Competitiveness and Pay Formation

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Introduction

An important objective of economic policy is to raise the living standards of the population. To achieve this, our ability to compete on international markets is critical. This is particularly important as we now live in an exchange rate regime over which we have little or no control. In these circumstances we need to develop a system of income determination which contributes to the maximum increase in living standards and the lowest level of unemployment. Private companies are always free to make their own arrangements designed to meet their particular needs subject to complying with statutory obligations in the area of employment standards and minimum wages. Alternatively they may participate in national pay agreements.

In this paper we set out a framework for income determination under a national pay agreement. If there is no agreement, the model we propose could apply in the public sector.

Our proposals are developed around what we argue are three essential guidelines for public policy and economic and business behaviour:

1. **Export and other foreign earnings[2] are in the long run the only sustainable source of economic growth – our living standards depend to a very considerable extent on the willingness of non-residents to buy our goods and services.**

2. **We must recover and enhance competitiveness.**

3. **Pay formation across the economy must reflect the two previous requirements i.e. pay formation should reflect the overarching requirement of underpinning export and foreign earnings growth through enhanced competitiveness.**

We regard these as necessary guidelines for good policy and economic behaviour. Of course, they are necessary but not sufficient! Sustainable and positive outcomes also require sound fiscal policies and appropriate supply side, infrastructural and demand management policies. They also require an efficient business environment – ideally underpinned by vigorous competition on the domestic market. In this paper we argue the case for these three guidelines and then go onto explore outline proposals for a process which reflects the requirement that pay formation reflects the need to recover and enhance competitiveness.

[2] For the purposes of this paper, foreign earnings include export revenues as well as all forms of "invisible" earnings such as investment and royalty incomes etc.

1. Foreign Earnings, including Exports, are in the Long Run the only Sustainable Source of Economic Growth

We take the well established arguments for the gains from trade as a given. Our argument is that our prosperity (and as a consequence our ability to fund and achieve a range of desirable social policy goals) depends to a very considerable extent on our ability as an economic area to **profitably** sell goods and services to firms and people in other countries. Because the ultimate focus of this paper is on pay policy we want to emphasise the meaning we attach to **profitability** in this context. We want to see increasing returns for both labour and capital. We are not advocating policies which imply a "race to the bottom". There is absolutely no point to policies where exports are achieved through measures, such as suppressing pay or profits or which through tax and public expenditure policies have the effect of reducing living standards and incomes in this country.

We need to export to assure prosperity – if only to provide the funds for our purchases of imports. Also, over the much cited "long- run" we need to at least balance our transactions on the current account with the rest of the world – or perhaps, given the projected aging of our population, run small surpluses which would form the basis for future streams of investment income? Allied to this we would argue that even on an annual basis we would be well advised to avoid the balance of payments on the current account shifting strongly into deficit[3].

This may seem to be a somewhat old- fashioned argument now that we are firmly embedded in the Euro zone and no longer face the balance of payments constraints which apply to a country with an independent currency. We do not, of course, face the same balance of payments constraints as when we had a (nominally) independent currency. A severe deficit in the Irish balance of payments on the current account no longer creates the immediate pressures, such as a run on the currency and upward pressures on the Irish interest and inflation rates which it would have faced in the pre-EMU days. But, the long-run consequences are not greatly different. A sustained balance of payments deficit with the rest of the world must be financed, either through foreign borrowing or through increasing foreign ownership of assets in this country, or more likely through a combination of both[4]. None of which are desirable outcomes.

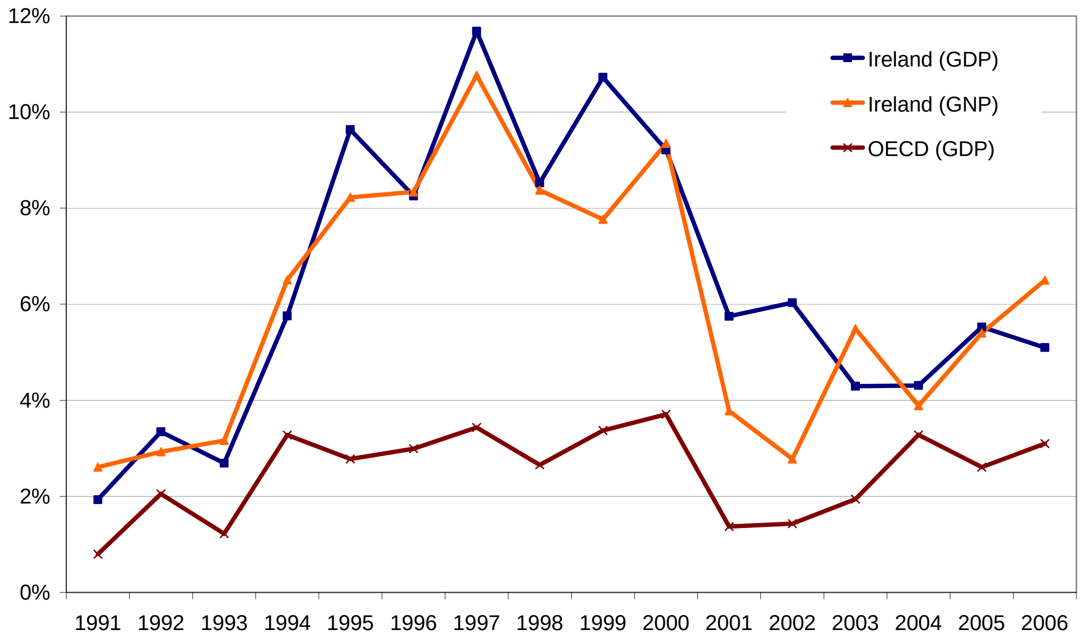
[3] Deficits on the balance of payments can of course be appropriate in the short run if they are used to finance productive investments – but in the long run the contribution of these investments should contribute to future surpluses.

