

**Labor's New Paradigm:
The Changing Rules of Work and Pay**

by

**John V. Duca
Senior Economist and
Assistant Vice President**

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**Research Department
Federal Reserve Bank of Dallas**

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The December labor report will likely show that the unemployment rate has been at or below 5 percent for 9 straight months. While wage inflation has drifted higher and worker shortages abound, there is less upward wage pressure than past experience would suggest. Moreover, inflation has drifted lower, not higher, as the unemployment rate has fallen below trigger levels that historically had pointed to rising inflation.

One increasingly popular explanation for this combination of low unemployment and subdued inflation is that we are in a new era in which technological innovation and fierce competition is curtailing inflation. Under this new paradigm, two sources of low inflation are cheaper imports from increased worldwide capacity and technological innovations that boost productivity growth. In addition to these factors, fierce competition plausibly has kept a lid on how much firms are willing to bid up wages and is inducing firms to find more efficient ways of employing and paying workers.

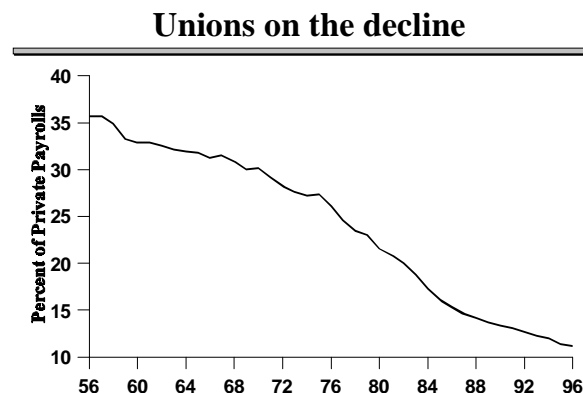
My presentation focuses on these new labor practices and whether they constitute a new labor paradigm. Throughout my presentation, I will draw heavily on several of my recent research studies of changes in labor market practices that I have co-authored with Professor David VanHoose of the University of Alabama. First, I will discuss how the rules of work and pay are changing and then why they are changing. Next, I will discuss how well these new rules are working by comparing the U.S. with other major nations. Finally, I will conclude by discussing the broader meaning of these changes.

How Work and Pay Are Becoming More Market Sensitive

Generally speaking, work and pay have become more market-sensitive. With respect to employment, this is reflected in a declining share of union workers in the private sector and in the rising use of temporary and part-time workers.

The figure below shows the falling share of private sector workers represented by unions and indicates that the most dramatic declines occurred in the late 1970s and early 1980s. As a result, fewer workers are covered by 2 to 4 year contracts that fix wages in advance of market conditions.

Figure 1



The increased use of temporary and part-time workers has also made employment more market-sensitive. Figure 2 plots the rising share of workers supplied by personnel agencies, such as Manpower. By switching to such workers, firms lower production costs not only by paying fewer benefits to such workers, but also by better matching employment to swings in production such as using part-time workers to handle busier weekend shopping periods or hiring temporary computer programmers to fix year 2000 problems.

Pay has also become more market-sensitive. Available data show three patterns. First, union contracts, which set wages ahead of market conditions, are less prevalent as shown earlier. Second, union contracts are much less likely to be indexed for inflation. While indexation protects workers' purchasing power, it also ties a firm's wage bill more to general price increases than to the price of its particular output. Third, there is more profit-sharing. I will now elaborate on the latter two points.

Figure 3 plots the share of union contracts with indexation clauses that boost wages for inflation according to negotiated formula. Clearly, inflation risk, as reflected in the inflation rate, is a major factor affecting the use of indexation formulas. For example, in the high inflation 1970s, indexation clauses were quite common as workers sought to protect their purchasing power from high and variable inflation. However, inflation is not the only factor affecting the use of indexation provisions. Indeed, inflation in the early 1990s was at levels near those of the 1950s, but indexation was half as prevalent in the more recent period.

