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Tax for Equity (T4E) - Getting Wages back on Track

by Frank Hoffer[1]

During the last few decades productivity gains have not been shared fairly in most societies. The resulting growth in inequality has been one of the root causes of the crisis. Austerity and further aggressive wage cuts are currently aggravating the problem. As wage developments are continuously trailing long-term productivity growth, governments need to act in leading economies back to a more balanced growth path. Profits generated by monopolising productivity gains and depriving workers of wage rises in line with productivity should become subject to special taxation. Such a Tax for Equity (T4E) would ensure fair competition and close the opportunity for profit maximisation through wage repression.

Sharing productivity growth

To ensure inclusive and sustainable growth, productivity gains have to be shared between capital and labour. For this to happen, real wage growth needs at least to match the long term productivity growth in a society. As central banks aim at a certain level of inflation, nominal wage growth needs therefore to equal national productivity growth plus the targeted inflation rate of the central bank. Following such a balanced wage norm the increased productive capacity will be absorbed by the higher aggregate demand resulting from the simultaneous increase of wages and profits. Wage growth below productivity leads to either deflation as witnessed in Japan or aggressive export surplus strategies as in Germany; or - if prices are sticky - a decline in real wages, aggregate demand, production and employment. As markets have failed to deliver such balanced wage developments there is a need for policy intervention to stop the macro-economically undesirable wage repression. Wage restraint was achieved in many countries through a weakening of the collective bargaining system, an unprecedented rise in precarious employment and the creation of large unprotected low pay sectors.

Towards rational wage setting

Trade unions are too weak to ensure a fair-sharing of productivity gains, and decisions by governments to enlarge the legal scope for unprotected forms of work have made things worse. The insufficient wage growth has resulted in a global lack of aggregate demand. To avoid further deflationary downward pressure on wages, and beggar-thy-neighbour policies, requires that enterprises do not abuse their market position and do not force desperate workers to accept low wages. There is a need to correct the power imbalance in the labour market that results in ever greater inequality and dysfunctional macroeconomic outcomes. With depressed wages, even higher profits do not result in increased investment, because investment decisions are not so much based on past profits than on future profit expectations.

Current wage setting practices allow unproductive enterprises to stay afloat by receiving *de facto* wage subsidies from the workers. This has the same negative impact on overall productivity as other subsidies that artificially maintain uncompetitive enterprises in the market. From the enterprise perspective there is no difference whether the subsidy is a government hand-out or a wage concession. As with other subsidies, wage concessions might be justified as an emergency measure to absorb an economic shock, but they should never be permanent.

In light of the failure to maintain decent wage growth, there is a need for policy to reverse this socially and economically negative trend. Governments should support systems of more centralised or coordinated wage-setting. An efficient way would be taxation that makes it unattractive for enterprises to push wage below the productivity-related wage norm. Any cost savings gained from lower nominal unit labour costs achieved by undercutting the wage norm should be highly taxed.

Taxing wage dumping

How would this work? Every enterprise would report the hourly wage of their employees to the tax authorities. The difference between the average hourly wage increase actually paid to all employees except executive management and the wage norm will be subject to the tax for equity (T4E).

With the T4E, companies underpaying their employees – meaning paying a wage increase below the wage norm – would have to pay a 75 per cent tax on cost savings achieved through underpaying workers. The rate should not be set at 100 per cent, as there might be situations that justify a slight deviation from the wage norm. The T4E gives a strong incentive for workers and employers to share prosperity and it can be assumed that it will

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support collective bargaining processes. Employers will most likely prefer to give a motivating pay rise to their workers instead of paying higher taxes and as a one dollar reduction in wages will only result in 25 cents of cost savings, the economic case for wage repression is much weaker. Workers will also feel more confident in demanding fair wages as this is supported by state tax policies. Under these new rules of the game, only in extremely difficult economic situations would wage agreements below the wage norm be expected. The high tax rate would only be imposed on cost savings that have been gained by underpaying the employees. Hence, it will only create an additional 'tax burden' for enterprises that achieve a business advantage through unfair labour practices. The tax would not replace collective bargaining as a wage-fixing mechanism. Employers can freely choose to share the productivity gains with their employees through adequate wages, or with society at large through the T4E. However, their ability to gain a competitive advantage by wage subsidises from their workers would be severely limited. But would employers not try to circumvent the tax through further outsourcing? There is no tax that business is not trying to circumvent, but as the tax would apply for all employers including employment agencies it would not create an additional incentive for outsourcing.

The tax would improve the competitive position of highly productive enterprises that share their productivity gains with their employees. The T4E would strengthen the market position of the best enterprises economically and socially and allow them to grow faster as they would no longer suffer from unfair competition through wage dumping. It would massively decrease incentives for employers to abuse market power. The tax would speed up structural change and force unproductive enterprises to exit the market. As rapid productivity growth is the best guarantee for increased prosperity, that is intended and in principle desirable. However there might be short-term restructuring needs that make it difficult to meet the wage norm in a specific year. Therefore, enterprises should be able to claim an exemption for a maximum of two years within a decade, if this request is agreed with the workers' representatives or, in its absence, by a two-thirds majority of the workforce.

Can it work?

But would the T4E not price people out of work? Within the dominant economic discourse the explanation for poverty wages is low marginal productivity of the worker, and the reason for unemployment is wages above the market clearing level. Any increase in labour costs above the market level will benefit some by pricing others out of employment. However, the current crisis where millions of highly skilled people can't find work at any wage shows how wrong this mantra of neoclassical economists is. It implies that the level of employment is determined in the labour market, while in the real world it depends on the level of aggregate demand. The latter is determined by investment + consumption + exports – imports. Supporters of unprotected labour markets have so far failed to provide conclusive evidence that lower wages, or higher wage dispersion, have resulted in better employment performance. Ultimately, employment generation through wage repression only works if it increases international competitiveness and generates export surpluses. However, competitiveness is a relative term and one country can only gain competeiveness, if another one loses and as Özlem Onaran pointed out in an earlier GLC article (see: (http://column.global-labour-university.org/2013/03/planet-earth-is-wage-led.html)) planet earth is a closed economy and not all countries can sell more than they buy.

Is T4E not merely a nice idea, impossible to implement in the age of globalisation? Not at all. Globalisation has no direct impact on wages in non-tradable sectors where, in many countries, the most dismal wage developments have been observed. Concerning the export sector, it would obviously be desirable that no country aims at a constant trade surplus. It would be optimal, if after readjusting current imbalances, all countries would follow productivity-oriented wage policies at the aggregate level. However, in the absence of international coordination adjustments in the exchange rate, or where that proves to be impossible, a strategic use of Value Added Tax (VAT) would allow countries to pursue a productivity-orientated and equitable wage policy. Governments can always, in a revenue-neutral way, increase VAT, and lower non-wage employment costs. Exports would become more competitive, and the relative prices of imports would increase. Both factors would help to counter unfair trading practices based on wage repression.

Slashing wages and squeezing the poor is not only morally bad, it is just not working as a way out of the crisis. As the old recipes are failing we certainly do not need more of the same. T4E offers the opportunity to rebalance our economies and our societies by penalising wage dumping, rewarding the most competitive enterprise and, ensuring fair wages.

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