From wage suppression to sovereign debt crisis in Western Europe:

Who pays for the costs of the crisis?

Version 2

Özlem Onaran
Middlesex University
Department of Economics and Statistics
The Burroughs, London NW4 4BT, UK
+44 20 8411 5956
o.onaran@mdx.ac.uk

Prepared for the Day Conference
Economic Policy: in Search of an Alternative Paradigm
Dec 3, 2010
Middlesex University

Abstract:

This paper discusses the costs of the crisis with respect to public finance and labour market outcomes. The paper shows the effects of the crisis on public debt, and discusses the possible effects on the functional distribution of taxes and the composition of public spending between public goods and inputs. With regards to labour market outcomes, we discuss the trends in employment, unemployment, wages, wage share, and personal income distribution after the crisis.

Keywords: crisis, public debt, wages, wage share, unemployment, employment
1. Introduction

This paper develops on the argument that the rise in inequality is one of the main causes of the global crisis and discusses how the costs of the crisis are being distributed. Throughout the crisis the governments have heavily intervened to socialize the losses and risks of the private financial sector, although the profits of the fragile growth regime, which has led to the crisis, remain to be private. What we understand from the socialization of the costs is not only the use of the tax money for generous rescue packages in a narrow sense, but also the broader effects of the crisis on distribution. We discuss the costs of the crisis with respect to public finance and labour market outcomes. With regards to public finance, we show the effects of the crisis on public debt, and discuss the possible effects on the functional distribution of taxes and the composition of public spending between public goods and inputs. With regards to labour market outcomes, we discuss the trends in employment, unemployment, wages, wage share, and personal income distribution after the crisis.

The following section discusses the distributional background of the crisis in Western Europe based on the cases of three countries in the core (Germany, France, Britain) and four countries in the periphery of Europe (Greece, Ireland, Portugal, Spain). Section three analyses the distribution of the costs of the crisis. Section four concludes with policy implications.

2. From wage suppression to sovereign debt crisis

There has been a secular deterioration in the labour share in Europe as well as in the global economy since the early 1980s along with the dominance of neoliberalism. The increase in globalization, in particular the mobility of capital, and the stagnation in aggregate demand and rise in unemployment have been the central powers behind this pro-capital redistribution of income.

However, the decline in the labour share has created a potential source of crisis: profits can only be realized if there is sufficient effective demand for the goods and services. But the decline in the purchasing power of labour has a negative effect on consumption, given that the marginal propensity to consume out of profits as well as rentier income is lower than that out of wages. This affects investments negatively, which are already under the pressure of shareholder value orientation. The decline in the labour share has been the source of a potential realization crisis for the system. Thus neoliberalism only replaced the profit squeeze and over-accumulation crisis of the 1970s with the realization problem.

The financial innovations seemed to have offered a short-term solution to the crisis of neoliberalism in the 1990s: debt-led consumption growth. The debt-led growth model was facilitated by the deregulation in the financial markets and the consequent innovations in
mortgage backed securities, collateralized debt obligations and credit default swaps. However, without the unequal income distribution the debt-led growth model would not have been necessary or possible. Particularly in the US, but also in Britain, Ireland or some continental European countries like Netherlands, Denmark, Spain, Greece, and Eastern Europe the household debt increased dramatically in the last decade. The increase in housing credits and house prices fuelled each other; then the increased housing wealth thanks to the housing bubble served as collateral for further credit, and fuelled consumption. Because of high debt levels, the fragility of the economy to the possible shocks in the credit market also increased.

The mirror image of the debt-led consumption model was global imbalances: a current account deficit in the US that exceeded 6% of the GDP was financed by the surpluses of some other developed countries like Germany and Japan, developing countries like China and South Korea, and the oil rich Middle Eastern countries. Similar imbalances took place within Europe between the surplus countries in the core and the periphery of Europe. In Germany current account surpluses and the consequent capital outflows were made possible by wage moderation, which has suppressed domestic consumption and fuelled exports. The wage suppression strategy and current account surpluses of Germany were matched by current account deficits, public or private debt in countries like Britain and Italy in the core as well as Greece, Portugal, Spain, and Ireland in the periphery of the Eurozone or in Eastern Europe.

At the root of the problem of these divergences within Europe is the neoliberal model that turned the periphery of Europe to markets for the core countries without any prospect of catching up. The lack of a sufficiently large European budget and significant fiscal transfers targeting productive investments in the periphery led to persistent differentials in productivity. Stability and Growth Pact as well as EU competition regulations limited the area for manoeuvre for the implementation of national industrial policy. In the absence of industrial policy and productive investments to boost productivity, and unable to devalue, the strategy of competitiveness was based mainly on wage moderation, and increased deregulation and precarisation in the labour markets, which further eroded labour’s bargaining power throughout the EU. In Ireland the integration to the core took the form of attracting Foreign Direct Investment based on low wages; and consequently despite productivity booms in the 1990s, real wage increases remained much lower than that in productivity until 2000s. Overall labour’s share in income declined sharply in that period (see Figure 1).

Figure 1
The decline in the wage share does not reflect the full dimensions of increase in inequality in some countries. In both Ireland and Britain, the share of top 1% in total income (before tax) increased dramatically from the post-war low levels of 6-8% respectively to 10-13% as of 2000 (Atkinson and Piketty, 2007). While this is very similar to the trends in the US, in the other continental European countries, such a rise in top income did not take place or has been at a much more modest as in the case of Germany. Part of this increase is related to the hike in managerial wages, which makes the fall in the wage share look more modest than it is in reality for the majority of the wage earners.

