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Wage Setting in Finland:  
Increasing Flexibility in  
Centralised Wage  
Agreements

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**By**

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## Abstract

### **Wage setting in Finland: Increasing flexibility in centralised wage agreements**

The centralised wage agreements have helped to contain inflation. There is evidence that wage increases were more moderate when a central agreement was concluded than in periods when no central agreement was reached. Nevertheless, there is also evidence that centralised wage setting has had some drawbacks in terms of reducing employment among low-skilled and younger workers because of high minimum wage floors. In the current wage setting system there are components that allow for greater relative wage flexibility. These should be used more extensively. The role of the government in future agreements should be to encourage greater relative wage flexibility within the current bargaining framework.

This paper relates to the 2006 Economic Survey of Finland ([www.oecd.org/eco/surveys/finland](http://www.oecd.org/eco/surveys/finland)).

JEL classification: E24; J23; J3; J31; J50; J52.

Key words: labour market; wage-setting; minimum wages; labour cost.

\* \* \* \* \*

## Résumé

### **Fixation des salaires en Finlande : Accroître la flexibilité dans les accords salariaux centralisés**

Les accords salariaux centralisés ont aidé à maîtriser l'inflation. On peut constater que les hausses de salaires ont été plus modérées lorsqu'il y avait accord centralisé que dans les périodes où on n'y était pas parvenu. Néanmoins, on constate aussi que la détermination centralisée des salaires a pour inconvénient, du fait du niveau élevé du salaire minimum, de réduire l'emploi chez les personnes peu qualifiées et les jeunes. Le système actuellement en vigueur comporte des éléments qui permettraient une plus grande souplesse salariale relative. Il faudrait les faire jouer davantage. Le rôle du gouvernement dans les accords futurs devrait être d'encourager une plus grande souplesse salariale relative à l'intérieur du système actuel de négociation.

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([www.oecd.org/eco/etudes/finlande](http://www.oecd.org/eco/etudes/finlande)).

Classification JEL : E24; J23; J3; J31; J50; J52.

Mots clés : marché du travail ; fixation des salaires; salaire minimum; coût du travail.

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## **Wage setting in Finland: Increasing flexibility in centralised wage agreements**

by Åsa Johansson<sup>1</sup>

Wage setting in Finland is characterised by a high degree of centralisation and co-ordination between union and employers' federations. Together with the Finnish government, they conclude tripartite income policy agreements covering not only wages but also employment policy, pension schemes and taxation. These tripartite income policy agreements date back to 1968 and usually last from one to two years, the agreements setting out the guidelines for the collective agreements between trade unions and employers' associations. This paper reviews first the macroeconomic benefits and then the microeconomic costs of these income policy agreements. In the context of the latter a quasi minimum wage is calculated using collective agreements across traditional low-wage sectors and this is found to be relatively high in international comparison. The paper concludes by considering what the government's role should be in the next agreement.

### **The current income policy agreement for 2005-07**

At the end of 2004 the union and employers' federations together with the government signed a tripartite income policy settlement for the years 2005-07 which is in force until the autumn of 2007. The pay increases are of a mixed nature for the first year and percentage-based for the second year. The agreement provides for an increase of € 30.06 a month or at least 1.9% in the first year and an across-the-board 1.4% in the second year. A union-specific element, which allows part of the wage increase to be negotiated at the local level, is paid in each of the years, first 0.6% and then 0.4%. An equality increment of 0.3% is paid in the second year in low-pay sectors, where pre-dominantly women are employed. This mixture of flat rate and percentage increases results in proportionally higher increases for people with low pay, reflecting the "solidarity" aspect of Finnish wage-bargaining. The union-specific element varies according to the details of the collective agreement concerned.

In the current wage agreement an indexation clause is included allowing for additional nominal wage increases contingent on consumer price index (CPI) inflation. This clause states that if between October 2004 and October 2005 consumer price inflation exceeds 2.6%, then wages should be raised by an amount corresponding to the percentage exceeding this threshold at the next general increase, though only if inflation was more than 0.4% above the threshold (*i.e.* at 3%). This clause was not invoked because CPI inflation remained well below the threshold and was expected not to exceed it. A rationale for this type of clause is risk sharing between firms and employees; contingent on workers being more risk-averse than firms this type of real wage insurance could be justified in wage bargaining.

