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Global Labour Column

UNIVERSITY OF THE WITWATERSRAND, JOHANNESBURG

column.global-labour-university.org | Number 291, October 2017

A perspective on wage inequality from the ILO Global Wage Report

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In recent years the share of labour compensation in Gross Domestic Product (GDP) declined in many countries around the world. At the same time wage inequality reached levels considered by many to be both socially and economically unsustainable. Too much inequality not only erodes social cohesion, it also reduces opportunities for social mobility, hurts consumption by lower income groups, weakens the middle class, and creates societies in which elites live in a separate world.

Reducing inequality has thus become more central for policy makers in many parts of the world, as is reflected not only in the International Labour Organisation (ILO) decent work agenda, but also in the 2030 Sustainable Development Agenda, which calls for decent work for all as well as fiscal, wage and social protection policies to progressively achieve greater equality.

The latest ILO Global Wage Report focuses on wage inequality, taking as the starting point that overall wage inequality results from a combination of differences in average wages *between* enterprises and wage inequality *within* enterprises.

This enterprise perspective differs from the more traditional focus on skills as the major source of inequality. Many studies have documented how technology, globalisation, pressures from financial markets, labour market deregulation and trade unions' weaker bargaining power have contributed to increased wage inequality between highly skilled workers and workers with lower levels of education. But individual characteristics alone (including age, educational attainment, and years of tenure) do a relatively poor job of explaining the variation in workers' wages.

The simple human capital model used in the Global Wage Report shows that there are sometimes enormous differences between people's actual wages and the wages predicted for these individual characteristics. The discrepancy is large anywhere in the distribution, but particularly large at the top, where workers are hugely 'overpaid' for their characteristics, and at the bottom, where they are grossly 'underpaid'.

Inequality between enterprises matters

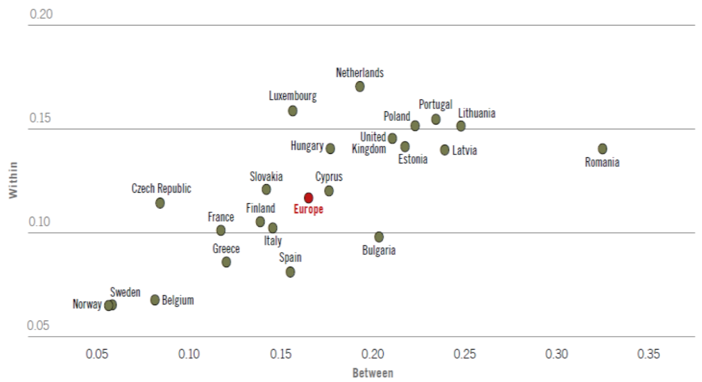
Recent literature has emphasised the importance of differences in average wages between enterprises as a source of wage inequality. Research at the OECD, for example, found that the most productive firms are pulling ahead, and this productivity gap is causing a wage gap: 'When higher productivity means higher wages, the increasing productivity gaps between firms could translate into wage gaps. Indeed, that's exactly what we see in the data', write Berlingieri, Blanchenay, and Crisculolo (2017).

The ILO Global Wage Report shows that in many countries there is indeed some correspondence between a low level of wage inequality among individuals and a low level of wage inequality between enterprises (as in Norway, which has low wage inequality and where 90% of enterprises have middle-of-the-road average wages), or between higher levels of inequality of each type (as in the United Kingdom, which has more wage inequality and a higher proportion of enterprises with very low or very high average wages). Developing countries have both higher wage inequality and more inequality between enterprises than developed countries.

Don't overlook wage inequality within enterprises

But inequality between firms is only part of the story. Using the European Structure of Earnings Survey, the Global Wage Report finds that on average in Europe, wage inequality *within* enterprises accounts for a considerable 42% of the total variance in wages, with notable country variations (see Figure 1).

Figure 1: Decomposition of wage inequality between and within enterprises in Europe



Note: The estimates show the decomposition of the total variance excluding the residual. Adding the "between" and "within" values for each country independently provides a measure of total variance (excluding the residual). For example, in the case of Belgium, total variance (on the logarithmic scale) amounts to 0.147 where the "between" and "within" components are 0.082 and 0.068, respectively.

Source: ILO estimates based on SES database.

