44. Labour market institutions and inequality

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Throughout most of the world, earnings from work are the most important source of household income. While these earnings depend on where the person works and what the person does, they will also hinge on the governance of the labour market, through macroeconomic policies that support full employment and via the institutions that regulate the workplace, such as unions, collective bargaining, minimum wages and the regulation of employment contracts. Over the past several decades, many governments have neglected full employment as a policy objective, and these labour market institutions have been weakened.

Introduction

Among non-retired households, earnings from work are by far the most important source of household income. How much a person earns at work and how earnings are distributed across the labour market depends on labour market institutions. Labour market institutions – the laws, policies and practices – that govern the labour market can be designed to support the creation of quality jobs with decent wages and working conditions, and to support those who cannot work or who are unable to find work.

The erosion of labour market institutions, or in some countries the lack of them, has contributed to rising inequality in many countries across the world, including in North America, Europe, Asia and parts of Africa. In Latin America, on the other hand, many countries experienced a decline in inequality in the 2000s due in part to the strengthening of labour market institutions. Thus if a country wants to improve equity, it needs to strengthen its labour market institutions.

By labour market institutions, I am referring to the more familiar institutions that regulate the workplace such as unions, collective bargaining, minimum wages, the type of employment arrangement, and working time regulations, although other institutions also have a bearing on the operation of the labour market. In particular, macroeconomic policies in support of full employment are necessary for achieving more opportunities and higher earnings in the labour market, and social protection policies are necessary to support workers when they are no longer working, raise the incomes of those who are working, and improve workers' access to the labour market though social policies that provide child care, elder care and other forms of social support. *Figure 44.1* illustrates the different policy areas that shape labour market outcomes. As other articles in this report address social protection policies, the main focus of this article is on macroeconomic policies in support of full employment and labour market regulations.

Figure 44.1 **The different policy areas that shape labour market outcomes**

Source: Author's illustration.

Macroeconomic policies are part of employment policy

Full employment policies are necessary for achieving equitable societies. Indeed, the OECD has found that a 1 percentage point decrease in the unemployed population reduces the overall Gini coefficient of the working-age population by 0.65 percentage points (OECD, 2011). Moreover, unemployment does not affect all workers equally. In industrialized countries, it is the less educated, poorer workers, as well as young people, women and minorities, who are more likely to be unemployed. In developing countries, it is the more educated who experience higher unemployment rates, as the less educated typically turn to self-employment in the informal economy and do not show up in unemployment statistics. This means that a policy of raising interest rates to contain inflation is particularly harmful to specific groups in the labour market.

Achieving full employment requires supportive monetary and fiscal policies that can stabilize the business cycle and support productive investment by the private and public sectors. In most countries, there are fewer jobs than there are workers. But unfortunately job creation has fallen off the macroeconomic policy agenda over the past several decades. Price stability has been the sole policy goal of monetary policy, and while controlling inflation is important, it should be considered alongside policies to boost investment and job creation (Islam and Kucera, 2014).

Fiscal policy is needed to boost aggregate demand during downturns, and to provide funds for public investment in physical and social infrastructure, which ultimately supports private enterprises. Unfortunately, tax-to-GDP ratios are low (in some cases around 10 per cent of GDP) in many developing countries, limiting the ability of governments to invest in infrastructure, which is fundamental for economic development as well as being an important source of direct and indirect job creation. Low tax revenues also limit the ability of governments to invest in public services such as education, training and care services, with implications for the quality of the labour force and workers' ability to access the labour market. In terms of equality, low tax revenues also limit the amount of redistribution that is possible. Moreover, fiscal policy has tended to be procyclical, augmenting boom and bust cycles and further exacerbating volatility in the labour market.

Income from work and the regulation of work

Income from waged work and self-employment accounts for the vast majority of individual and family incomes. According to the OECD (2011), 83 per cent of household disposable income among the working-age population is earnings from work, with 73 per cent stemming from waged work and 10 per cent from self-employment. The remaining income sources include rents (4.9 per cent) and government transfers (12.3 per cent) (see *Figure 44.2*).

