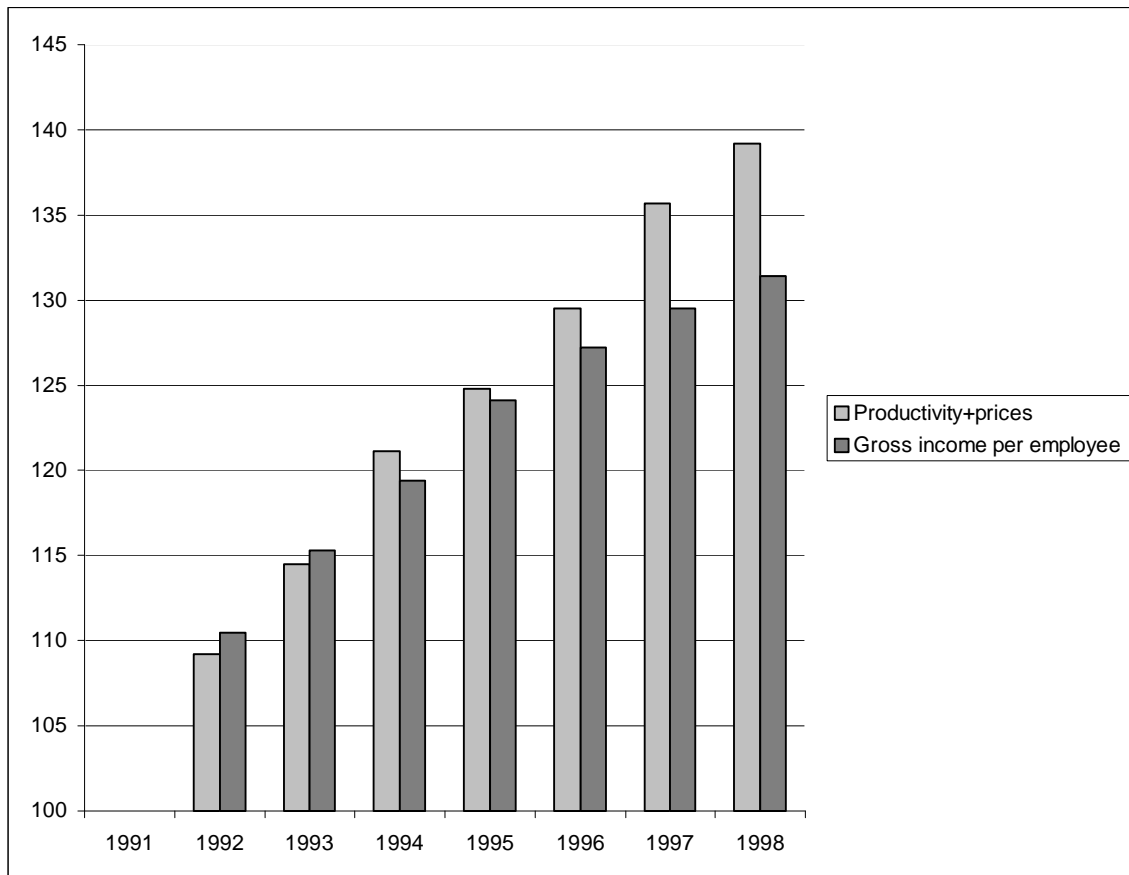
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**Figure 1: Development of Productivity, Prices and Employee Income  
1991-1998 (1991=100)**



Source: Wirtschafts- und Sozialwissenschaftliches Institut, Collective Agreement Archive 1998.

**Table 1: Wages and salaries, negative drift and use of the “cost neutral distributive” margin in Germany 1992-2002**

Year	Cost of living	Labour productivity per employee	“Cost-neutral” distributive margin	Gross wages and salaries per employee	Collectivity agreed wages and salaries	Use of the “cost-neutral” distributive margin	Negative Drift
	(A)	(B)	(A+B=C)	(D)	(E)	(D-C=F)	(D-E=G)
1992	5	3.9	8.9	10.5	11	<b>1.6</b>	-0.5
1993	4.5	0.5	5	4.6	6.5	<b>-0.4</b>	-1.9
1994	2.7	2.7	5.4	2.2	2.9	<b>-3.2</b>	-0.7
1995	1.7	1.9	3.6	3.5	4.6	<b>-0.1</b>	-1.1
1996	1.4	1.5	2.9	1.8	2.4	<b>-1.1</b>	-0.6
1997	1.9	2.6	4.5	0.8	1.5	<b>-3.7</b>	-0.7
1998	1	1.9	2.9	1.4	1.8	<b>-1.5</b>	-0.4
1999	0.6	0.9	1.5	2	3	<b>0.5</b>	-1
2000	2.1	3	5.1	1.5	2.4	<b>-3.6</b>	-0.9
2001	2.4	1.3	3.7	2	2.1	<b>-1.7</b>	-0.1
2002	1.3	1.3	2.6	1.7	2.7	<b>-0.9</b>	-1

Source: Wirtschafts- und Sozialwissenschaftliches Institut, Collective Agreement Archive 2002.

### **Abstract:**

Why, at the onset of a downturn in economic activity and an upswing in unemployment (in the early 2000’s), did the leading trade unions in Germany decide to demand-and in some cases strike for- larger wage increases and denounce a government-led policy of wage moderation, rather than strengthen their adherence to such a policy? Two (related) explanations of this apparently nonrational behavior were offered by German unionists at an informal conference on union policy-making in Germany, Japan, and the U.S. In the first place, it was claimed that at the grass roots union members might be expected to accept wage restraint only if they are convinced that they would be punished for failure to do so (e.g. to accept subcontract wages in marginal enterprises) or if acceptance would be virtually certain to ensure reward in the form of increased job security and employment (e.g. by the adoption of more expansionist fiscal or monetary policies). And second, some of the union participants at the conference claimed that the failure of real wages to grow as rapidly as productivity tends to engender feelings of unfair or inequitable treatment among unionists, which, if allowed to persist, could override the requirements of rational self-interest in pursuing wage policies aimed solely at maximizing the net wealth of the membership.