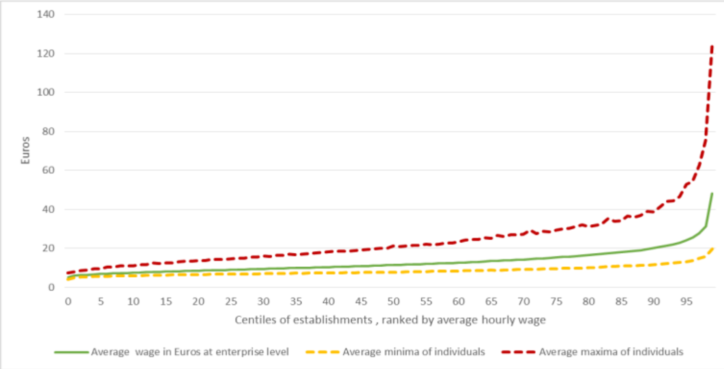
In the USA, a recent study (Song et al, 2015) shows that wage inequality within enterprises accounts for more than half of total wage inequality. In other words, if there was no wage inequality *within* enterprises - if all workers were to receive exactly their enterprise's average wage - wage inequality in the USA would be cut by more than half.

Of course, reducing wage inequality to zero within enterprises is neither realistic nor desirable. Some employees have more responsibilities and skills than others, and these should be adequately rewarded. But has inequality within some enterprises gone too far?

When comparing the wages of individuals to the average wage of the enterprises in which they work, the Wage Report finds that in medium and large European enterprises, most people (close to 80%) are paid less than the average wage of the enterprise in which they work. In real estate and financial services, 99% of workers earn less than the average. The average is thus a very imperfect measure of what workers in those enterprises really earn.

Zooming in on the enterprises with top average wages, we find that inequalities grow to sometimes enormous levels. This can be seen in Figure 2, which ranks all enterprises according to their average wages, and also shows the highest and the lowest wage in these groups of enterprises. In the top enterprises, wage inequality explodes.

Figure 2: average wages and wage inequality in Europe (22 countries)



Source: ILO Global Wage Report (ILO estimates based on the weighted average using 22 economies from the Eurostat SES). The countries are Belgium, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, France, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden and the United Kingdom.

Strikingly, what is true for overall wage inequality is also true for the gender pay gap. While the hourly gender pay gap for Europe is about 20%, in the 1% of enterprises with the highest average wages in Europe, the gap amounts to no less than 48%.

What can be done to reduce wage inequality?

Beyond improving skills and education for those at the bottom of the pyramid, what can be done to reduce wage inequality?
Given the magnitude of wage inequality within enterprises documented here, it is clear that enterprises' self-regulation has a role to play in keeping wage inequality within socially acceptable bounds. Many CEOs effectively determine their own pay, and shareholders have often been unable to ensure executive remuneration in line with social values or even company performance. Initiatives to regulate top wages have focused on the transparency of remuneration and on shareholders' say over pay. Now there are questions as to whether more regulation or higher taxes are necessary to discourage compensation packages based on short-term shareholder value rather than long-term enterprise performance.

Minimum wage legislation and collective bargaining also have a central role to play to reduce inequality between and within enterprises, as the experience of various European countries and Alvarez et al.'s case study of Brazil (2016) have shown. But differences in the way collective bargaining is organised have different effects. When collective bargaining is at the company or workplace level, the effect is restricted to wage inequality within enterprises. When collective bargaining takes place at the national, industry or branch level in multi-employer settings with coordination across levels, a larger proportion of workers are covered and inequality is likely to be reduced both within and between enterprises. The extension of collective agreements by governments to all workers in a particular sector or country can reinforce these effects.

Given that differences in average wages between enterprises are an important determinant of overall wage inequality, promoting broad-based productivity growth among enterprises may simultaneously permit higher average wages and reduce wage inequality. OECD research suggests that 'laggard firms' can be encouraged to imitate the productivity performance of 'frontier firms' through adoption of new technologies and best practices. According to Criscuolo (2015), 'some firms "get it" and others don't'.

Things may not, alas, be so simple. One major policy challenge comes from fragmentation, or what David Weil (2014: 4) calls 'fissured workplaces': the transformation in how business organises work, focusing on core activities and shifting many low paid jobs – janitors, security guards, drivers, front-desk staff and so on - to separate employers. In such cases, there may be little scope for improving productivity in the low value added segment. As Weil points out,

> … the new organization of the workplace also undermines the mechanisms that once led to the workforce sharing part of the value created by large corporate employers. By shedding employment to other parties, lead companies change a wage-setting problem into a contracting decision. The result is stagnation of real wages for many of the jobs formerly done inside (Weil, 2014: 4).

The solution may thus have to include responsible purchasing practices by lead companies as well as initiatives to ensure the inclusion of all parts of the supply chain into collective bargaining agreements.

Author

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