Figure 2

Use of temporary workers rose strongly in the 80s and 90s

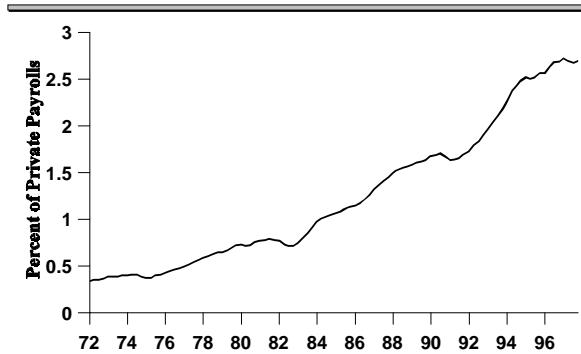
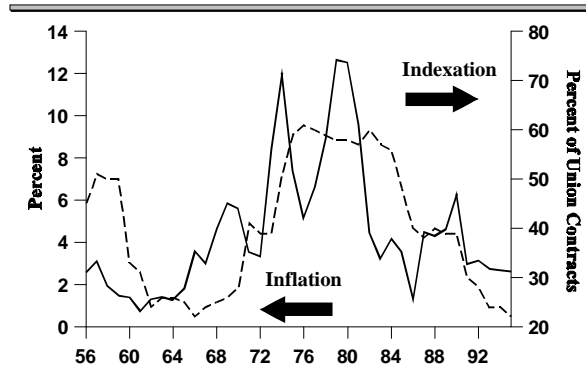


Figure 3

Fewer union contracts indexed for inflation as compared to the 50s



While cost-of-living escalators have become less prevalent, the use of profit-sharing has risen dramatically since the early 1980s as shown in Figure 4. As of 1993, the latest year available, over 20 percent of pension plans contained a form of profit-sharing, up from less than 10 percent in 1980, the earliest year available. Most of these profit-sharing provisions include employee stock ownership plans or profit-based contributions to thrift plans, both types of which are provided to employees at Southwest Airlines. Other historical data show a more limited use of non-deferred forms of profit-sharing, such as cash bonuses.

Why is deferred profit-sharing more common? One reason is that workers do not have sufficient wealth to see their weekly take-home pay vary greatly with market conditions, but are better able to handle profit volatility over the long-run, such as in the form of retirement accounts. For this reason, deferred profit-sharing is more palatable to workers, and yet also enables firms to make pay more market responsive.

Figure 4

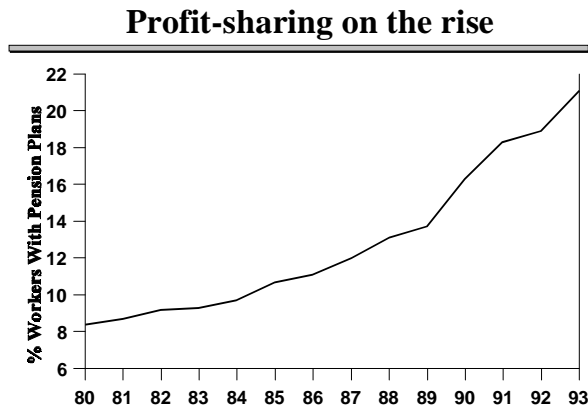


Figure 5

- The evolving nature of profit-sharing**
-
- **Deferred profit-sharing more common, workers:**
 - less able to handle take-home pay volatility
 - better able to handle long-run pension variation
 - **Nevertheless, shift to variable (non-deferred) pay**
 - recent salary and *Beige Book* surveys
 - short- and long-run pay more market responsive

Nevertheless, recent salary and *Beige Book* surveys indicate that a shift from merit-base pay to more variable cash pay is underway. This more recent phenomenon implies that both short-run and long-run pay are becoming more market-responsive.

Why Have Work and Pay Become More Market-Responsive?

Arguably, greater competition forces firms to become more efficient, as profit margins are tighter and fear of losing market share to lower cost competition is heightened. Fiercer competition can arise not only for traded goods facing foreign competition, but also in deregulated markets, such as communications, where the entry of new firms and the ending of price and other regulations forces firms to compete more with one another. In such an environment, firms no longer enjoy stable profit margins and protection from competition that once enabled them to shield workers from swings in market conditions.

In particular, greater competition induces firms to make pay and work more market-responsive; to cut middle management overhead and incentivize pay so workers become more self-managed; and to share profits in exchange for wage cuts when restructuring. In addition, greater competition more closely aligns profits with workers' market value, as prices and profits more closely reflect wage costs adjusted for productivity. For these reasons, greater competition induces firms to make pay more market-responsive and makes profit-sharing a more attractive way of doing so.