However, wage moderation also did not save the countries in the periphery of the Eurozone, like Greece, Portugal, Ireland, Spain, since Germany was engaged in a much more aggressive wage and labour market policy: in the 1990s and 2000s productivity increases exceeded changes in real wages in all Western EU countries (except Portugal), with the gap being largest in Germany and Ireland (see Table 1). In Germany and Spain real wages even declined in the 2000s. Thus the gap between wages and productivity in Germany in the 2000s was due to real wage decline, and not necessarily high productivity. Moreover, in the periphery nominal labour costs have increased faster than in Germany due to a higher rate of inflation.

Table 1

The low investments despite a high profit share explain the stagnant productivity and low rates of GDP growth in Germany. German case is also in striking contrast to France, where the gap between real wage and productivity growth is the smallest. France did not have Germany’s export boom, but domestic demand and employment growth has been much stronger.

With weak domestic demand due to low wages, exports were the main source of growth in Germany, but this has been detrimental for the exports of the peripheral countries due to both loss of competitiveness and the contraction of the domestic demand in Germany. Indeed Germany is like the China of Europe with large current account surplus, high savings and low domestic demand. This neo-mercantilist policy has also been a model for some other countries like Austria and the Netherlands. In Spain, Greece, and Portugal consumption led by private debt has filled in the gap that low exports and high imports have created. In Ireland the effects of the core-periphery relationship have manifested themselves differently: Ireland has had a trade surplus but a current account deficit due to massive repatriation of profits by the Multinational Enterprises. Construction boom, real estate bubbles, and private debt have been a typical feature particularly in Spain and Ireland to maintain growth and consumption in an
era when wage share was falling. In Greece and to a lesser extent Portugal fiscal deficit also played a compensating role along with the debt of the households and corporations. This is the background of the divergences between the periphery and the core in Europe, which has led to serious sovereign debt problems in the periphery.

There have been significant differences in the effects of the crisis in different European countries due to these divergences, which already existed prior to the crisis. In the core, Britain had a deep recession due to dependence on financial sector, its own overextended banks, over-indebted private sector, and housing bubble, and GDP contracted by 6.4% peak to trough (between the first quarter of 2008 and the third quarter of 2009), and the recession has lasted longer than in Germany and France. The exposure of the domestic banks to the toxic assets in the US financial markets has been one of the earliest transmission mechanisms of the crisis to the other core European countries like Germany and France. Germany did not have a household debt problem, but has particularly suffered from the curse of its neo-mercantilist strategy of export based growth via wage dumping, as the export markets shrank. From peak to trough (from 2008.Q1 to 2009.Q1) German GDP declined by 6.6%, while French GDP contracted by just 3.9% in the same period. Contrary to Germany, in France a better developed system of automatic stabilizers, a larger state sector and a better position in terms of income inequality made the conditions of the crisis more moderate at the onset, since the weakening of international demand was less important (Fitoussi and Saraceno, 2010).

In the periphery of Europe, Ireland, with its disproportionately large banking sector and the bust of its housing bubble has had the deepest recession. The contraction in Ireland’s GDP has reached 14.3% from peak to trough (between 2007.Q4 and 2009.Q4). The recession also hit Spain hard with the collapse of the housing bubble and the consequent contraction in construction, and GDP has contracted by 4.9% from peak to trough (from 2008.Q1 to 2009.Q4). Most importantly the imbalances between the core and periphery of Europe, and the limited fiscal capacity of the periphery to tame the crisis evolved into a sovereign debt crisis in Greece followed by Ireland, Portugal, and Spain in 2010. As of the second quarter of 2010 (the latest available data), the recession in Greece was still deepening, and the economy has contracted by 5.7% compared to the peak in 2008.Q3. Ireland, Greece, and Spain are expected to end 2010 in a recession. The length of the recession has also been longer (7-8 quarters as of 2010.Q2) than in the core countries.
Following speculations about Greece’s default and exit from the Euro, the Eurozone governments’ decided a bailout package of €110 billion in spring 2010 after months of hesitation. EU unveiled later in May a further package of €500 billion to be supported by a €250 billion IMF facility to defend all Eurozone countries.

The ECB’s initial response was only to announce in March 2010 that it will continue to accept from the banks bonds with ratings as low as triple-B-minus as collateral; later it even accepted the Greek bonds after they were downgraded to Junk status. Finally in May under the pressure of banks and the Commission, ECB made a U-turn and launched a programme of buying up the bonds of the peripheral Eurozone countries from the banks.

3. Who pays the costs?

In the following, we will discuss the costs of the crisis and their distributional effects under two headings: public finance and labour market outcomes.

3.1 Public finance

The most obvious cost of the crisis has been the increase in public debt and budget deficits. The increase in budget deficits would not be there, if it were not for the bank rescue packages, counter-cyclical fiscal stimuli to tame the crises, increases in social protection spending due to the rise in unemployment, and the loss of tax revenues during the crisis. The crucial question is then who will carry the burden of the debt either in the form of increases in taxes or decreases in public spending. Thus the question of distribution of the costs becomes a question of changes in the composition of taxes and spending.