[4] It can, of course, be argued that foreign direct investment (FDI) allows us to support a current account deficit. But in the long run FDI should result in an increase of exports and in this sense the presence (and importance to the Irish economy) of FDI does not affect our argument.

Recent Economic History

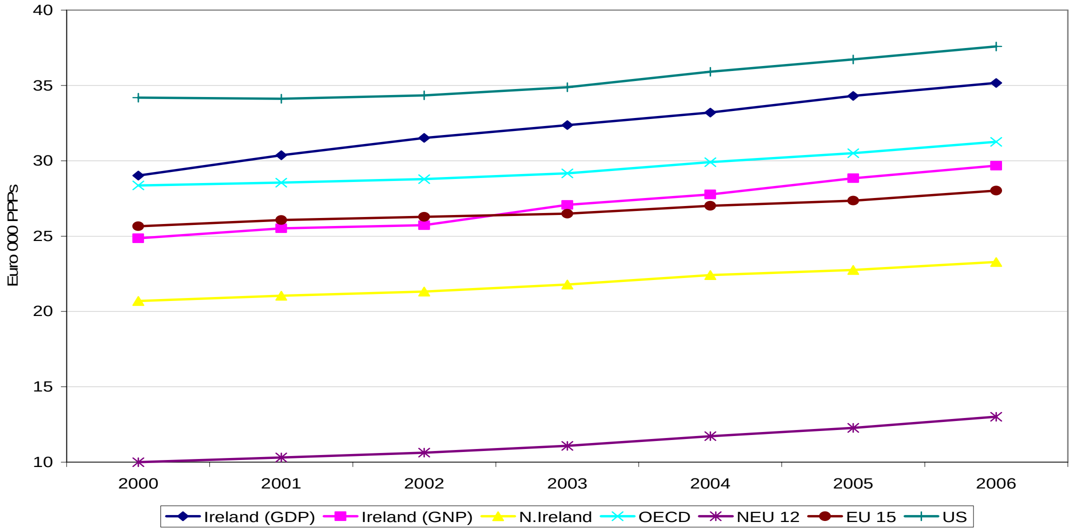
The very strong positives in the story include the exceptional growth performance of the Irish economy. Since 1990 the Irish economic growth rate has significantly exceeded the OECD average leading to significant increases in GDP/GNP per capita (Figures 1, 2 and 3) and in the quality of life of Irish citizens.

Figure 1: Growth in GDP & GNP in Ireland, Compared to OECD Average, 1990-2005



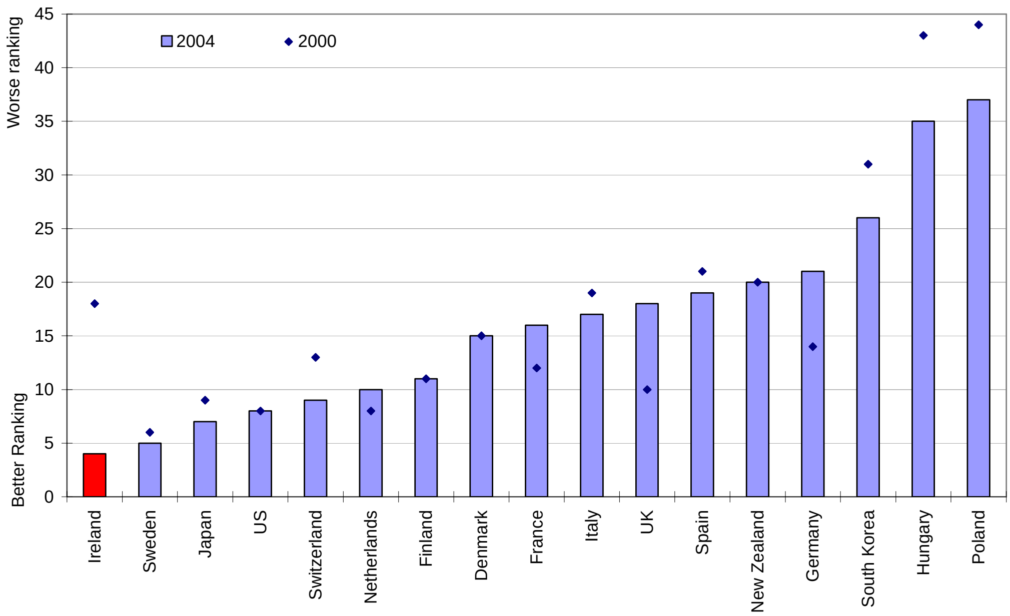
Source: Groningen Growth and Development Centre, Total Economy Database, 2007; Central Statistics Office, Annual National Accounts

Figure 2: Levels of GDP per Capita, Ireland and Selected Economies, 2000-2006 (Euro 000 PPPs)



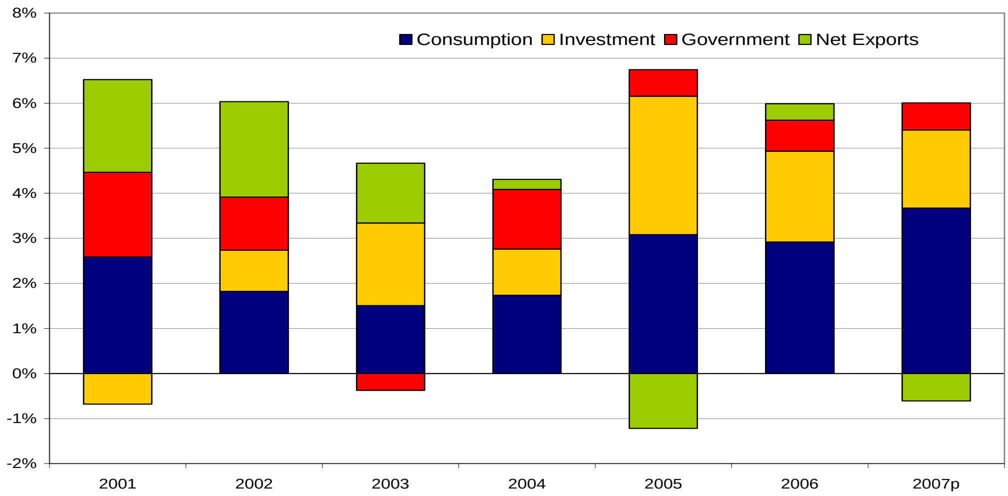
Source: Forfás calculations; Groningen Growth & Development Centre, Total Economy Database, January 2007; UK Office for National Statistics [online]