Figure 6

- Why these changes?**
-
- Greater competition:**
- Forces efficiency, makes profit margins tighter
 - Arises from:
 - foreign trade for manufacturers
 - deregulation: energy, transport., banking, commun.
 - Prevents firms from shielding workers

Figure 7

- Why these changes?**
-
- Greater competition induces firms to:**
- Make pay & hours more market responsive
 - Cut mgmt & incentivize pay to boost efficiency
 - Share profits to gain wage cuts in restructurings
 - Share profits to make pay more market responsive

As a result, one would expect that profit-sharing should trend upward with a measure of market competition, as shown in Figure 8 below. This measure of competition rises as firms' pricing power declines, adjusted for swings related to the business cycle, oil prices, and exchange rates. My research shows that this overall measure of competition also tends to rise when the degree of unionization and the prevalence of inflation clauses in labor contracts fall.

But how can we tell if it is competition and not other factors that are making employment and pay more market-sensitive? One way to do this is to compare deregulated or traded goods industries with other sectors. Industry data reveal two things. First, most of the drop in unionization since the early-1980s is due to declines in unionization rates within industries, rather than to shifts in employment from more unionized industries, like manufacturing, to less unionized industries. Second, as shown in Figure 9, the biggest declines in unionization rates were in manufacturing and deregulated industries, as compared to other sectors. Changes in the prevalence of inflation indexation in union contracts also follow both of these patterns.

Figure 8

The rise of profit-sharing and goods market competition

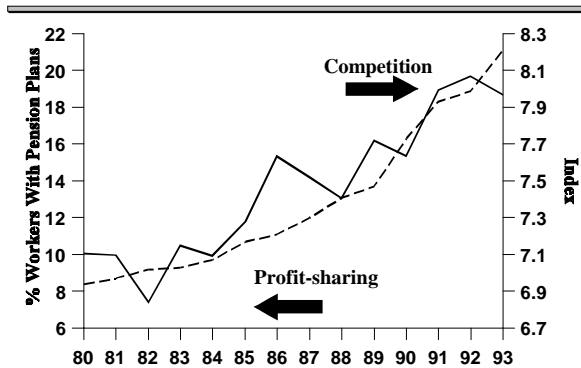
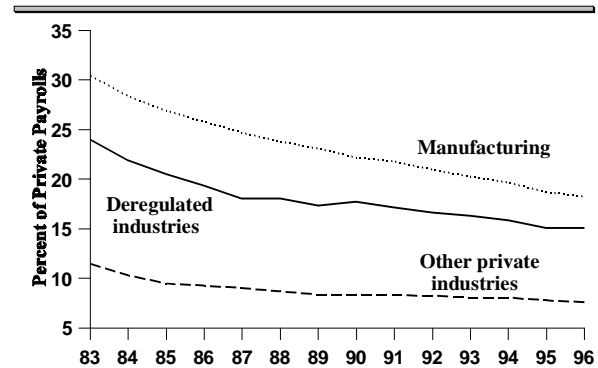


Figure 9

Unions decline in manufacturing and deregulated industries

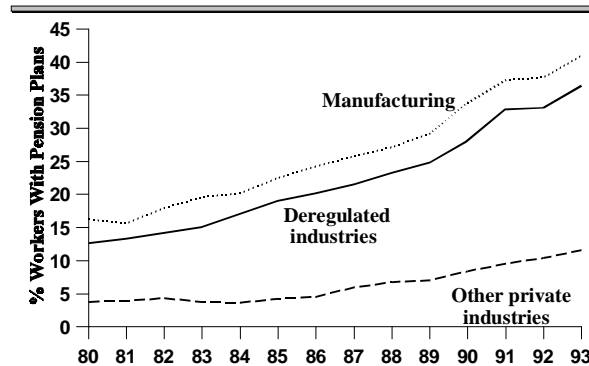


Why has profit-sharing become more prevalent? Clearly, some industries are better suited to profit-sharing arrangements than others because the nature of work and the ability to monitor work effort vary across sectors. Such factors would account for why differences exist across industries at a given point in time. In addition, changes in generational attitudes toward profit-sharing might account for why profit-sharing has risen in virtually all industries. However, across time, changes in how much competition an industry faces relative to others could account for why the use of profit-sharing has risen more in some industries than in others.

