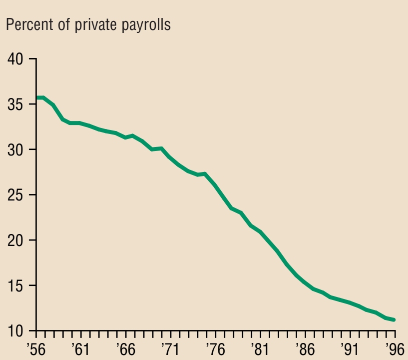
The New Labor Paradigm

More Market-Responsive Rules of Work and Pay

IN THE LAST year or so, inflation has drifted lower while the unemployment rate has fallen below trigger levels that historically have been associated with rising rates of inflation. Indeed, since mid-1996 the unemployment rate has been 5 percent or lower—well below the 5.5 percent to 6 percent trigger-level estimates of many mainstream empirical economists—while consumer price inflation has remained tame.[1]

One explanation for this combination of low unemployment and subdued inflation is that we are in an era in which massive technological innovation and intense competition are curtailing inflation. Under this new paradigm, three sources of inflation restraint are (1) cheaper imports from increased worldwide capacity, (2) fiercer competition among firms in nontraded goods industries, and (3) technological innovations that boost productivity.[2] Behind the first two sources is the idea that increased competition in product markets has restrained firms from bidding up wages and has led companies to find better ways of employing and paying workers that have made work and pay more market responsive.

CHART 1
UNIONS ON THE DECLINE



SOURCE: Duca and VanHoose (1998). See note 3.

After reviewing how and why the rules of work and pay have been changing, this article briefly assesses how well the new labor paradigm is functioning in the United States and how well other major economies are performing. Finally, the broader meaning of these new labor practices is discussed.

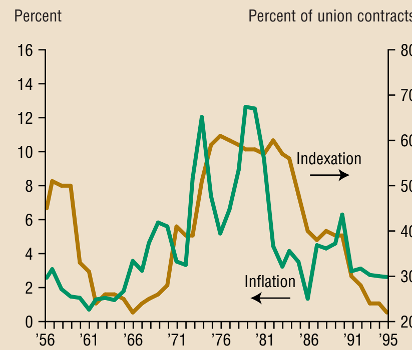
How New Rules of Work and Pay Are More Market Responsive

In general, work and pay have become increasingly market sensitive. With respect to employment, this sensitivity is reflected in a declining share of union workers covered by medium- and long-term wage contracts and in the rising use of temporary and part-time workers. Chart 1 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.[3]

The increased use of temporary and part-time workers has also made employment more market sensitive. By switching to such workers, firms lower production costs not only by paying fewer benefits but by better matching employment to swings in production—for example, using part-time workers to handle busier weekend shopping periods.

In three key ways, pay has also become more market sensitive. First, long-term wage contracts—which set wages well ahead of market conditions—are less prevalent, as evidenced by declining unionization rates. Second, fewer union contracts contain indexation clauses that boost wages for inflation according to a negotiated formula (*Chart 2*).[4] While indexation protects workers' purchasing power, it also ties a firm's wage bill more to general price

CHART 2
FEWER UNION CONTRACTS INDEXED FOR INFLATION AS COMPARED WITH THE 1950S



SOURCE: Duca and VanHoose (forthcoming). See note 7.

increases than to the price of that firm's particular output. Clearly, inflation risk, which is often measured by the inflation rate, boosts the use of indexation formulas. For example, in the high-inflation 1970s, indexation clauses were 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. Inflation in the early 1990s was at levels near those of the 1950s, but indexation was only half as prevalent in the more recent period.

The third key change is that profit sharing has risen dramatically since the early 1980s. Chart 3 shows the increased portion of workers who enjoy profit-sharing provisions among those who have either defined-benefit or defined-contribution pension coverage.[5] Most of these profit-sharing provisions include employee stock-ownership plans or profit-based contributions to thrift plans. Other data show less use of nondeferred forms of profit sharing, such as cash bonuses.

