Policy Discussion Forum

This new section of the Quarterly Economic Commentary (QEC) hopes to foster debate on topics of contemporary relevance and importance for the Irish economy. Articles or comments on the topics put forward and recommendations for topics to be addressed can be set to the Editor of the QEC. The opinions expressed in this forum are not necessarily those held by the Editor or the ESRI. Indeed contrary views are most welcome to enhance the policy discussion this section hopes to engender.

The first topic to be addressed is a recurring theme in the QEC over the last year.

HOW CAN WAGE BARGAINING WITHIN SOCIAL PARTNERSHIP BE BEST MODIFIED?

The fall in the rate of unemployment to historical lows and increasing inflation have put mounting pressure on the centrepiece wage bargaining mechanism within the social partnership framework. The established process over the last fourteen years has been to have a rigid formula of *ex ante* agreed wage rate increases reinforced by direct personal taxation reductions. While in every agreement the wage terms have, in the main, exceeded those set out, the process helped foster certainty about labour costs by anchoring wage expectations and encouraging industrial peace. In the context of the large labour surplus throughout the last decade, this mechanism facilitated the exceptional employment growth in recent years. This employment growth resulted from the strong competitiveness of the Irish economy reflecting good productivity growth, moderate wage growth and beneficial currency movements in comparison to the main trading partners.

Within the last year, the centralised wage bargaining mechanism as currently configured has been exposed as the economy's policy environment and labour market have altered considerably. The policy environment is clearly that of a regional economy within a large monetary union depending on a combination of fiscal and incomes policy to provide partial short-term demand management. The tightness of the labour market has meant that the terms of the agreement are largely non-binding in many area of the economy as employers compete for scarce labour resources. Those areas where the national agreements are at least nominally binding, mainly in the public sector, are increasingly showing sign of industrial unrest sparked by dissatisfaction with perceived relativities in the share of the economic success.

It is arguable that the Irish economy will find centralised wage bargaining beneficial within economic and monetary union (EMU) to dampen overshooting in wages leading to sharp competitiveness losses at times of sharp currency appreciation. It does seem clear, however, that flexibility mechanisms in contrast to current rigid wage setting will be required. The protracted renegotiation of the terms of the latest agreement, the Programme for Prosperity and Fairness (PPF), at the end

of last year with its requirement to use the Budget to prop it up, merely reinforced the critical need to update the model.

Two flaws in the current model seem apparent. The first is the inability to reflect different *ex post* outcomes for output in the preset wage terms. This has been particularly acute in the last two years when output growth in real terms has averaged over 10 per cent. In 1999 the final instalment of the previous national wage agreement was offering 1 per cent wage growth, while output growth in 2000 in real terms is likely to be nearly double the 5.5 per cent wage term in the first phase of the PPF.

The second flaw is the lack of any short-term demand management supports the current wage bargaining structures offer domestic policy-makers. The recent renegotiation of the PPF is a clear example. Having rather perversely been motivated by seeking an indexation for faster than anticipated inflation rather than the more justifiable output increases, the additional wage terms secured will further exacerbate, in the absence of mitigating but uncontrollable external influences, the demand pressures eroding the real value of wages.

These are not the only flaws in the process and certainly there is the danger of overlooking the idealised theoretical setting of alternative mechanisms in comparison with the imperfections of the current system in its realistic setting. Notwithstanding this, the aim of our discussion is to consider modifications to the current system to overcome the inherent flaws.

The two articles that follow consider modifications to the current system. They take as a premise that social partnership is worth maintaining but that it needs to reflect the new and more dynamic context in which wage determination is likely to take place. Donal de Buitleir and Don Thornhill outline a formula for a gain sharing arrangement aimed primarily at the public sector where most pressures are emerging but they suggest that the approach could be applied across the economy. This mechanism is based on *ex post* outcomes and is similar to profit sharing arrangements in the private sector. The second article by John McHale addresses the need to ensure compatibility of the wage bargaining process with short-term demand management options. His proposal is for the use of deferred compensation mechanisms as part of the wage bargain. He critically views the proposed national special savings incentive scheme as a missed opportunity to harness the social partnership wage elements in a flexible manner. These two proposals are not mutually exclusive but are not necessarily advanced as a unitary approach. It is hoped that competing proposals will be advanced, motivated in part from this discussion.