Table 2a shows the budget deficit/GDP during 2006-2010 in selected countries. In all countries there is a significant increase after the crisis, but most notably in both Spain and Ireland as well as in Germany budget surplus of 2007 turned into a deficit. In Ireland the change has been the most dramatic. Ireland’s major problem has been the guarantees of the government for the whole debt of the banks. As the housing bubble bust and international funding became scarce, the banks engaged in leveraged property lending found themselves in the edge of bankruptcy and the state had to support the capital of the banks beyond initial expectations. This will hike the budget deficit of the government to 32.4% as of 2010. The crisis had already led to an initial budget deficit of 7.3% of GDP in 2008 and 14.3% in 2009. Faced with the new needs to support its leveraged banking sector with a disproportionate size relative to the size of its small economy, Ireland had to accept a bailout package of €85 billion from the IMF and EU.

Table 2a and b
Table 2b shows the ratio of public debt to GDP. Again debt/GDP ratios have been modest in all cases except Greece until the crisis. Between 2007 and 2010, the cost of the crisis has been an increase in the public debt by 10.8% in Germany, 19.2% in France, and 33.4% in Britain. In the periphery the cost has ranged between 20.0% in Portugal to 35.2% in Greece and the most dramatic increase is by 72.4% in Ireland. Britain in the core and Ireland in the periphery stand out with the highest increases in public debt due to their overextended banking sector.

This is the background of the financial crisis, which is now being repackaged as a public debt crisis by the governments. How the governments will change the composition of their tax revenues and spending in order to deal with the debt problem is the next question in terms of the distribution of the costs of the crisis. Regarding the distribution of taxation, the time lags in the release of the tax data by functional income groups does not let us make a concrete analysis yet. However, even before the austerity measures most of the tax burden fell on labour income, or consumption—a regressive type of taxation—as can be seen in Table 3. The two categories together make up 68.4% (in Britain) to 81.6% (in Germany) of total tax revenues in 2007 according the latest data available. Austerity measures, which will be discussed in more detail below, will lead to further shifts in this direction due to increases in the VAT. Perversely some countries like Britain and Greece are decreasing corporate tax rates along with increases in the VAT, which will increase the share of labour taxes in financing the costs of the crisis further.

Table 3

Regarding the changes in the composition of public spending, it is too early to see the full effects. In particular social protection spending, e.g. unemployment benefits, is initially counter-cyclical. But the planned cuts aim at a tightening of the conditions of unemployment benefits or freezes in the benefits. Yet if these measures result in a deepening of the recession, despite a worsening in the conditions of the unemployed, the total unemployment benefit payments or other welfare spending may paradoxically increase. Another change we will observe in the medium run will be a fall in state pension payments along with cuts/freezes in pensions and increases in the retirement age. In general we can expect a shift in the composition of spending from public goods, which benefit the immobile factor of production, i.e. labour, towards public inputs, which favours capital, i.e. the mobile factor of production, as countries try to compete for attracting firms during a global recession in the current state of the political balance of power relations between labour and capital. In addition to social protection spending, expenditures in education, health, culture, and recreation fall under this
category of public goods that will be the targets of cuts or privatization efforts. Although in some countries, there may be some persistence in the share of spending on social protection or other public goods based on the path dependency of institutional structures and balance of power relations, even in these cases we can expect that more of the social spending will be financed by taxes on labour and consumption in the future. This is consistent with the finding of Onaran et al (2010) and Onaran and Boesch (2010) about the effects of globalization on taxation and social spending.

In the following, we present the details of the austerity measures announced so far in the selected countries. Ireland, until recently, had been the role model pointed out by the EU politicians for Greece in spring 2010, as it had already smashed public sector wages between 5-15%, cut social welfare spending and other spending in order to decrease its budget deficit to 10% in 2011 and 2.9% in 2014. These brutal spending cuts and the detrimental pro-cyclical fiscal policy in Ireland had been praised, since they had at the time restored market confidence without aid from the EU. However, now as the new problems with the banking sector have emerged, the government has further committed itself to a new round of austerity policies (Burke, 2010): real spending on education and health will fall by 7.5% and 12.5% respectively. Expenditure on other programmes will drop by 27.5%. Social welfare budget will be cut between 5-10%. There will be possibly public sector job cuts despite the former consensus between the unions and the government (McDonald, 2010). Minimum wage will be cut by 12%. In the meantime, Ireland is resisting any increase in its record low corporate tax rate of 12.5%.

The list of measures implemented in Greece are similar: Greece committed to cut its budget deficit from 13.5% of GDP in 2009 to 3% in 2013 via dramatic cuts in spending, public sector employment and wages and pensions, increase in retirement age, cuts in unemployment benefits, tax hikes in indirect taxes and reduction in corporate taxes, along with a fight against tax evasion. Public sector wages are to be cut by 20-30%, and frozen for three years; only one out of five retired employees in the public sector is to be replaced (Lapavitsas et al, 2010). There are also efforts to increase the use of temporary labour contracts. Finally a large privatisation programme is planned for public land, ports, airports, railways, finance, energy and utilities (Lapavitsas et al, 2010).

Portugal and Spain have also committed to austerity packages with higher taxes on consumption, decreases in social spending and pensions, and freezes/cuts in wages and employment in the public sector. Spain has cut public sector wages by 5% and passed a new labour code to increase labour market flexibility.
In the core of Europe, Britain is leading austerity policies. The aim is to cut the budget deficit, which is 11.4% of GDP in 2009 and 11.8% in 2010, to 1.1% of GDP by 2015-16. Dramatic cuts in the welfare budget and the tightening of the conditions of eligibility for the job seekers allowances, cuts in most government expenditures including higher education and housing, pay freezes in the public sector, planned restructuring in public sector pension schemes are supposed to make up three quarters of the decrease in the deficit. Only one quarter of the decrease in the deficit is via increases in taxes. The government has increased the VAT in 2011 while it is decreasing the corporate tax rate from 28% to 24% by 2014 starting from 2011. There is a levy of 0.04% on the bank balance sheets in 2011; however the decline in corporate tax rates will possibly more than offset this levy. No new levy is introduced on bank bonuses or profits. Capital gains tax increased slightly and the income tax threshold for personal allowance is raised to 7475. Overall the measures will reduce the income of lower income households more than that of higher income households (Emmerson, 2010).