Figure 3: Ranking in the United Nation's Human Development Index, 2000-2004



From 1995 to 2003 net exports were a consistently strong driver of economic growth – particularly so in 2001 and 2002. The contribution of net exports declined in 2003 and 2004 and turned negative in 2005 and 2007 – Figure 4.

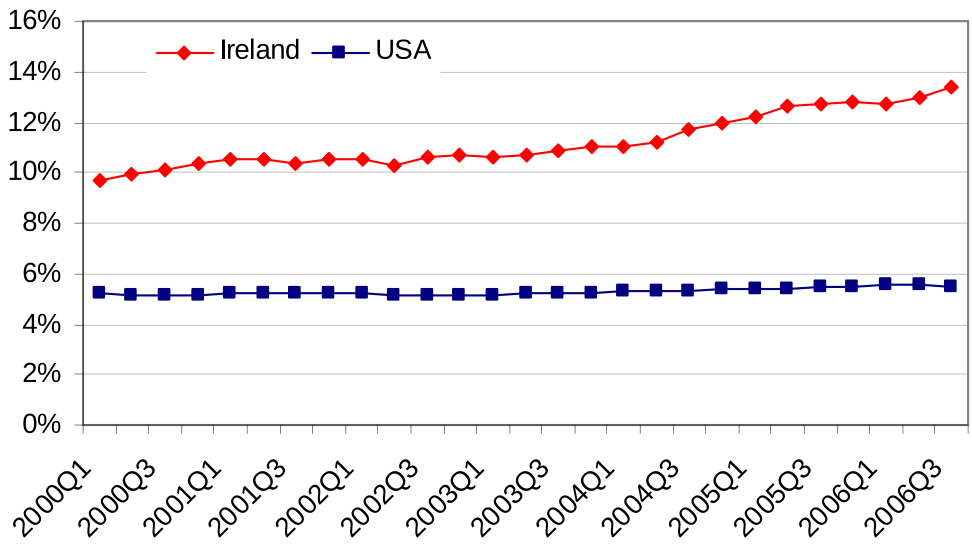
Figure 4: Contribution of Net Exports to Irish Economic Growth, 2001-2007



Source: Forfás calculations, Central Statistics Office, Annual National Accounts [online]

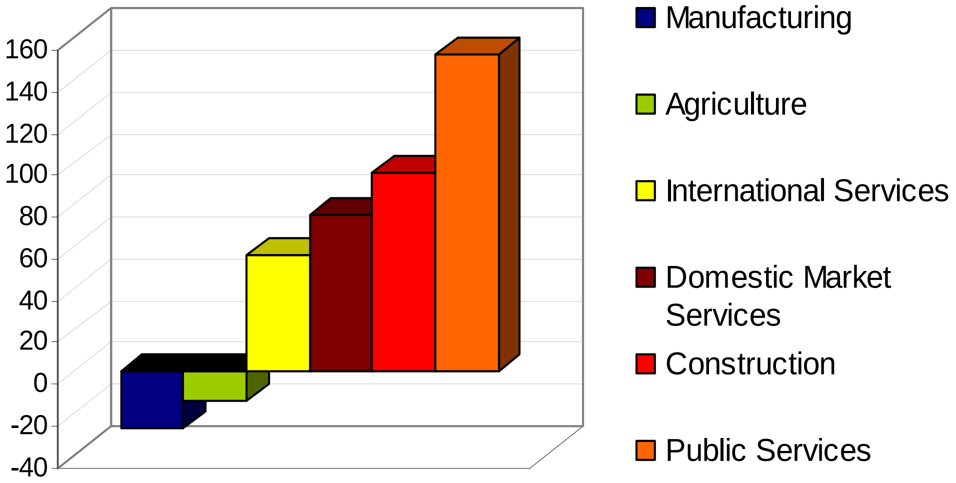
This has been reflected in changes in the composition of employment with increasing reliance on construction, public services and domestic (non tradable) market services for employment creation – figures 5 and 6.

Figure 5: Construction as proportion of total employment, Ireland & USA, 2000-2006



Source: European Central Bank; Central Statistics Office, ESRI.