Indeed, as shown in Figure 10, the most pronounced increases in profit-sharing have occurred in deregulated industries, such as transportation, or in sectors facing heightened competition from abroad, such as manufacturing. In addition to making it more desirable to make pay more market-sensitive via profit-sharing, increased competition may have induced more profit-sharing through a restructuring channel. In deregulated industries that have restructured, some firms have gained wage and layoff concessions by agreeing to share future profits. For example, workers at United Airlines agreed to wage concessions in the early 1994 in exchange for eventually owning a majority stake in that airline.

Figure 10

Profit-sharing rises in manufacturing and deregulated industries



How Well Are the New Rules of Work and Pay Working?

Now that we understand how and why new rules of work and pay have arisen, a natural question is to ask how well are they functioning? To do this, I will briefly review what this new paradigm means for American workers. Then, I will provide some international perspective by reviewing how well labor markets are functioning in other industrialized nations.

How Well Are the New Rules of Work and Pay Working in the U.S.?

For American workers, the new labor paradigm has:

- (1) increased short-run job uncertainty through an increased probability of being laid off or temporarily employed in economic expansions;
- (2) forced workers to focus on lifetime employability rather than lifetime employment at a particular firm;
- (3) encouraged the use of portable pensions like IRA and thrift plan accounts; and
- (4) boosted the use of deferred profit-sharing, and more recently, variable cash pay.

Abstracting from the business cycle, American workers face more uncertainty about their jobs and pay in the 1990s. By this standard alone, the new rules of work and pay seem to be a step down. However, conditions change and more appropriate criteria are whether we would have been better off following the old rules in the 1990s and whether other labor practices used overseas have worked better in recent times. To address these issues, let's look at how well labor market practices have worked in Continental Europe, Japan and South Korea, and Great Britain.

How Well Are Other Labor Markets Functioning?

In the Continental European countries of Germany, France, and Italy, laws protect workers from being fired and industries from domestic and foreign competition. As a result, senior workers at big, established firms enjoy a sweet life (*La Dolce Vita*) of job security, high pay that is indexed for inflation, and long vacations. However, by boosting labor costs above market levels, these rigid practices have stymied job creation for the young; led to mounting, double-digit unemployment rates; slowed economic growth; and led to both high taxation and high budget deficits.

In Japan and South Korea, as in Continental Europe, laws protect workers from being fired and firms from much competition. Two key differences are (1) that pay includes a year-end company-wide bonus that partly reflects company profits, and (2) large conglomerates dominate these economies and shift workers with lifetime employment from slack industries to faster growing ones. Thus, the Japanese-Korean system makes pay and employment more market sensitive than in Continental Europe, but this market sensitivity is far less than in the U.S. As a result, the need to lay off workers or to dramatically cut pay in dying industries has mounted over the long-run. Compounding this problem is a lack of financial transparency about firm profitability and the habit of many Japanese banks to prop up ailing firms for which they serve as both active shareholders and lenders. Thus, rather than continuously making enough minor market adjustments, Japanese and Korean firms have allowed problems to build to the point where very large and painful changes will need to be made.

Figure 11

How other nations compare: Continental Europe

Laws restricting firing & competition result in:

- *La Dolce Vita*, for senior workers at big firms
- For others, no job creation, high unemployment
- Slow economic growth
- High taxes and budget deficits



Figure 12

How other nations compare: Japan & South Korea

- Like Europe, restrict firing and competition
- Two key differences:
 - company-wide flexible bonuses
 - lifetime jobs within big conglomerates
- But long-run structural imbalances mounting



The realization that changes are needed has led the new South Korean President, Mr. Kim, who is both a populist and a leading critic of the Korean conglomerate system, to comment after his recent election that:

“Only the businesses that can adjust to the market economy and international competition will survive. Those which cannot will surely perish because that is the cold, harsh reality of globalization.”

One international bright spot has been Great Britain, which has allowed restructuring activity, scaled back laws that prevent job dismissal, and scaled back unemployment and welfare benefits that encourage idleness. Like American workers, British workers now endure more short-run job and pay uncertainty at their particular employers. But paradoxically, they also enjoy more longer-run job security within their general economy and better income prospects in the form of lower unemployment and faster growth that stem from having a more market-oriented system.