Although the deficit in Britain is one of the highest in the EU, the average maturity of the debt is 13.7 years, the interest rate is at historical lows, and the ratio of debt to GDP is only 68.2% in 2009 and 77.8% in 2010 despite the significant increase after the crisis. This is well below many other EU countries. Moreover public sector cuts at this stage will turn stagnation into a double dip recession. Under these circumstances the talk about a fiscal crisis looks more like an excuse of the business lobbies to avoid tax increases to finance the budget deficit, and make the wage earners pay the costs of the crisis through cuts in income, jobs, and social services, to create a situation of “national emergency” to smash the remaining power of the trade unions, particularly in the public sector, and to decrease the size of the public sector. This situation shows a striking resemblance to the motivations of the Thatcher government as described by Sir Alan Budd - a monetarist economist and a Treasury civil servant in the 1970s, chief economic adviser to the Treasury during 1991-1997- in an interview in 1990: “many in the Thatcher government never believed for a moment that [monetarism] was the correct way to bring down inflation. They did however see that this would be a very good way to raise unemployment. And raising unemployment was an extremely desirable way of reducing the strength of the working classes... What was engineered - in Marxist terms - was a crisis of capitalism which re-created the reserve army of labour, and has allowed the capitalist to make high profits ever since” (cited in Cohen, 2003). If we replace “monetarism” by “tight fiscal policy” and “inflation” by “public debt/budget deficit”, this can well fit the discourse of the current government of Britain.
In the other core countries of Europe budget deficits have also increased, but not as dramatic as in the periphery or in Britain. However, there is still talk of tight fiscal policy. France and Germany have just increased the retirement age. Another major problem in the core will be the costs of the bailout packages for the periphery. The Eurozone governments are indeed protecting their own banks that are holding the bonds of the governments in the periphery against a default. The bulk of the Greek bonds are held by German and French banks (The Economist, 2010). Outside the Eurozone, Britain is also troubled: it tried to stay out of the large defence scheme; however this proved to be premature after the attacks to the bond markets of Ireland. As a result of the involvement of the Banks in Britain in the Irish banking industry, British tax payers in Britain will finance up to £10 billion of the rescue package as a result of the government’s attempts to bailout the Banks in Britain. This is in striking contrast to the cuts in spending in Britain.

The speculators also now worry that these measures are not a solution to the problems: first they think that the default of Greece or other countries in the periphery may be inevitable given the popular resistance, the size of the debt and the recession. Second, in a schizoid way, they are also worried that austerity measures will deepen the recession in not only Greece or Ireland but also core countries like Britain, and create a double dip in the global economy, decrease tax revenues, and make it even harder to pay the debt back. They are right; there is a major inconsistency in this austerity plan: as the recession becomes deeper, tax revenues will become lower and despite severe cuts, budget deficits do not improve as much as planned as can already be seen. The estimates of IMF indicate that if Greece reduces its budget deficit to 2.6% of GDP by 2014, its GDP will contract so much that its debt to GDP ratio will rise above 150%. The latest developments in Ireland are also very telling: despite being the poster boy of austerity measures at the beginning of 2010, in less than one year the banking crisis put Ireland once again under focus; the austerity plans are now creating the conditions of a deepening recession in both Greece and Ireland, and it is unclear how the austerity plans will rescue the public or private sectors from insolvency. Finally, the worries about private debt, which may make further rescue packages necessary, are growing.

A long global recession seems very likely without the support of strong and coordinated fiscal stimuli. The uncertainty about the strength of the recovery is making new investments as well ashirings less likely. Decline in income and confidence, job losses, the pressure to pay back debt is restraining household consumption. Both investments and consumption will not return back to normal even when the banks relax credit. The presumed positive effect of reduced budget deficit on private investments is based on the argument that
lower government borrowing leads to lower interest rates and a higher private investment and spending. Under the current conditions where consumers and firms are trying to reduce their debt and interest rates are already low, this channel has no relevance.

3.2 Labour market outcomes

These conditions are turning the public debt crisis into a jobs crisis. Table 4 shows the cumulative change in GDP, employment, and hours worked (all seasonally adjusted) from the peak to trough of each variable as well as the second quarter of 2010 (the latest data available in the OECD National Accounts) compared to the peak. In Germany, France, Britain, and Portugal employment started falling one to three quarters after GDP. The fall in employment has lasted longer than that in GDP in all countries except Germany, and although the fall has stopped in the core countries, it is still going on in the periphery. In Germany after the initial job losses, employment has recovered, and the overall decline in employment is just 0.1% in 2010.Q2 compared to the peak. France has also had a modest fall in employment of 1.7% in 2010 compared to the peak. These outcomes in France and in particular in Germany are related to the adjustment of hours worked due to the short working time arrangements supported by government subsidies (Leschke and Watt, 2010). Hours worked started to decrease earlier and have fallen more than employment in Germany and France. Interestingly in Ireland, Spain, and Portugal the reverse is true: hours have decreased more than employment from peak to 2010 second quarter. This can be explained by the lack of fiscal capacity to support short time work arrangements. In all countries except Portugal there has been a rise in part-time employment. Unfortunately there is no data for hours worked for Britain and Greece.