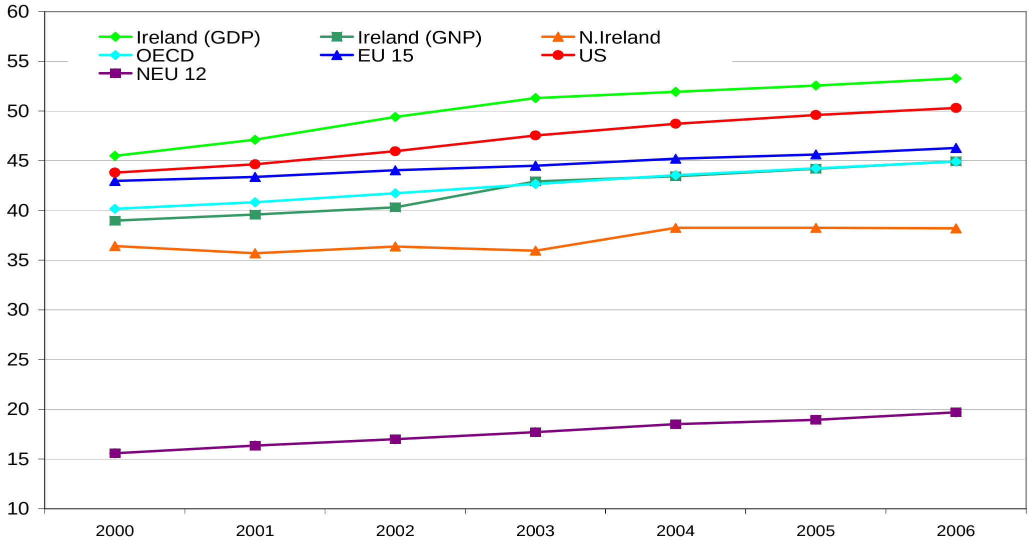
Figure 6: Sources of employment growth (000s jobs), Ireland, 2000-2006



Source: European Central Bank; Central Statistics Office, ESRI.

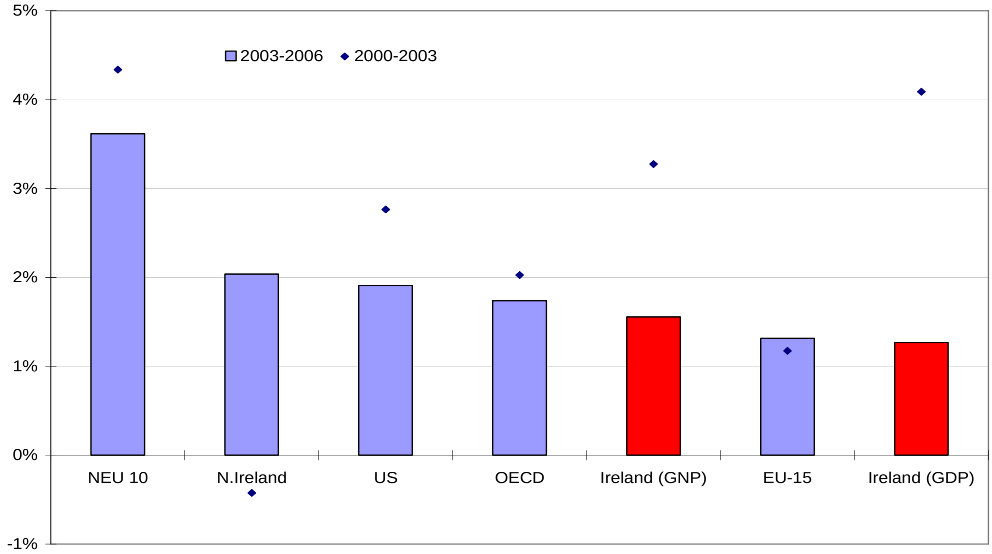
While productivity levels have remained high the shift in economic activity towards consumption and away from the foreign sector has been reflected in declining productivity growth levels – Figures 7 and 8.

Figure 7: Per Hour Output, Ireland and Selected Economies, 2000-2006 (€ value added)



Source: Forfás Calculations; Groningen Growth & Development Centre, Total Economy Database, January 2007; United Kingdom, Office for National Statistics, 2007 [online]; Northern Ireland Department of Enterprise, Trade & Investment, Northern Ireland Labour Force Survey: Historical Supplement Spring 1984 – Spring 2006, March 2006

Figure 8: Annual Average Growth in Output per Hour Worked, 2000-2006

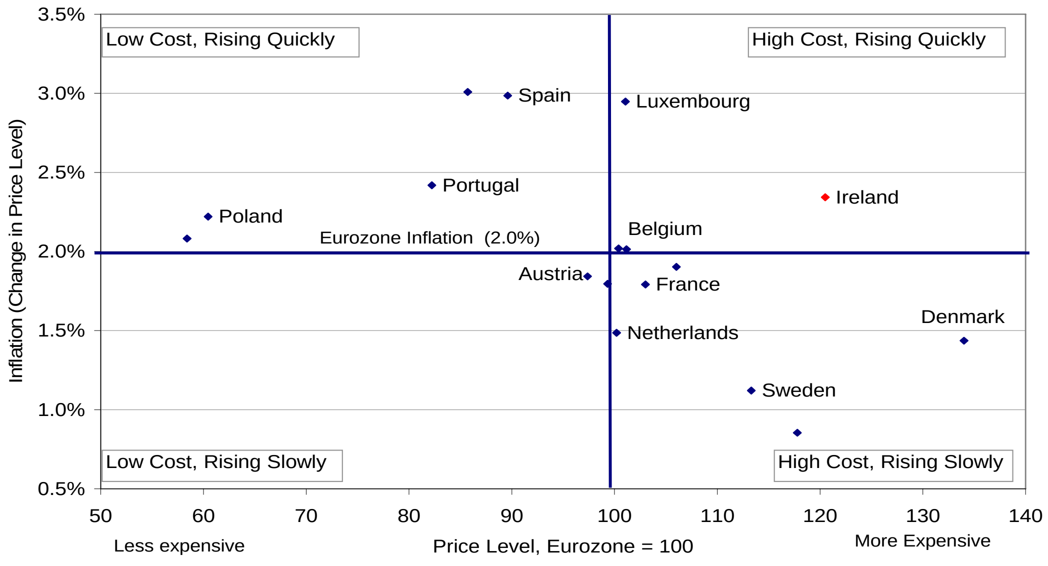


Source: Forfás Calculations; Groningen Growth & Development Centre, Total Economy Database, January 2007; United Kingdom, Office for National Statistics, 2007 [online]; Northern Ireland Department of Enterprise, Trade & Investment, Northern Ireland Labour Force Survey: Historical Supplement Spring 1984 – Spring 2006, March 2006