Figure 13

How other nations compare: Great Britain

- Allow restructurings, cut job “protections”
- Cut unemployment/welfare benefits
- Less job and income security at particular firms
- But lower unemployment and faster growth



What Is the Broader Meaning of the New Labor Paradigm?

What is the broader meaning of the new labor paradigm? At a fundamental level, the new labor paradigm in the U.S. has made work and pay more market-responsive. Furthermore, the new labor paradigm in the U.S. and Great Britain has outperformed the older labor paradigms of other major economies in the 1990s. But the new labor paradigm also has implications for both monetary policy and economic policy in general.

Implications for Monetary Policy

With respect to monetary policy, the new labor paradigm has several implications for how to interpret economic gauges and for how the Federal Reserve conducts policy.

Figure 14

Implications for monetary policy

- **Traditional wage measures obsolete**
 - ▶ **understate pay growth and flexibility**
- **Shifts relationship betwn labor mkts & inflation**
 - ▶ **import prices more important**
 - ▶ **capacity pressures affect inflation more slowly**
 - ▶ **economy can sustain higher capacity levels**
 - ▶ **may boost long-run, sustainable growth**

First, increased profit-sharing has made our existing measures of wages obsolete because they do not include most deferred forms of profit-sharing, including stock options. Thus, employee costs are likely rising faster than our gauges indicate, but are also more flexible than our current gauges imply.

In addition, greater competition in the market place, which has created this new labor paradigm, affects the relationship between tight labor markets and inflation in several ways. First, the more important is foreign trade, the *more* inflation depends on foreign prices and exchange rates and the *less* inflation depends on domestic capacity pressures. Second, greater competition implies that inflation is slower to rise when the economy is overheated because individual firms would lose more market share if they increased prices before their competitors. Third, firms are willing to produce more at a given price level under greater competition, which may also boost efficiency by making the economy more market- and customer-driven. This implies that the economy can operate at higher levels of capacity without inflation rising. Fourth, to some extent, the increased market sensitivity of employment and pay allows the economy to more readily adjust to new technology, which boosts the incentives for innovation and thereby long-run growth. Hence, the new paradigm might permit the Fed to allow the economy to grow somewhat faster without sacrificing price stability because the economy is less inflation prone.

More General Implications

The new labor paradigm has other, more general policy and economic implications.

To some extent, increased profit-sharing implies that current wage measures understate pay, further implying that living standards for U.S. workers have been understated. And, as Cece Smith has pointed out, the increased use of stock options and profit-sharing implies that outside investors face the risk that future profits will be diluted when stock options are exercised or profits are shared. For this reason, more and better disclosure of profit-sharing arrangements is needed.

Figure 15

More general implications of the new labor paradigm

- **Current wage measures understate pay**
 - ▶ living standards understated
 - ▶ more profit-sharing disclosure needed
- **Allows more frequent economic adjustments that:**
 - ▶ boost short-run uncertainty
 - ▶ lower long-run uncertainty & boost growth

At another level, the new labor paradigm enables firms and workers to make more frequent economic adjustments. While this boosts short-run uncertainty, it reduces the risk of big costly adjustments that mount when economic adjustments are postponed. For this reason, fewer imbalances build which come to a head in economic downturns when it is harder for laid off workers to find new jobs. Thus, the new labor paradigm has enabled the U.S. economy to adapt faster to our changing world and perform better than foreign economies which have pursued more rigid policies. Paradoxically, the very labor paradigm that has subjected American workers to more short-run adjustments and uncertainty has reduced long-run uncertainty and boosted growth by creating a more robust economy. In contrast, workers abroad who have more legal “job protection” are facing mounting unemployment and huge, costly adjustments. These labor market differences are analogous to the differences between floating and fixed exchange rate regimes, in that floating exchange rates help trade and investment flows continuously adjust to changing fundamentals, while fixed exchange rates remain stable until economic fundamentals force large and very painful discrete changes.

Some nations, particularly those in Continental Europe, show a great reluctance to shed the labor laws and anti-competition policies that have contributed to double-digit unemployment. Instead of adapting to the churn, Germany, France, and Italy are pursuing a currency union as an economic elixir to their poor economic performance at a time, ironically, when fixed exchange rate arrangements are failing or are under pressure around the world. On a brighter note, other industrialized nations, such as Great Britain and Canada, have taken strides toward deregulating their economies, while others, like South Korea and perhaps Japan, have only just begun.