Table 4

In Germany, France, Britain, and Greece the fall in employment in cumulative (as of 2010.Q2 compared to the peak) has been less than the fall in GDP (compared to its own peak); however the reverse is true for Spain, Portugal, and Ireland. The higher share of temporary contracts in Spain and Portugal (31.7% and 22.4% as of 2007 compared to 14.4%-14.6% in France and Germany), the concentration of the crisis in the construction sector in Spain and Ireland, and the lack of short time working arrangements have contributed to this fact. Britain did not have a government subsidized short working time arrangement; however voluntary unpaid leaves, wage freezes, or nominal wage cuts have led to a less severe fall in employment compared to the fall in GDP.

As a result in Germany short working time arrangements have significantly moderated the rise in unemployment rate, which has increased by a mere 0.5%-point at its peak in
2009.Q2 compared to 2008.Q4 (see Figure 2). Unemployment rate in Germany is now even lower than its pre-crisis level. However it is yet to be seen what will happen to unemployment in Germany when the short working time arrangements are eventually terminated and the export-led recovery loses steam as the advanced economies stagnate. The termination of short working time arrangements may spread the problem of unemployment from lower skilled temporary workers to higher skilled workers.

Figure 2

France and Britain have experienced increases of 2.3%-points and 3%-points in unemployment respectively as of the third quarter of 2010 (compared to the trough point), and the increase has been persistent and continuing during the weak recovery in 2010. The increases in Greece and Portugal have been 4.7%-points and 3.2%-points respectively as of 2010 (the second quarter in Greece and third in Portugal compared to the trough point). Particularly high increases took place in Ireland and Spain: 9.5%-points and 11.4%-points respectively (as of 2010.Q3 compared to the trough point). Unemployment rate is now as high as 20.6% in Spain and 13.9% in Ireland. Unemployment is expected to increase further and display a significant persistence in all countries. ILO (2010) estimates that employment rates will not return back to the pre-crisis levels before 2014.

Firms might want to make use of the recession to rationalize a strategy of increasing productivity and start a new wave of firing or engage in hiring freezes long after the recovery. As firms increase the working hours and delay hiring, this worsens the job chances of the unemployed and the young first time job seekers, and may lead to an increase in discouraged workers who drop out of the labour market. The crisis has already led to an increase in long term unemployment as well as youth unemployment rate. The share of long term unemployed in total has increased in all countries except Germany in 2009 compared to 2008 (see Figure 3). The increase had started already in 2007 in Spain, Ireland and Britain. The sharpest increases have been in Ireland and Spain with 1.7%-points and 2.3%-points respectively. Youth unemployment has increased in all countries, although in Germany the change is very modest at the moment (see Figure 4). The increase has been 4%-point in France and Britain in 2009 compared to 2008. Again the most dramatic rise took place in Ireland and Spain with the youth unemployment rate reaching to 24.4% and 37.8% respectively in 2009. There are also structural problems of unemployment in sectors like automotive industry and construction, where the crisis only uncovered the already existing bottlenecks. Recovery of the aggregate economy will not necessarily create jobs in these sectors.

Figures 3-4
It can be argued that the unemployed have been the first victims to pay the costs of the crisis. The effects on the living conditions of the rest of the working population is only starting to be felt through cuts in spending in social services and the consequent rise in the cost of living in countries like Britain, Greece, Ireland, Spain, and Portugal, who have started major austerity programmes in 2010. Wage cuts/freezes in the public sector, which are either planned or already under way, will also hurt the wage earners in the private as the public sector wages play a signal role for bargaining. The effects of increased unemployment on the bargaining power of workers will also be felt increasingly more. However most of these effects on wages will be realised by a lag. Moreover wages are often bargained in the previous year, and there is a time lag until labour market and macroeconomic conditions are reflected in the future contracts. In particular, the crisis has come after a period of increasing consumer price inflation in late 2007 and early 2008 following the food and energy price shocks. In several countries real wages had decreased in 2008 (France, Britain) or stagnated (in Germany, Ireland, Portugal) partly due to unexpected inflation (own calculations based on OECD National Accounts data). The wage bargains for 2009 had reflected the persistence of these expectations or the correction of the previous losses (O’Farrell, 2010). As a consequence, in 2009 real wages in the aggregate economy have increased in all countries but Germany, where they were just stagnant (own calculations based on OECD National Accounts). The private sector wages have decreased in Germany and Britain in 2009 (own calculations based on OECD Economic Outlook).

Table 5 shows the latest developments in real wages for 2010. The real wage data for the aggregate economy is available as of the second quarter of 2010 in the OECD National Accounts; however there is no data for private sector wages in the National Accounts. The real wage data in the private sector is calculated based on the forecast for labour compensation in OECD Economic Outlook (June 2010), which however only reports annual data for wages in the private sector. Since the data sources are different and the private sector data is based on forecasts from June 2010, a comparison of the private and public sector wages is not possible.