The economic impacts of these changes are reflected in:

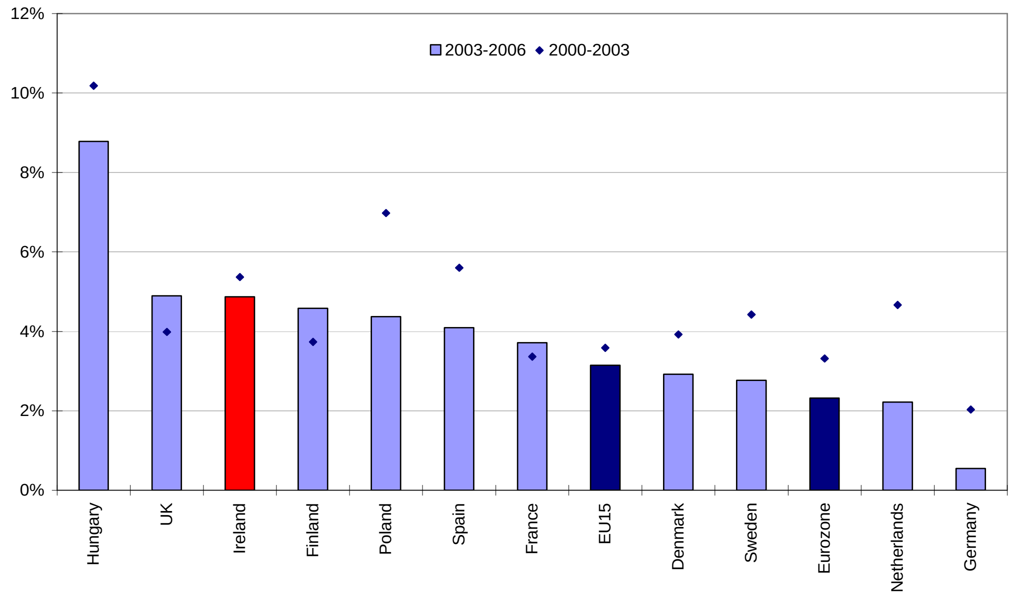
- High rates of cost and price increase compared with competitor countries (Figure 9 and 10);
- A growing balance of payments deficit on current account (Figure 11); and,
- Increasing levels of household debt (Figure 12).

Figure 9: Price Level 2006, and Inflation 2003 to 2007, EU Member States



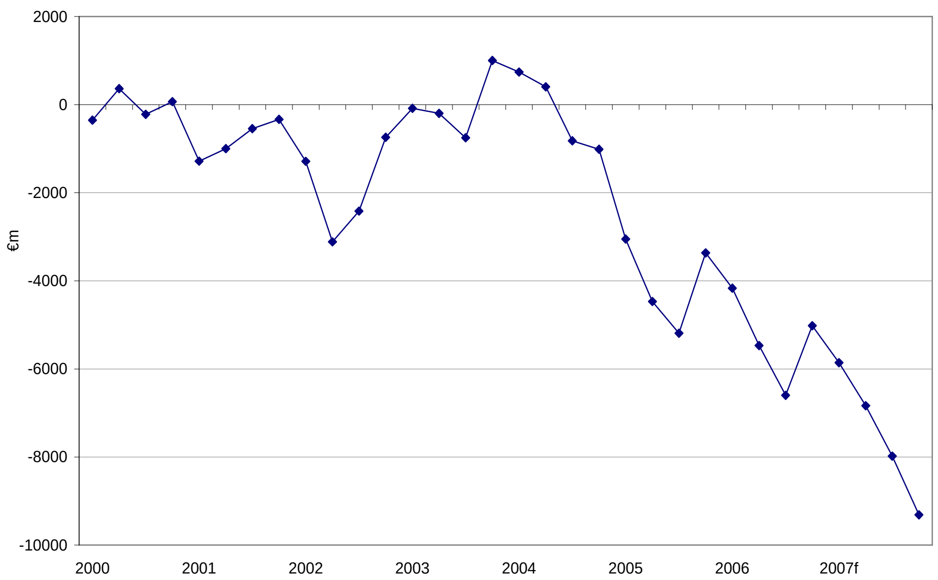
Source: Eurostat, Economy and Finance Indicators, 2007 [online]

Figure 10: Labour Cost Growth Rates, 2000-2006



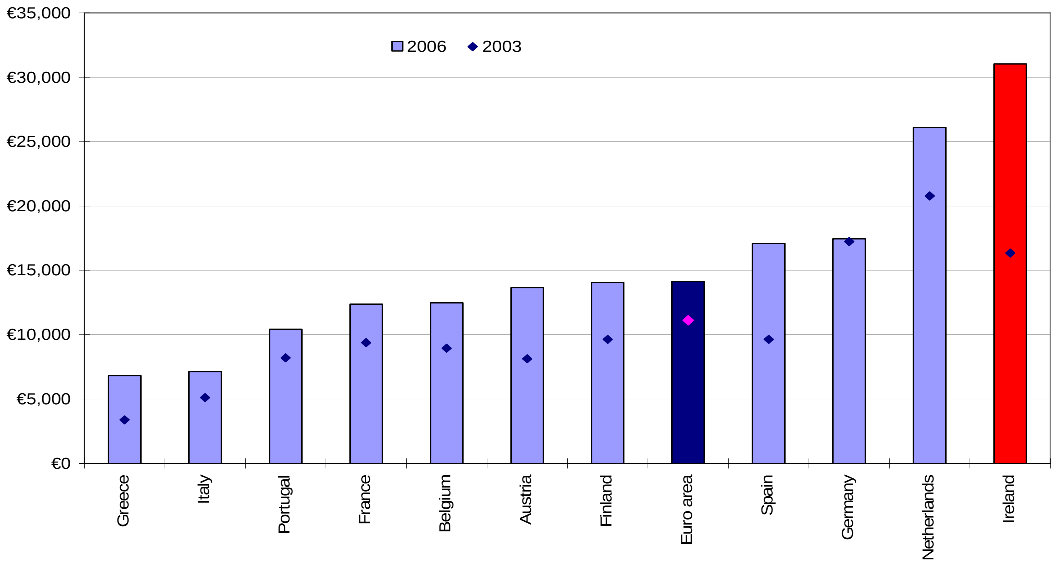
Source: Eurostat, General and Regional Indicators, 2007 [online]