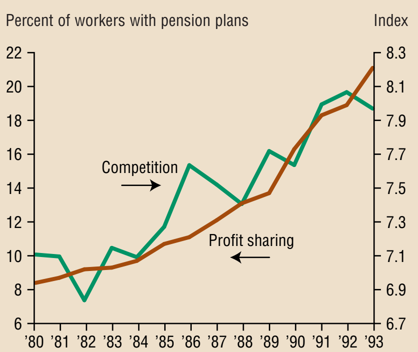
Deferred profit sharing is more common because workers do not have sufficient wealth to smooth their consumption if their weekly take-home pay were to vary with profits that are highly sensitive to market conditions. They are, however, better able to handle profit-related volatility in their compensation over a longer horizon, such as in their retirement accounts. Nevertheless, recent salary and Federal Reserve Beige Book surveys indicate that annual base/hourly pay is increasingly being supplemented by variable cash bonuses. This shift suggests that pay is becoming more market responsive in both the short run and the long run.

Why New Rules of Work and Pay Are More Market Responsive

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

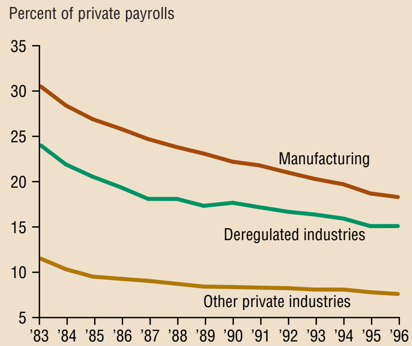
In particular, greater competition induces firms to make pay and work more market sensitive; to cut management and add incentives to compensation so workers become more self-managed; and to share profits in exchange for wage cuts when companies are restructuring. Greater competition also encourages firms to use profit sharing to make pay more market responsive. With tougher competition, profits are more tightly aligned with a worker's market value because prices and profits more closely reflect wage costs adjusted for productivity. As a result, profit sharing should trend upward with a measure of market competition. Chart 3 plots a measure of competition, which rises as firms' pricing power declines and which is adjusted for swings related to the business cycle, oil prices and exchange rates.[6] Research has shown that as this overall measure of competition rises, long-run wage contracts and inflation indexation in labor contracts become less prevalent.[7] But how can we tell competition is the key factor making work and pay more market sensitive? One way is to compare deregulated and traded goods industries with other sectors.

Chart 3
The Rise of Profit Sharing and Goods Market Competition



SOURCE: Duca and VanHoose (forthcoming). See note 6.

Chart 4
Unionization Declines in Manufacturing and Deregulated Industries



SOURCE: Bureau of Labor Statistics; author's calculations.

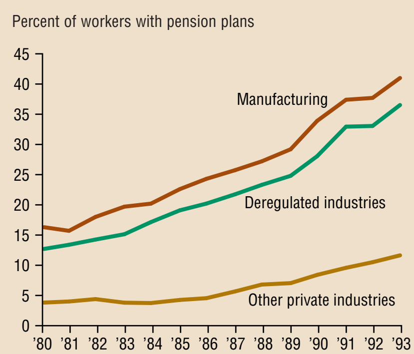
Industry data indicate that the drop in unionization since the early 1980s stems mostly from declines in unionization rates within industries rather than from shifts in employment from more unionized industries to less unionized ones. Moreover, the biggest declines in unionization rates were in manufacturing and deregulated industries, as shown in Chart 4.[8] Declines in the use of inflation indexation also follow these patterns.