A MECHANISM FOR SHARING THE FRUITS OF GROWTH

DONAL de BUITLEIR and DON THORNHILL *

1. Introduction

The need for greater flexibility in the pay elements of the national social partnership agreements in reaction to economic growth outturns was stressed in a previous *Quarterly Economic Commentary* (McCoy *et al.,* 2000). This argument, as well as economic developments during the past twelve to fifteen months have prompted us to revisit the proposal which we put forward in November 1999 for a system of gain sharing based on the performance of the economy (de Buitleir and Thornhill, 1999). Our original proposal was made in advance of the conclusion of the negotiations on the Programme for Prosperity and Fairness (PPF). We saw a number of advantages for our proposal. These included equitable sharing of the success of the Irish economy across all sectors, increased income flexibility, which is desirable within European Economic and Monetary Union (EMU) where we no longer have the ability to adjust the external value of the currency and a system of income determination, which would maintain and enhance competitiveness. In the event, the partners to the negotiations concluded an agreement along the conventional lines of previous agreements.

The PPF came under pressure virtually immediately. The direct strain came from higher than anticipated inflation. This was addressed in the subsequent adjustment to the agreement.[1] However, the concerns about inflation and the maintenance of real living standards also seem to be associated with a developing sense among some groups of employees that they are not securing a proportionate (or equitable) share in the improved fortunes of the economy. This in turn seems to have caused some groups

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[1] See McHale (2000) for an extensive comparison of the range of inflation control options proposed at that juncture.

of employees to question the value to them of the partnership approach to the settlement of pay and industrial relations.

The partnership approach has been in place for more than a decade and it is not surprising that it has come under strain. The question arises as to whether or not it is worth continuing with this broad approach. On balance we believe that it is, provided that arrangements can be negotiated which reflect current economic and social conditions – which are very different to those of the late 1980s when the first arrangement, the Programme for National Recovery (PNR) was negotiated. It may be worthwhile remembering the remarkable achievements that have been realised through the partnership process and the pursuit of sound fiscal policies and to contrast those with the dismal economic and social circumstances of the 1980s.

With moderation in nominal pay as a central theme, the successive agreements have yielded results. However, the distinction between real and nominal pay was central to the process. Real incomes are higher and employment has increased to the point indeed where there are now serious labour shortages in many sectors of the economy. The tax burden has been reduced, public services (including social welfare benefits) have improved and the public finances are much healthier, (see Nolan *et al.,* 2000).

The pay moderation, which was an essential part of the agreements, enhanced competitiveness and thereby increased employment. The buoyant economy allowed the Government to reduce income tax, which improved real incomes. Incomes were given a further boost by the fall in interest rates, which resulted from our membership of EMU. We would not, of course, have been eligible for EMU membership if there had not been the economic and fiscal recoveries, which the partnership agreements made possible.

Such success, however, has brought its own problems including pressures on inadequate infrastructure, increasing congestion and rising house prices. The unrest evident among some groups of employees, which appears to be due, in part at least, from perceptions that the rewards of economic growth have not been shared fairly is of particular concern and relevance to the partnership process The unease generated by these perceptions has also been exacerbated by the rapid increase in the cost of residential accommodation.

A "free for all" is a possible alternative to the continuation of the partnership process. It can be argued that this might bring some benefits particularly in allowing for necessary relative pay adjustments. But a "free for all" could also result in increased recourse to strikes and other forms of industrial action and in some instances to uncompetitive pay settlements. The outcome would be job losses that would be difficult to recover. For this reason it is in our view worth seriously trying to devise partnership arrangements which would be sufficiently flexible, and yet robust enough, to address the challenge of combining real and perceived equitable sharing with mechanisms for pay increases which are responsive to economic circumstances and which, of course, accord with sound fiscal policy.[2]

[2] Flexibility in wage contracts in response to possible currency fluctuations with major trading partners within EMU would also be a desirable feature. Geary and Honohan (1995) and Geary (1996) proposed a mechanism for sharing of the currency risk between employers and employees through such a flexible wage contract.

2. A Mechanism for Gain Sharing

Our proposal is based on the assumption that any pay agreement should meet the following criteria:

1. It should allow for equitable sharing of the fruits of economic growth.
2. It should maintain or enhance the competitiveness of the Irish economy, which has been a major contributor to growing employment and reducing social exclusion.
3. It should be consistent with fiscal stability.