Figure 11: Current Account Balance, (€) 2000 -2007f



Source: Forfás calculations; Central Statistics Office; Economic & Social Research Institute

Figure 12: Household Borrowing per Capita (2003-2006)



Source: European Central Bank, Aggregated Balance Sheet of Euro Area Monetary Financial Institutions

2. We must recover and then enhance Competitiveness

The picture painted above does not by any means signal imminent doom. The outlook for the Irish economy is good, subject of course to good economic management and behaviour and reasonably favourable international economic conditions. But the imbalances identified in the preceding paragraphs and diagrams do indicate a loss of competitiveness. Restoring this lost competitiveness and then enhancing it is an important policy imperative.

As a concept competitiveness traditionally had a very strong focus on comparative costs of production. The understanding of the concept has become increasingly sophisticated (and as a consequence impossible to collapse into a single or small number of indicators[5]). The NCC defines national competitiveness as "*all those factors which impact on the ability of firms in Ireland to compete on international markets, in a way which provides Ireland's people with the opportunity to improve their quality of life*"[6]. From this perspective, competitiveness, while being partly about costs, prices and pay, is very much about business performance through innovation and productivity built on foundations of sound fiscal and economic policies. As framed by the NCC competitiveness embraces economic concepts of sustainability and comparative advantage – both of which are also reflected in the notion of improving the quality of life.

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[5] For example, the 2006 Benchmarking Report from the NCC published comparative inter- country data in respect of 135 indicators

[6] Annual Competitiveness Report 2006, Volume 1, Benchmarking Ireland's Performance – see www. competitiveness.ie

So how Competitive is the Irish Economy?

Figure 13: The strengths and weaknesses of Irish firms

Strengths	Weaknesses
• Existing base of high performing manufacturing firms with a strong track record in large scale facility construction and operation. • A growing internationally trading services sector. • High rates of entrepreneurship. • An adaptable work force which exhibits flexibility, creativity and a 'can do' attitude. • A deepening pool of human capital. • An international reputation for flexibility and responsiveness. • A culture of openness to new ways of working, ideas and people. • A reputation as a secure location to manage IP and regulatory matters. • A growing reputation in a range of emerging activities such as managing regional headquarters functions, IP management and distribution, hosting and management of digital content, online sales, high value customer management, supply chain management and R&D.	• Limited management expertise in innovation and international sales and marketing. In addition, the majority of people employed in MNC manufacturing are involved in production rather than other activities such as R&D, SCM, or marketing and sales. • Adoption of best practice management techniques remains relatively low. • Given international competition, many firms have limited ability to increase output prices, despite growing input costs. • Restrictive mandates from some overseas headquarters to add functions to MNCs in Ireland. • Dependence of many indigenous exporters on a limited number of international markets and customers. • A limited number of Irish services companies have grown real scale. Given low profitability, for most of these companies, shareholder value is released through trade sale rather than dividends. • Under exploitation of ICT, particularly among small firms. • Limited capabilities to absorb the output from State funded R&D.

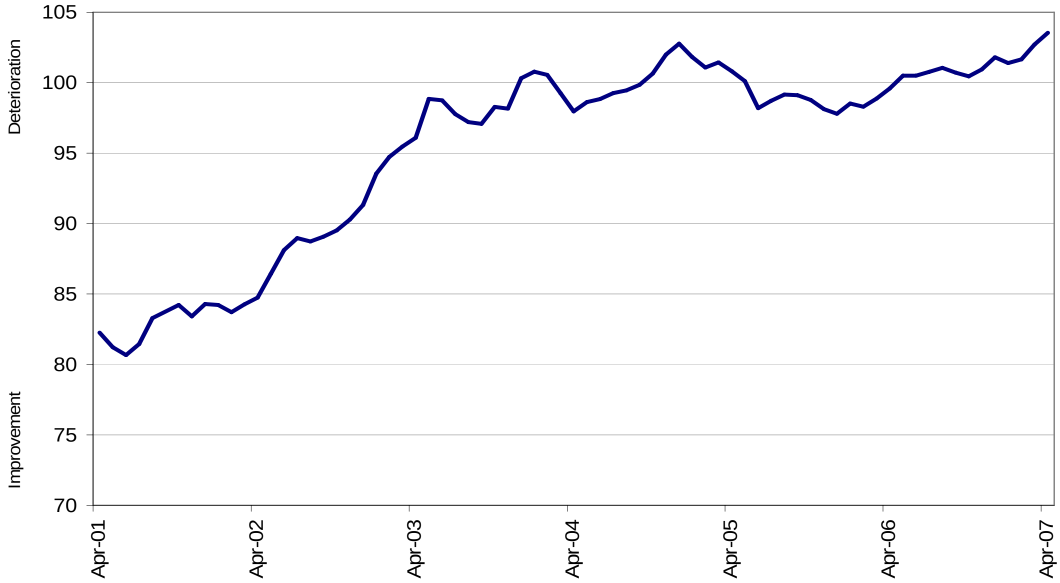
International rankings show that while Ireland still ranks among the more competitive economies among developed countries our previous exemplary position has been slipping – Figure 14.