Table 5

In France in 2010 real wages are stagnating in the private sector, and decreasing slightly in the aggregate economy; thus despite unemployment real wages have been preserved in 2010. In Germany real private sector wages have fallen in 2010, and the aggregate wages as of 2010.Q2 are slightly lower than in their peak (in 2009.Q1). This fall is due to the lower hours of work rather than a fall in hourly wages. In Britain in 2010 both total
and private sector wages are falling; the fall in aggregate wages as of 2010.Q2 has reached 1.75% compared to the peak (in 2009.Q4). Also in the periphery both aggregate and private sector wages are falling. The cumulative decline in aggregate wages in Greece has been particularly high by 7.1% as of 2010.Q2 compared to 2009.Q3. Sharp and long-lasting increases in unemployment are likely to make the wage losses much stronger in the future.

Data on personal income inequality is released with a time lag; however in 2008 compared to 2007 the ratio of the income share of the top 20% to the bottom 20% have already increased in France, Britain, and Spain. There is a decrease in the other countries. In Britain, data is also available for the income share of the top 10% to the bottom 10%, which has increased from 7.04 in 2007 to 7.28 in 2008. The Gini coefficients in 2008 have also increased in France and Britain compared to 2007 (from 26 to 28 in France and from 33 to 34 in Britain). Although the increases in inequality in this first year of the crisis are modest, it is still striking given the hikes in top income shares on the way to the crisis. In Britain between December 2009 and April 2010, bonus payments increased by 16% in the aggregate economy, and 25% in the financial sector. Although bonus payments still remain below the levels seen in 2006-07 and 2007-08, they are still 50% higher than they were in 2000 across the whole economy. Again in Britain the number of High Net Wealth Individuals (with investable assets above $1 million) has increased by 23.8% in 2009 indicating a partial even if not complete recovery in the wealth of the HNWI.

Finally Figure 1 shows the trends in the adjusted wage share after the crisis. In 2008 and 2009 the share of wages in GDP has increased in a counter-cyclical fashion as a result of decreases in productivity, with the exception of Britain in 2008 when wage share fell. However, in 2010 in all countries both in the core and the periphery the wage share is expected to decrease according to the estimates of the European Commission Economic and Financial Affairs (AMECO, November 2010 forecasts). The sharpest decreases are taking place in Ireland (2.2%-points) followed by Greece (1.8%-points), Britain (1.2%-points), Portugal (0.7%-points), and Spain (0.6%-points).

It is usual that during a recession, labour’s income share slightly increases. However, the long recession of Japan is indicative how wages may develop if the recession persists. In Japan, in the later years of the recession, not only wage freezes but also nominal wage declines took place as deflation persisted (in 1998-99, 2002-04, 2007). The firing of many workers in the first half of the 2000s has been influential in this process. After the recession, the institutionalized wage co-ordination mechanism was almost broken down (Uemura, 2008). As a measure against labour hording in large Japanese firms, the number of non-
regular workers increased dramatically; there has also been a shift towards unstable service jobs (Uemura, 2008). All these developments have led to a weakening in the bargaining position of unions and the suppression of nominal wage growth. Overall the wage share decreased by 6.9%-points as of 2007 compared to 1998, and 6.6%-points compared to 1992. The decline in the wage share contributed to a decline in domestic demand, and exports became an important source of demand again in Japan, which also increased the pressure of international competition with the other Asian countries and the increasing number of foreign affiliates of the Japanese multinational firms (Uemura, 2008).

The long recession of Japan led to a strong and continuous increase in unemployment from a level of 2.1% in 1991 to 5.4% in 2002. Despite the recovery since 2003, unemployment as of 2007 was still higher than in 1997. Adverse developments in total unemployment, long term unemployment and youth unemployment took place despite a strong decline in male as well as female labour force participation rate, which declined from 64.1% in 1992 to 59.6% in 2007. Although the unemployment rate in Japan in its peak point is still lower than in most other advanced countries, it is important to realize that drastic increases in unemployment can radically change the industrial relations and wage bargaining process in a persistent way.

The experience of Japan shows that the episodes of crisis intensify the distributional struggle. The crisis also creates a hysteresis effect that destroys the bargaining power of labour for a long period afterwards. Diwan (2001) defines crises as episodes of distributional fights, which leave "distributional scars". Needless to say, the global dimension of this crisis will make these effects stronger.

4. Policy implications

The existing policies in Europe has three fundamental flaws: First the decision of the EU is assuming that the problem is a lack of fiscal discipline and repeats the old faith in strengthening the surveillance of budget deficits; it does not question the reasons behind the deficits; it ignores all the structural problems regarding divergence in productivity, imbalances in current accounts due to the “beggar my neighbour” policies of Germany. The austerity packages throughout the EU are pushing the countries into a model of chronically low internal demand based on low wages. The deflationary consequences of wage cuts may turn the problem of debt to insolvency for private as well as the public sector. In the past in Germany low domestic demand was substituted by high demand for exports. But it is not possible to turn the whole Eurozone into a German model based on wage suppression and austerity, since without the deficits of the periphery German export market will also stagnate.
Particularly for the periphery of Europe contraction in domestic demand means prolonged recession. Second, the mainstream policies are based on the argument that Europe has a sovereign debt crisis, which ignores the fact that public debt would not have increased at the current rates if it were not for the financial crisis, which was prevented by unprecedented bank rescue packages; which in turn increased the budget deficits along with lost tax revenues and increased social spending because of the crisis. Therefore the banking sector, which has generated the crisis, should pay for the effects of the crisis on the public budget –the current policies in Europe aim at exactly the opposite. Third, the underlying reason behind the crisis was unequal distribution of income and wealth. Thus a fundamental reversal of this process requires redistribution in favour of labour.