If these criteria can be met then it may be possible to continue and develop the partnership process.

The model we propose is specifically designed to provide for "gain sharing" in the public service where, of course many of the pressures and concerns about equity and competitiveness are now most acute. However, as we explain below it could also be extended (with or without modifications) to the private sector, to groups such as pensioners and those in receipt of social welfare payments. Under this model we saw two elements in any agreement:

1. Provisions for a "platform" or basic pay increase
2. An annual lump-sum element related to the growth of the economy.

Our model, as outlined, does not include any provision, such as the benchmarking arrangements in the PPF, which could allow for relative pay adjustments, but it could be extended to do so.

The basic increase should be relatively low and could be pitched at the expected rate of inflation in the euro area. The growth element, or growth dividend, parallels private sector profit sharing schemes. A different measure to company profits, as a reference needs to be chosen when we are dealing with the economy as a whole. Our proposal is that the growth dividend would be a percentage increase linked to the growth in GNP per person at work.

We have considered a number of other reference points. However, we choose this measure because:

1. It provides a good measure of national economic performance.
2. It is more widely understood than other possible measures.
3. It is a key driver of net tax revenues i.e. tax revenues depend on the value of goods and services produced in the economy.

Even though in the rest of this article we refer to GNP per person at work, we consider that it would be appropriate to adjust this by deducting from GNP the value of the expenditure by public authorities on current goods and services. If this were not done increases in the cost of the public service pay bill would feed into pay increases.

In developing this mechanism we were conscious of the need to ensure that it would be compatible with fiscal stability, that the public finances would not be put under strain during an economic downturn by making large payments resulting from earlier more buoyant circumstances. The model we propose below would achieve this. As we indicated above the growth dividend parallels that of the existing private sector profit sharing schemes. Under these schemes, employees are given a non-pensionable lump-sum award in cash or shares based on the profits earned in the previous year. For example, employees get an award in 2001 which is based on profits earned in 2000 and is provided for in the 2000 accounts.

3. How the Mechanism Might Operate in the Public Sector

In our proposal we envisage that the details would be a matter for negotiation between the social partners but that the outline of a scheme might be along the following lines within the public sector. At this time we can only illustrate the broad lines of the proposal and to do so we need to use current economic data and forecasts. For that reason we illustrate the process with a hypothetical example commencing with the December 2000 Budget. Although the presentation is somewhat stylised it does have the advantage of illustrating possible pay increases which are relevant to current values and circumstance and can therefore be compared with other possible outcomes.

In this example the Minister for Finance would, in the December 2000 Budget, have made a provision for public service pay in the estimates for 2001. This could have consisted of two elements; an agreed "platform" or basic pay increase, which would be paid in the normal way to employees during 2001, and a growth-related element to be paid in, say, June 2002 based on estimated GNP growth in 2001. The provision for the growth dividend for 2001 would be revised in the December 2001 Budget based on the latest and more reliable estimates for GNP growth in 2001. Before the end of 2001 this total growth dividend for the public sector would be allocated to a *"Growth Fund"* which would be statutorily established as an Exchequer Fund from which payments would then be made to individual employees. If desired, an advance payment could be made in December 2001.

In 2002, the payment from the Exchequer into the Growth Fund and the growth dividend for individual employees would be set by reference to growth in the base year (i.e. two years previously). This would provide a useful buffer against shocks in that the amount of the growth dividend would be automatically adjusted. This mechanism would also automatically allow for adjustments to be made following the annual revisions that are made to the value of GNP as more complete and refined data and estimates become available.

The estimate of the growth in GNP per worker would necessarily have to be preliminary. To ensure public confidence in the validity of the estimate an independent board should confirm that it was reasonable. The objective would be to build on the growth dividend over a period of years to achieve a situation in which it was sufficiently large to ensure that the distributions to individuals were significant. In the event of this being achieved, it might be desirable to make the payment in two instalments, say in May and November.

The growth dividend we have described depends essentially on the performance of the market sector of the economy. We think that this is quite reasonable. The public service contributes positively to economic performance if it provides efficient public services. However, we do think that it is important for both equity and incentive reasons that the payment is not an automatic entitlement to be paid regardless of productivity improvements in public service as a whole or in parts of the service. Payment of the growth dividend could be linked to agreement on appropriate productivity measures.