Figure 14: Where Does Ireland Stand Internationally?

Source: World Competitiveness Yearbook, Institute of Management Development; Global Competitiveness Report, World Economic Forum

This diagram reflects differences in the criteria and weightings used by the World Economic Forum (WEF) and the Institute of Management Development (IMD) but the trends are consistent. A broadly similar picture is shown by data tracking movements in the harmonised competitiveness indicator shown in Figure 15. This indicator combines changes in inflation and movements in the effective exchange rate. Since 2000, there has been a loss of price competitiveness, reflecting the combination of higher price inflation in Ireland and an appreciation in the trade-weighted exchange rate.

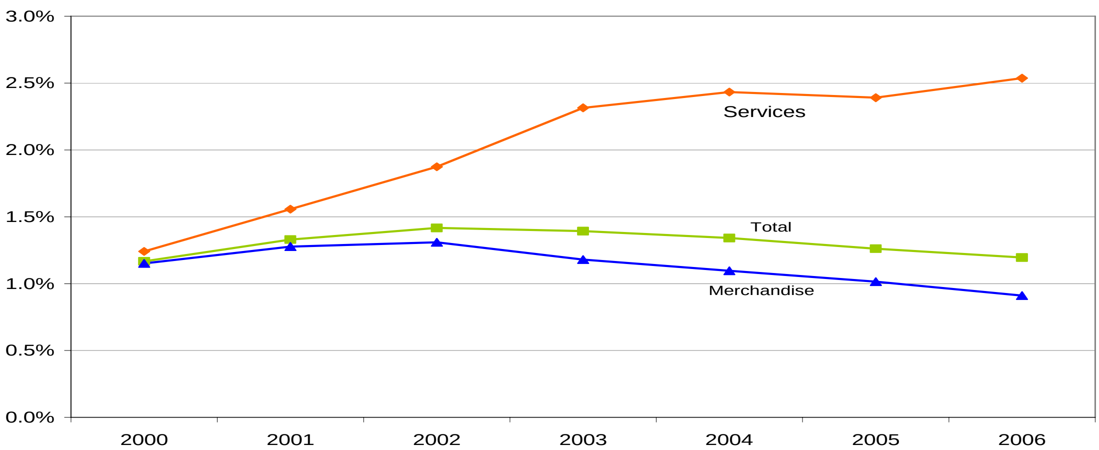
Figure 15: Harmonised Competitiveness Indicator, 2001-2007 (2004 =100)



Source: Central Bank of Ireland

These trends are consistent with a loss in Ireland's share world markets (Figure 16). However, recent data for exports are encouraging as is the strong performance for services exports which increased in 2006 after a slight decline in 2005.

Figure 16: Ireland's Share in World Merchandise and Services Trade, 2000 - 2006



Source: World Trade Organisation

Cost increases are an important part of the story as is the need to attempt to reverse the trend of declining productivity growth rates – see figures 8 and 10 above[7].

In summary; while the policy emphasis through investment and other policies is to move production of goods and services up the so-called "value added chain", costs (including pay costs) continue to be important.

[7] Services prices are over 20% above EU-15 average, with particularly high prices for utilities, hotels and restaurants and some locally-traded business services including industrial and commercial rents, energy costs, some legal and professional fees and waste disposal charges. Electricity prices for industrial users are now the third highest in the EU-25". "Ireland's Competitiveness Performance", Cassidy and O'Brien, Central Bank Quarterly Bulletin, April, 2007

3. Pay Formation should reflect the Overarching Requirement of Underpinning Export Growth through Enhanced Competitiveness

The guideline which we derive from the above discussion is that in order to sustain competitiveness, pay increases in Ireland should reflect price movements in our international markets and well as our productivity performance.

- If our objective is to increase world market share compensating ourselves for domestic cost increases which are higher than those prevailing in our markets is counterproductive. This has implications for the practice of including inflation compensation in discussions about pay.

- Real pay increases which move in line with achieved productivity increases allow us to maintain competitiveness. Improved productivity, allied with, and indeed driven by a continuing shift in production towards goods and services which incorporate increasingly higher levels of embedded knowledge and human capital, is the key to future prosperity.

This thinking is reflected in our proposed outline model for pay formation. Our attention is focused on the non –traded sector and, within that on the public sector. The reason for our focus on the non- traded sector should be evident. Firms in this sector and particular public service organisations are not directly exposed to foreign competition and in general face less intensive pressures from competitors to improve efficiency and contain costs than is the case for exporters.

Outline of the Pay Formation Model

Our proposal is that there would be two elements to pay increases:

1. **An annual basic or "platform" pay increase related to a trade weighted measure of inflation for internationally traded goods and services in our trading partners[8].**

2. **A growth related payment linked to increases in productivity per person at work – measured as the change in GNP per person at work (possibly with adjustments – see later discussion).**

There are elements of a hybrid approach to our proposal. We allow for some reflection of inflation changes in our proposal and also for a productivity adjustment. The first component is "optional", the second is essential.

We illustrate this approach using a hypothetical illustration as to how it could operate in the public service but as we explain later there is no reason why it could not be applied more generally.

In our example the Minister for Finance in, say, the 2010 Budget, would make a provision for public service pay in the 2010 estimates for public expenditure outlined in the unified Budget statement for that year[9] . This provision would contain the "platform" for basic pay increases which could be paid directly to public service employees in the normal way. The second growth related provision would be related to the estimated change in GNP per person in the labour force (as per agreed adjustments) during 2009. Before the end of 2010 this amount (adjusted for revisions in the estimated change in GNP per capita) would be allocated to a **"Growth Fund"** which would be statutorily established as an Exchequer Fund from which payments could then be made to individual employees during 2011. The cycle would then roll forward as described in Figure 17.