A radical restructuring of public finance is the only way to address these three problems. There are two aspects of this new policy of public finance: First, a highly progressive system of taxes, coordinated at the EU level, on not only income but also wealth, higher corporate tax rates, inheritance tax, and tax on financial transactions is central to this process. This would make the banks, the private investment funds, as well as the individuals with high income and wealth and the corporations pay the costs of the fiscal crisis, and reverse the pro-capital income distribution. To cite a recent historical case from Britain, between 1974 and 1979 the top income tax rate was 83% on annual incomes above £90,500 in today’s prices (£24,000 in 1979). This is a striking comparison to the current top income tax rate of 50% above an annual income of £150,000 in Britain.

The second important dimension of restricting public finances is debt restructuring and default in both the periphery and the core of Europe following a process of debt audit. This has to be coordinated at the EU level as part of a broader public finance policy to make the responsible pay for the costs of crisis. Debt default is not just a question of solvency as in the case of Greece or Ireland; but it is also a question related to the origins of the public debt. In Britain despite the discourse of the government, public debt could be paid without major cuts; however the newly generated debt because of the crisis that amounts to 33.4% of GDP still raises the question why taxes of working people should be used to pay this debt.

Finally EU policies should aim at reversing the origins of the divergences within the EU. On the incomes and labour market policy level, there is need for a fundamental correction of the wages in both the periphery and the core to reflect the productivity gains of the past three decades fully. To facilitate convergence a minimum wage should be coordinated at the EU level. Fiscal policy and incomes policy should also be coordinated: higher productivity growth in poorer countries of the EU will help to create some convergence in wages, but
regional convergence should be supported by fiscal transfers and public investments to boost productivity in poorer regions. Furthermore a European unemployment benefit system should be developed to redistribute from low to high unemployment regions. This requires a significant EU budget financed by EU level progressive taxes.

Fiscal policy should completely abandon Stability and Growth Pact, and public spending should aim at the multiple targets of full employment, ecological sustainability, equality, and regional convergence. Monetary policy should be consistent with fiscal policy targets. The ECB should be turned into a real central bank with the ability to lend to member states. The Euro and the monetary union can only survive if it is supported by policies of regional and social convergence.
References:

Burke, M. 2010. Who is being bailed out? The Guardian, 27.11.2010, p. 43
McDonald, H. 2010. Lame duck PM likely to get budget passed, The Guardian, 27.11.2010, p. 24
The Economist 2010, Greece’s sovereign debt crisis, April 17, 66-68.
Figure 1a-b: Adjusted wage share, Selected Western EU MS*

*Compensation per employee as percentage of GDP at factor cost per person employed

Source: AMECO (Economic and Financial affairs, Annual Macroeconomic Indicators online database, updated in November 2010)
Table 1. Average annual % change (compound) in real wages and productivity, 1991-2007

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>United Kingdom</th>
<th>Greece</th>
<th>Ireland</th>
<th>Portugal</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real wages</td>
<td>1.09</td>
<td>0.40</td>
<td>1.91</td>
<td>1.56</td>
<td>1.98</td>
<td>2.00</td>
<td>0.19</td>
</tr>
<tr>
<td>Productivity</td>
<td>1.23</td>
<td>1.36</td>
<td>2.08</td>
<td>1.97</td>
<td>2.88</td>
<td>1.70</td>
<td>0.60</td>
</tr>
</tbody>
</table>

Source: OECD National Accounts
Real wages = Labour compensation/number of employees/private consumption price deflator
Productivity = GDP/number of employed persons
Table 2a: Budget Deficit/GDP (%)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>-1.64</td>
<td>0.19</td>
<td>0.04</td>
<td>-3.30</td>
<td>-4.95</td>
</tr>
<tr>
<td>France</td>
<td>-2.32</td>
<td>-2.73</td>
<td>-3.34</td>
<td>-7.58</td>
<td>-7.98</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-2.73</td>
<td>-2.79</td>
<td>-4.89</td>
<td>-11.41</td>
<td>-11.84</td>
</tr>
<tr>
<td>Ireland</td>
<td>2.96</td>
<td>0.14</td>
<td>-7.26</td>
<td>-14.28</td>
<td>-32.30</td>
</tr>
<tr>
<td>Spain</td>
<td>2.02</td>
<td>1.91</td>
<td>-4.06</td>
<td>-11.19</td>
<td>-9.80</td>
</tr>
<tr>
<td>Portugal</td>
<td>-3.94</td>
<td>-2.65</td>
<td>-2.90</td>
<td>-9.43</td>
<td>-8.53</td>
</tr>
</tbody>
</table>

Table 2b: Public debt/GDP (%) and change in debt in 2010-2007 (%-points)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>67.6</td>
<td>64.9</td>
<td>66.3</td>
<td>73.4</td>
<td>75.7</td>
<td>10.8</td>
</tr>
<tr>
<td>France</td>
<td>63.7</td>
<td>63.8</td>
<td>67.5</td>
<td>78.1</td>
<td>83.0</td>
<td>19.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>43.4</td>
<td>44.5</td>
<td>52.1</td>
<td>68.2</td>
<td>77.8</td>
<td>33.4</td>
</tr>
<tr>
<td>Ireland</td>
<td>24.8</td>
<td>25.0</td>
<td>44.3</td>
<td>65.5</td>
<td>97.4</td>
<td>72.4</td>
</tr>
<tr>
<td>Greece</td>
<td>106.1</td>
<td>105.0</td>
<td>110.3</td>
<td>126.8</td>
<td>140.2</td>
<td>35.2</td>
</tr>
<tr>
<td>Spain</td>
<td>39.6</td>
<td>36.1</td>
<td>39.8</td>
<td>53.2</td>
<td>64.4</td>
<td>28.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>63.9</td>
<td>62.7</td>
<td>65.3</td>
<td>76.1</td>
<td>82.8</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Source: Ameco