This means that an individual's well-being is for the most part dependent on the income that the individual and the individual's family earn from work, which in turn depends on where the person works and what the person does, but also on the institutions that govern the labour market, including unions, collective bargaining, minimum wages and the regulation of employment contracts. In countries where labour markets are less regulated, or are regulated to allow employers more latitude in setting employment conditions, there is a wider dispersion of labour market earnings.

Unions influence the wage distribution through their engagement in broad economic and social policy debates, but also as parties to collective bargaining agreements negotiated at either the firm or sectoral level. The influence of collective bargaining will depend, however, on whether the system is 'narrow', limited to the parties or the immediate bargaining unit, or an 'encompassing system', whereby collective bargaining agreements are extended to workers in the broader economic sector who are not members of a union. Under both systems there will be wage compression, but because narrow systems are limited to unionized firms, the effect of the wage compression on broader wage inequality in the labour market will depend on the degree of unionization in the economy (Hayter, 2015).

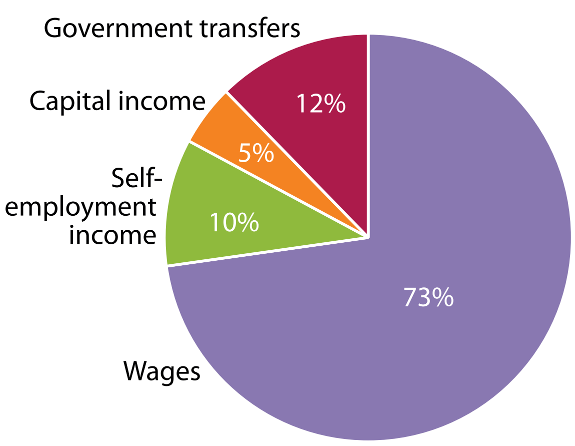
Over the past several decades, trade union density has fallen in many (though not all) developed and developing countries (ILO, 2015*a*). As a result, the wage compression effects of the narrow systems have become even more limited. Under encompassing systems, collective bargaining agreements continue to be extended despite declines in trade union density, although even here, opt-out clauses and a movement from centralized to decentralized systems have eroded some coverage.

Nevertheless, extension has allowed these systems to have a greater effect on compressing wages in the overall economy (International Labour Organization (ILO), 2015*a*).

In some countries, unions have played an important role in influencing policies to the benefit of workers, particularly those at the bottom of the pay scale. This is particularly true for tripartite negotiations on the minimum wage as well as on social protection and social services. But the declining influence of labour has affected its ability to act as a countervailing force in many countries. The financial crisis of 2008, the ensuing Great Recession, the austerity measures being imposed in many parts of the world, and the deregulation of labour laws and collective bargaining in Europe in the 2010s, are all manifestations of its weakening voice.

Minimum wages by definition ensure a minimum level of earnings for those at the bottom of the pay scale, and are an effective tool for compressing the wage distribution as well as lessening the incidence of low pay in both developed and developing countries.[1] According to the ILO, approximately 90 per cent of countries have minimum wages. There is a wide diversity in the world's minimum-wage systems, including their wage-setting processes, their scope, complexity and effectiveness, and their absolute and relative values (ILO, 2008).

Figure 44.2 **Components of disposable income, working-age population, mid-2000s, thirty OECD countries**



Source: OECD (2011, p. 230).

Minimum wages are particularly important in countries where collective bargaining is restricted to the firm level, as they ensure that all workers benefit from a wage floor. And even in developing countries where minimum wage laws are less enforced, empirical evidence demonstrates that minimum wages reduce inequality, in part due to 'lighthouse effects', whereby formal minimum wages provide a reference for bargaining among informal waged employees and their employers (Souza and Baltar, 1979).

Despite the benefit of minimum wages for equality, there has been considerable debate in the economics profession on their employment effects, specifically on whether raising the minimum wage leads to job losses, as the competitive labour market model suggests. Yet there exists substantial empirical evidence for negligible effects on employment, and sometimes for positive effects by encouraging workers to enter the labour market (Belser and Rani, 2015; World Bank, 2012). And at the macroeconomic level, higher minimum wages can stimulate consumption and aggregate demand. Nonetheless, minimum wages should not be set at a level that is too high, which promotes non-compliance, or at too low a level, which negates the effectiveness of this important policy tool.