Some industries are more suited to profit sharing than others because the nature of work and the ability to measure an individual's contributions vary across sectors. Such factors would account for differences across industries in a given time period, while changes in generational attitudes might account for why profit sharing has risen in general. However, changes in how much competition an industry faces relative to others might explain why profit sharing has risen more in some industries than in others. Indeed, the largest increases in profit sharing have occurred in sectors with greater foreign competition, such as manufacturing, or in deregulated sectors, such as transportation (*Chart 5*).[9]

How Well Are the New Rules of Work and Pay Performing in the United States?

For Americans, the new labor paradigm has (1) increased short-run job and pay variability, (2) fostered the use of portable pensions like IRA and thrift plan accounts, (3) forced workers to focus more on lifetime employability than lifetime employment at a particular firm, and (4) boosted the use of profit sharing. Quite apart from business cycle

Chart 5
Profit Sharing Rises in Manufacturing and Deregulated Industries



SOURCE: Bureau of Labor Statistics; author's calculations.

fluctuations, American workers face more uncertainty. By this standard alone, the new labor paradigm seems to be a step down. However, economic conditions change, which implies that older labor practices may no longer function well, particularly in a more competitive marketplace. Therefore, determining whether we would have been better off with the old rules and whether labor practices used in other industrialized nations have worked better in recent years would be better criteria for evaluating the new labor paradigm.

How Well Are Other Labor Markets Performing?

In Germany, France and Italy, laws protect workers from being fired and industries from domestic and foreign competition. Consequently, senior workers at big established firms enjoy job security, long vacations and high pay indexed for inflation. However, by boosting labor costs above market levels, these rigid practices have resulted in stymied job creation for the young; mounting, double-digit unemployment rates; slow economic growth; and high taxes and high budget deficits.

In Japan and South Korea, as in Continental Europe, laws protect workers from being fired and firms from much competition. However, two key differences exist. First, pay includes a year-end company-wide bonus that partly reflects company profits. Second, large conglomerates dominate these economies and move workers with lifetime employment from slack industries to faster growing ones. Thus, the Japanese/South Korean system makes pay and employment more market sensitive than in Continental Europe, but this market sensitivity is far less so than in the United States. As a result, the need to lay off workers or to cut pay dramatically in dying industries has mounted over the long run. So rather than continuously make enough minor market adjustments, Japanese and South Korean firms have allowed problems to build to the point that very large and painful changes will be required.

One international bright spot is Great Britain, which has allowed restructurings, scaled back legal "job protections" and cut unemployment and welfare benefits that encourage idleness. Like American workers, British workers now endure increased short-run job and pay uncertainty. But, paradoxically, they enjoy greater long-run employability within their whole economy. They also can expect better income prospects in the form of lower unemployment and faster growth, which have resulted from adopting a more market-oriented system.

What Is the Broader Meaning of the New Labor Paradigm?

Fundamentally, new labor practices in the United States have made pay and work more market responsive. Furthermore, the new labor paradigm in the United States and Great Britain has outperformed the older ones of other major economies in the 1990s. But this paradigm also has implications for monetary policy and economic policy in general.

With respect to monetary policy, the new labor paradigm has several implications for economic gauges and for Federal Reserve policy. First, increased profit sharing has made obsolete our existing wage measures, which exclude many deferred forms of profit sharing. Thus, labor costs are likely rising faster and are more flexible than our gauges indicate.

More significantly, the greater competition that has spawned new rules of work and pay affects the relationship between tight labor markets and inflation in several ways. First, the more important foreign trade, the more significant import prices are for our inflation rate. Second, greater competition implies that capacity pressures affect inflation more slowly because when the economy is overheated, individual firms risk losing more market share if they increase prices before competitors do. Third, firms are willing to produce more at a given price under greater competition, implying that the economy can sustain higher capacity levels without causing a rise in inflation.[10] Nevertheless, there is a good deal of uncertainty about where the new trigger levels are. Fourth, to some extent the increased market sensitivity of work and pay enables the economy to adjust more readily to new technology, which boosts the incentives for innovation and, consequently, long-run sustainable growth.