There should not necessarily be a one to one relationship between the percentage pay increase delivered by the growth dividend and the percentage increase in GNP per person at work. In our view, there are persuasive arguments why the ratio should be less than unity, in that the percentage for the growth dividend should be lower than the percentage increase in GNP per person at work. First, our model also provides for a

platform or basic pay increase as well as for the growth dividend. Second, employees benefit from other measures in partnership agreements including tax reductions, social inclusion measures and expenditures in areas such as education, health and childcare.

The tax treatment of the growth dividend would be a crucial aspect of the proposal. The question arises should the growth dividend attract some form of favourable tax treatment. From an equity standpoint all forms of income should be treated in the same way. On this basis the dividend would be liable to tax. However, other considerations may suggest a contrary view. The first is that it is very important in the national interest to attach priority to the principles of equitable sharing and pay flexibility and to get them established. To accord the growth dividend a certain measure of tax relief would substantially increase the prospects of getting the concept accepted.

Since any form of tax relief is likely to reduce the scope for more general tax relief which would apply to all taxpayers and not just those who were eligible for the growth dividend, policy makers would need to be persuaded that the loss of equity was more than offset by the gain to the community from having an income determination system which was more appropriate to the needs of the economy. There are also precedents for having tax relief that apply to limited categories of taxpayers; the PAYE allowance and the existing relief for profit sharing are but two.

One option is to follow the treatment given to payments under approved profit sharing schemes in the private sector. For example, if the growth dividend were invested in approved or designated investment funds for a minimum period of three years, it could be free of tax thus providing an additional incentive. If it were taken in the form of cash it could be subject to tax in the normal way. Such a scheme would give an important impetus to private savings, which would be useful as we prepare for the demographic shift towards an older population.

Our conclusion is that the growth dividend should attract the same measure of tax relief accorded to private sector profit sharing schemes. Where people already benefited under a profit sharing scheme, the same limit would apply to aggregate payments under both schemes. At present, the maximum benefit is £10,000 per annum.

4. Extending the Mechanism to Other Sectors

There is no reason why exactly the same mechanism could not apply to other sectors and groups in the economy. In the private sector, the system could apply in exactly the same way in firms, which do not have a profit sharing scheme. By agreement, the growth dividend in other firms could be integrated with or used to supplement payments under existing profit sharing schemes. Such schemes are well established in many firms and are increasingly valued by employees. However, where a company exceptionally felt that payment by reference to GNP could put its competitive position at risk, it could by negotiation substitute an alternative reference point.

The concept of sharing the benefits and rewards of economic growth and prudent fiscal management is central not just to our proposal but to the underlying ethos of successive partnership agreements. As a result we would be disposed, if it were practicable, to include all categories of pensioners within the scope of the proposal. We believe that the growth dividend should be paid to public service pensioners. This is because their pensions are linked to current pay levels. As long as this link persists, the growth dividend should apply to them. The growth dividend is an

alternative to a larger basic increase in current pay levels, which would otherwise apply to them automatically.

The position for private sector pensions is more complex. At present these schemes are funded and some provide for defined benefits and others for defined contributions. At present, many post-retirement increases in funded schemes are related to movements in the cost of living. The consequences for such funded schemes need more detailed consideration.

The position is also complicated for social welfare beneficiaries. An argument in favour of including them is that it is broadly accepted that social welfare benefits should move in line with income movements in the economy generally, see Callan *et al.* (1999). On balance we think that the growth dividend should be made to long-term social welfare beneficiaries on the basis that all should share in the benefits of economic growth.

5. What Would the Mechanism Deliver?

Table 1 illustrates the possible effect of the proposal over the five-year period 1999-2004. In this example the first gain-sharing dividend is due in 2000 and payments continue until 2004. We have used the macroeconomic projections contained in the ESRI *Quarterly Economic Commentary* and *Medium-Term Review* for the purposes of this illustration. In addition we have, also for illustrative purposes, assumed a ratio or "multiplier" of 0.8, that is the growth factor applied to basic pay for the purposes of calculating the gain sharing dividend would be the growth rate for "adjusted" GNP per person at work multiplied by 0.8.