[8] Enthusiasts for rigour (and complexity) could argue correctly that the inflation related element should not only be trade weighted but also adjusted for exchange rate movements.
[9] Under the new arrangements announced in September 2007, the Budget Day for 2010 would be in late 2009.

Figure 17: Illustrative Outline of the Pay Formation Cycle

Date	Actions
2010 Budget Day - in December 2009	Minister for Finance makes provision for public service pay for 2010. 1. Determines inflation related "platform" increase. 2. Determines "Growth related" pay increase as per changes in individual productivity across the economy in 2009.
Late - 2010	Minster for Finance makes payment to statutory "Growth Fund" based on latest GNP and labour force estimates for 2009.
2011	Payments of the "**Growth Dividend"** made to individual employees in line with negotiated agreements.
2011 Budget Day – December 2010	Minister for Finance makes provision for public service pay for 2011 1. Determines inflation related "platform" increase. 2. Determines "Growth related" pay increase as per changes in individual productivity across the economy in 2010.
End - 2011	Minster for Finance makes payment to statutory "Growth Fund" based on latest GNP and labour force estimates for 2010.
2012	Payments of the "**Growth Dividend"** made to individual employees in line with negotiated agreements.

The Devil is in the Detail

The model is presented in outline only. It allows for considerable flexibility and is by no means cut and dried. If the underlying model provides a basis for consideration there is considerable room for debate and negotiation.

Policy questions

1. **Should there be a "platform" increase linked to inflation?**

   There is, of course, an argument for tying pay increases to productivity only. Nonetheless the reality of the pay formation process is an expectation by employees for a response to the impact of inflation. The model as presented allows for immediate payment in respect of an inflation adjustment. In our view, any " platform" increase should be based on a trade-weighted measure of goods and services inflation in our export markets such as the Harmonised Indices of Comparative Prices (HICP) used by the European Central Bank and other comparable indices. As well as being economically realistic this would have the effect of enhancing awareness in Ireland of our comparative inflation performance. Ultimately, the case for or against this payment is a pragmatic one and the case for or against its inclusion should be determined by economic circumstances.

2. **Why use GNP per person at work?**

   This is widely used measure of productivity across the labour force and adjusts for changes in employment.

   Nonetheless the use of GNP per person at work is not without conceptual problems. As has been the case in recent years GNP growth can also be fuelled mainly by domestic demand factors such as personal consumption fuelled by borrowing or current public expenditure which do not reflect success in selling goods and services on export markets. A number of adjustments are possible. In an earlier variant of this proposal[10] we suggested deducting from GNP the value of expenditure by public authorities on current goods and services (PANCE) so as to avoid feeding the cost of increases in the public service pay bill into pay increases and to create a positive incentive for increasing productivity in the public service. A more conceptually complete approach might be to make a deduction for debt –stimulated household and public sector consumption by deducting from GNP a measure of the net increase in household and public net current indebtedness. This variant may be conceptually

[10] de Buitleir and Thornhill 2001

attractive but its application would encounter significant data and estimation problems.

3. **Should there be a one to one relationship between GNP growth per person at work and pay increases. Should it be adjusted?**

   We believe that there is a strong case for making adjustments to reduce the factor to less than a one to one relationship. There are a number of persuasive reasons including;

   1) The model provides for a platform increase.
   2) Employees gain from other measures now incorporated in national partnership agreements.
   3) In the short and medium term there is a need to recover lost competitiveness.
   4) Particularly so, if there is a fiscal incentive – discussed in the following paragraphs.

4. **Can the model be extended to the private sector?**

   There is no reason why the same mechanism could not apply across the economy. It could, for example, apply in exactly the same way as in firms which have profit sharing schemes.

5. **What about tax reliefs?**

   Notwithstanding considerations of tax equity we can see powerful arguments for extending some form of fiscal privilege to the **Growth Dividend.** One option would be to follow the treatment given to payments under approved profit sharing schemes in the private sector. For example if the Growth Dividend (or portions of the Dividend) were invested in approved or designated investment funds for three years it could be free of tax in line with the private sector scheme. Payments taken in the form of cash would be subject to tax in the normal way.

6. **Could it extend to public service pensioners and social welfare beneficiaries (including pensioners)?**

   Why not?

7. **Is this model applicable only within the framework of social partnership and national agreements?**

Technically yes, at least as regards the public service where pay is subject to central negotiation. On the wider question of the appropriateness or otherwise of national pay arrangements, we would have serious concerns about the "transition effects" of moving from a nationally determined framework to local bargaining. Overshooting, expensive and disruptive strikes are real risks as is the likelihood that vulnerable workers will lose out in the competition. However, we do see the need for greater responsiveness and flexibility in national pay arrangements in respect of macroeconomic conditions if they are to continue as a powerful positive force in economic development. We believe that this model offers these possibilities.

8. **Would payments from the Growth Fund be automatic?**

We don't think so. Payment should be linked to the achievement of agreed and appropriate productivity measures such as those under the Performance Verification Processes in the public sector.

9. **What about benchmarking Increases or other special pay awards?**

In our view, the arguments for and against need to be addressed in the context of the guidelines we set out at the beginning of this paper.

Technical Issues:
The model needs to have regard for the continuing process of revision of GNP, labour force data and other measures. The proposal allows for rolling forward of adjustments in the form of payments to the proposed **Growth Fund** from year to year. Nonetheless, explicit recognition needs to be given in the institutional arrangements for ensuring trust and confidence. This could perhaps be done by establishing a statutory supervisory commission or board to sign off on the estimates of GNP etc each year. The composition of this body could include trade union, employer, public service representative and independent members (one an international economic expert?) and should be chaired by one of the independent members.

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