The new labor paradigm has other, more general policy and economic implications. Increased profit sharing means that current wage measures understate total pay, further implying that living standards for U.S. workers have been understated. And the increased use of stock options and profit sharing indicates that outside investors face the risk that future profits will be diluted when stock options are exercised or profits are shared. Therefore, additional and better disclosure of profit-sharing arrangements is needed. New rules requiring firms to report profits on a diluted basis constitute a major step in this direction.

At another level, the new labor-market flexibility fosters more frequent economic adjustments. While this boosts short-run uncertainty, it reduces the risk of big, costly adjustments. For this reason, fewer imbalances build that typically come to a head during economic downturns when finding new jobs is harder for laid-off workers. Paradoxically, the very labor paradigm that has subjected American workers to increased short-run adjustments and uncertainty has reduced long-run uncertainty and boosted growth by creating a healthier overall economy. In contrast, workers abroad who have more legal job protection are facing mounting unemployment and huge, costly adjustments.

Some nations, particularly those in Continental Europe, are reluctant to shed the job-firing laws and anticompetition policies that have contributed to their double-digit unemployment rates. Instead of letting their labor markets adapt to the economic churn of job (and firm) creation and destruction, Germany, France and Italy are pursuing a currency union as an elixir to their poor economic performance at a time,

(Continued on page 12)

The New Labor Paradigm

(Continued from page 8)

ironically, when fixed exchange rate arrangements are failing or are under pressure around the world.[11] On a brighter note, other nations such as Great Britain and Canada have taken strides toward deregulating their economies. Still others, like South Korea and perhaps Japan, have only just begun.

—John V. Duca

Notes

My thanks to Mike Cox for useful suggestions and to John Benedetto for research assistance.

1 This is true even if the volatile food and energy components are excluded from the consumer price index (CPI) and if the CPI is adjusted for recent technical changes.

2 This is not to say that the so-called new paradigm lasts forever, of course, but that it lasts sufficiently long to be identified as such.

3 Data are from John V. Duca and David D. VanHoose, "The Rise of Goods Market Competition and the Fall of Nominal Wage Contracting," manuscript, 1998. Duca and VanHoose splice estimates from the Bureau of Labor Statistics and from Leo Troy and Neil Sheflin, *Union Sourcebook*, 1985, (West Orange, NJ: Industrial Relations Data and Information Services).

4 Bureau of Labor Statistics.

5 See Linda Bell and Douglas Kruse, "Evaluating ESOPs, Profit Sharing, and Gain Sharing Plans in U.S. Industries: Effects on Worker and Company Performance," U.S. Department of Labor, manuscript, March 1995.

6 For data and discussion, see John V. Duca and David D. VanHoose, "Goods Market Competition and Profit-Sharing: A Multisector Macro Approach," *Journal of Economics and Business*, forthcoming.

7 See John V. Duca and David D. VanHoose, "The Rise of Goods Market Competition and the Decline in Wage Indexation," *Journal of Macroeconomics*, forthcoming.

8 Data are from John V. Duca and David D. VanHoose, "The Rise of Goods Market Competition and the Fall of Nominal Wage Contracting," 1998, manuscript.

9 See John V. Duca and David D. VanHoose, "Goods Market Competition and Profit Sharing: A Multisector Macro Approach," *Journal of Economics and Business*, forthcoming. 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, 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 early 1994 in exchange for eventually owning a majority stake in that airline.

10 For evidence and discussion, see John V. Duca and David D. VanHoose, "Has Greater Competition Restrained United States Inflation?" 1998, manuscript.

11 For further discussion, see W. Michael Cox, "The Churn: The Paradox of Progress," *1992 Annual Report*, Federal Reserve Bank of Dallas, 1992, 5–18.

Federal Reserve Bank of Dallas
P.O. Box 655906
Dallas, Texas 75265-5906

BULK RATE
U.S. POSTAGE
PAID
DALLAS, TEXAS
PERMIT NO. 151