Table 3: Distribution of tax revenues (%), 2007

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>France</th>
<th>United Kingdom</th>
<th>Ireland</th>
<th>Greece</th>
<th>Spain</th>
<th>Portugal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes on labour income</td>
<td>54.6</td>
<td>51.8</td>
<td>38.6</td>
<td>34.2</td>
<td>41.8</td>
<td>45.6</td>
<td>42.9</td>
</tr>
<tr>
<td>Taxes on consumption</td>
<td>27</td>
<td>25.2</td>
<td>29.8</td>
<td>35.8</td>
<td>35.6</td>
<td>25.5</td>
<td>36.3</td>
</tr>
<tr>
<td>Taxes on labour income and consumption</td>
<td>81.6</td>
<td>77.0</td>
<td>68.4</td>
<td>70.0</td>
<td>77.4</td>
<td>71.1</td>
<td>79.2</td>
</tr>
</tbody>
</table>

Source: OECD National Accounts
<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
<th>Greece</th>
<th>Ireland</th>
<th>Portugal</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.2/peak</td>
<td>-2.16</td>
<td>-2.70</td>
<td>-4.55</td>
<td>-5.66</td>
<td>-11.98</td>
<td>-1.82</td>
<td>-4.58</td>
</tr>
<tr>
<td>peak/trough dates</td>
<td>09.1/08.1</td>
<td>09.1/08.1</td>
<td>09.3/08.1</td>
<td>10.2/08.3</td>
<td>09.4/07.4</td>
<td>09.1/08.1</td>
<td>09.4/08.1</td>
</tr>
<tr>
<td>length</td>
<td>4</td>
<td>4</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td><strong>Employment, total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>peak/trough</td>
<td>-1.73</td>
<td>-0.29</td>
<td>-3.19</td>
<td>-3.55</td>
<td>-12.53</td>
<td>-4.16</td>
<td>-9.64</td>
</tr>
<tr>
<td>10.2/peak</td>
<td>-1.55</td>
<td>-0.08</td>
<td>-2.54</td>
<td>-3.55</td>
<td>-12.53</td>
<td>-4.16</td>
<td>-9.64</td>
</tr>
<tr>
<td>peak/trough dates</td>
<td>09.4/08.2</td>
<td>09.4/08.4</td>
<td>10.1/08.2</td>
<td>10.2/07.4</td>
<td>10.1/07.4</td>
<td>10.2/08.2</td>
<td>10.2/08.1</td>
</tr>
<tr>
<td>length</td>
<td>6</td>
<td>4</td>
<td>7</td>
<td>10</td>
<td>9</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td><strong>Hours worked, total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>peak/trough</td>
<td>-2.12</td>
<td>-3.39</td>
<td>-13.90</td>
<td>-4.03</td>
<td>-8.68</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.2/peak</td>
<td>-1.81</td>
<td>-1.42</td>
<td>-11.45</td>
<td>-3.27</td>
<td>-8.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>peak/trough dates</td>
<td>10.1/08.1</td>
<td>09.2/08.2</td>
<td>09.3/07.3</td>
<td>09.3/07.4</td>
<td>10.1/08.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>length</td>
<td>8</td>
<td>4</td>
<td>8</td>
<td>7</td>
<td>7</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD National Accounts
Figure 2: Unemployment rate, %

Source: OECD Main Economic Indicators
Figure 3: The share of long term unemployed, %

Source: Eurostat

Figure 4: Youth unemployment rate (<25), %

Source: Eurostat
<table>
<thead>
<tr>
<th>Total economy*</th>
<th>2010 2 / peak**</th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
<th>Greece</th>
<th>Ireland</th>
<th>Portugal</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>-</td>
<td>-0.13</td>
<td>-1.75</td>
<td>-7.10</td>
<td>-1.14</td>
<td>-2.02</td>
<td></td>
</tr>
<tr>
<td>Total economy***</td>
<td>2010 2 quarters average / 2009 average</td>
<td>0.94</td>
<td>0.28</td>
<td>-0.24</td>
<td>-6.06</td>
<td>-0.50</td>
<td>-1.01</td>
<td></td>
</tr>
<tr>
<td>The private sector***</td>
<td>2010</td>
<td>0.27</td>
<td>-1.38</td>
<td>-0.83</td>
<td>-3.28</td>
<td>-2.47</td>
<td>-0.48</td>
<td>-0.34</td>
</tr>
</tbody>
</table>

*OECD National Accounts, quarterly. The data for Ireland ends in 2010.1
**Peak wage was in 2009.1 in Germany; 2009.3 in Greece and Ireland; 2009.4 in Spain and the UK
***annual data, OECD Economic Outlook
Endnotes

1 In Ireland wage share has recovered slightly during 2002-2007 from 46.6% to 50.1%; nevertheless remained lower than its peak level of 71.2% in 1975.
3 Compensation per employee deflated by private consumption deflator.
4 November 2010 detailed data appendix is not available yet.
5 In Portugal quarterly wage data for the aggregate economy is not available.