The type of employment arrangement that a person works under also influences the pay and working conditions of the worker, including their sense of job and income security. The decline of the standard employment relationship, witnessed by the rise in temporary employment contracts, dependent self-employment, temporary agency work and other forms of subcontracted work, is just beginning to be understood (ILO, 2015*b*). Since the 1990s, temporary contracts have become a distinguishing feature of labour markets in Southern Europe, the Andean countries and parts of Asia. Temporary contracts entail significant wage penalties for individual workers. Moreover in countries with high shares of these contracts, such as Spain, where over a quarter of the labour force are on temporary contracts, workers are less likely to switch between fixed-term and indefinite contract jobs, and risk becoming trapped. This is problematic not just for the individual, but for the labour market as a whole. It inhibits investments in training which are important for improving productivity, and creates segmented labour markets, which constrains mobility and opportunities (ILO, 2015*b*).

Moreover, workers employed under temporary contracts often do not meet the requirements for receiving unemployment insurance benefits, and may not be covered by collective agreements.

Part-time work is another employment arrangement that has implications on inequality. Whether it is a source of inequality will depend largely on how it is regulated. In countries where the laws reflect the principle of equal treatment of part-time workers, wages and benefits will be on a pro rata basis. Moreover, some countries grant employees the right to switch into and out of part-time work, mitigating the risk of part-time jobs becoming a career trap. Under these conditions, part-time work can be an attractive option for workers who need to reconcile work with personal responsibilities, and who might not otherwise have participated in the labour market. But in some countries, unregulated part-time work is sometimes a strategy on the part of employers to evade paying social security contributions, health insurance or holiday pay, resulting in lower earnings, fewer training opportunities and poorer job quality. In developing countries, part-time work is common among informal, self-employed workers, at times reflecting a strategy for reconciling domestic responsibilities with work, but also reflecting insufficient work opportunities.

In countries with large informal economies, many workers have scant legal protection and poor access to social security. Institutions that regulate the workplace, such as the labour inspectorate and labour courts, as well as programmes to raise legal awareness among workers and employers, are needed to improve compliance with the law.

Accessing the labour market

Finally, institutions are needed to support access to the labour market for workers, especially for women, who typically shoulder the burden of care responsibilities. Public care services can facilitate women's ability to enter or remain in paid work, with consequences for both gender and income inequality. When care services are not provided publicly, workers are not able to enter the labour market, or have less flexibility, less choice and bargaining power when they do enter it. If they do enter, they might delegate their domestic responsibilities to other, usually female, members of the household, which explains in part the higher share of young females who are not in education, employment or training (NEET) in lower-income families.

Other institutions can also affect participation in the labour market, for example by ensuring that groups outside working age, such as adolescents and the elderly, have the option of not participating. There is a significant negative relationship between the coverage and benefit levels of pensions and labour force participation by the elderly.

Conclusion

As work is the source of most household income, the institutions that regulate work have important consequences for the distribution of income within a country. Over the past several decades in many countries around the world, there has been an increase in the pay of highly skilled workers along with a rise in the national share of income going to capital. In many countries, less-skilled workers have seen their wages and working conditions decline as unions have lost power, minimum wages have weakened and non-standard employment arrangements have proliferated.

Reversing the trend of increasing inequality, and ensuring just societies requires a wide range of policies, including explicit macroeconomic policies to support full employment, well-designed institutions that govern working arrangements, and social policies and public social services that support the working and non-working alike. There is no one-size-fits-all model; rather, policies should be designed to reflect the economic, social and institutional characteristics of the country concerned.

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This text draws on Berg (ed.) (2015).

Note

1. See the two special editions of the *International Labour Review* on low-paid work in industrialized (Vol. 148, No. 4) and emerging economies (Vol. 151, No. 3).

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