Accordingly, in this example the dividend for an individual would be calculated as the product of his or her basic pay multiplied by the growth rate in "adjusted" GNP (i.e. GNP less the value of expenditure of public authorities on goods and services) multiplied by 0.8. We have chosen, for the purposes of the illustration, an individual whose earnings are equal to average male industrial earnings. Table 1 also shows the value to the individual of availing of a tax relief on sums placed in an authorised investment fund and of allowing funds to accumulate.

In this example the first annual payment is £670 in 2000. By 2004 the annual payment would have increased to £3,506. The benefits of investing the funds, on a tax-free basis are evident from Table 1. For example, assuming an average annual rate of return of 10 per cent on invested funds, the accumulated annual payments would amount to £11,570 in 2004. This allows for the accumulation of significant capital assets in a relatively short time frame.[3]

The performance-related element should be based on the cumulative increase in GNP (or an alternative reference point) over a base year. This does not mean that there will be double or triple payment for the same increment of GNP since the level of GNP (with adjustments for public sector consumption) in year 1 must be replicated in year 2 before there is any additional growth. A cumulative approach offers the prospect of stability in the annual payments and also creates a situation over, say a three-year period, where the payments to individuals are likely to be significant. Clearly, however accumulation could not continue indefinitely

[3] By way of comparison the average annual rate of return on managed funds over five years is an estimated 14.4 per cent. (Moneymate, November 2000).

and a new platform would need to be established in the event of a further pay agreement or arrangement.

Table 1: Calculation of Growth Dividend 1999-2004

Year	1999	2000	2001	2002	2003	2004
Real GNP (£m)	59,068	63,793	67,685	71,205	74,836	78,653
PANCE (£m)	8,753	9,147	9,531	9,874	10,230	10,598
Adjusted GNP (£m)	50,315	54,649	58,678	61,331	64,606	68,055
Numbers at Work (000s)	1,616	1,684	1,735	1,775	1,809	1,845
Adjusted GNP per person at work	31,136	32,450	33,518	34,554	35,721	36,890
Cumulative % Change		4.2%	7.7%	11.0%	14.7%	18.5%
Average Male Industrial Earnings £s	18,424	19,824	21,469	22,199	22,954	23,711
Multiplier	0.8	0.8	0.8	0.8	0.8	0.8
Value of "Dividend" £s		670	1,314	1,950	2,705	3,506
Potential value of Annual Dividend by 2004 @ 10% p.a. return, £s		980	1,749	2,359	2,975	3,506
Accumulated value of Dividend @ 10% p.a. – £s						11,570
Potential value of Annual Dividend by 2004 @ 15% p.a. return, £s		1,171	1,999	2,579	3,110	3,506
Accumulated value of Dividend @ 15% p.a. – £s						12,365

Notes: Adjusted GNP is derived from subtracting Public Authorities Net Current Expenditure (PANCE) from Real GNP. Real values use 1999 values as a base year. Data from ESRI *Quarterly Economic Commentaries* and *Medium-Term Review*.

It would also, of course, be possible to relate dividend payments only to annual changes in GNP per person at work. This would have the very considerable advantage of simplifying the model and would more closely parallel profit sharing arrangements in the private sector. However, payments could be more volatile than would be the case for the cumulative approach and as is apparent from the data in Table 1, would also be smaller in the second and subsequent years of a multi annual agreement.

Our recommended measure is GNP (adjusted for public authorities net current expenditure) per person at work. Deducting public expenditure on current goods and services removes the incentive to increase the payment merely by expanding public expenditure. Indeed, the measure chosen gives a slight incentive to increase productivity in the

public sector. The reference we suggest is an appropriate measure of productivity. Not to adjust for increases in employment would mean the economy was paying on the double for increases in output; first to the extra workers employed and then to existing workers for the output generated.

6. Conclusions

Pay determination must now accommodate itself to the disciplines of EMU as well as to the internal economic and social stains resulting from the strong economic growth since the mid 1990s. Clearly this is going to be difficult. We are not optimistic that the alternative to the partnership process of a free for all will serve the national interest.

The mechanism proposed in this article provides flexibility and equitable sharing of the growth dividend between people in different sectors of the economy and society. If the economy does well, the fruits of growth are shared more widely than before. If there is a shock, the adjustment is made more efficiently in the sense that the costs of adjustment are transmitted automatically and with minimum "friction". It could also give further substance to social partnership, which has underpinned the national agreements.

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