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1. This paper was originally prepared for the *OECD Economic Survey of Finland* published in May 2006 on the responsibility of the Economic and Development Review Committee. The author is grateful to colleagues in the OECD, especially Andrew Dean, Peter Hoeller, Val Koromzay, David Turner and Laura Vartia for their helpful comments. Special thanks go to Isabelle Duong for her statistical assistance. The author can be contacted at [asa.johansson@oecd.org](mailto:asa.johansson@oecd.org).

A more appropriate deflator for assessing real wage cost from the point of view of the employer is the output price, which has consistently undershot the private consumption deflator and also to some extent CPI inflation. Thus supplementary nominal wage increases contingent on consumer prices widen the wedge between the consumer real wage and the real wage cost of employers and may have adverse employment effects. Furthermore, following a large adverse supply shock, such as an oil price rise, indexation of nominal wages to consumer prices aggravates the direct negative employment effects of the shock.<sup>1</sup> In the current agreement there is a general escape clause stating that if the price rise is due to special external causes, the labour market partners can agree on using the indexation clause in another way. This reduces the risk that large term-of-trade shifts lead to a triggering of the indexation clause.

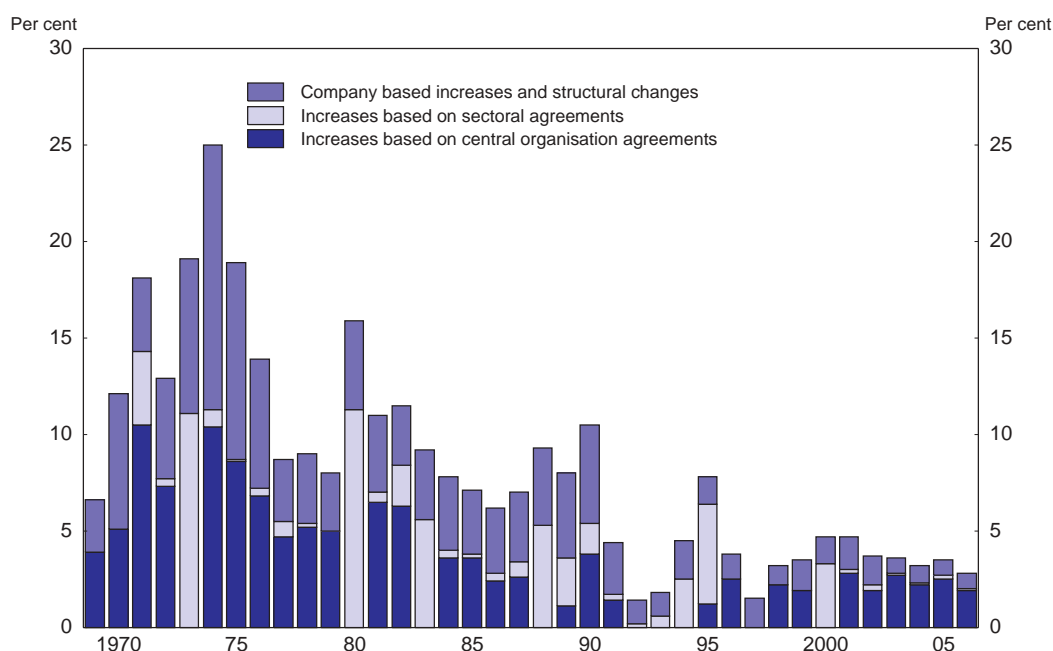
### **Macroeconomic benefits in terms of lower inflationary pressures**

Empirical and theoretical research generally supports the view that countries with more centralised and/or co-ordinated wage-bargaining systems tend to have lower aggregate wage outcomes than countries where bargaining takes place at the industry level (OECD, 2006a; Calmfors and Driffill, 1988; Flanagan, 1999). During the past 30 years most wage settlements were negotiated at the national level between union and employers' federations, often with government involvement. The coverage of the central agreement varies because the share of local trade unions that accept the central agreement varies from year to year, but generally the coverage has been wide. Nevertheless, in seven wage setting rounds no central agreement was reached (in 1973, 1980, 1983, 1988, 1994, 1995 and 2000). However, the absence of a central agreement does not imply that there is no co-ordination in wage-bargaining. Many industry-level wage bargaining rounds result in similar wage increase across industries (Uusitalo, 2004). The reason is that typically one of the larger unions reaches an agreement first and then the subsequent agreements do not differ much from the first agreement (so called "pattern-bargaining").

There is evidence that both agreed and actual nominal wage increases are lower when bargaining takes place at the national level (Uusitalo, 2004). The average wage increase was 1.8 percentage points lower during the centralised bargaining rounds and the difference is even larger, 4 percentage points, when comparing centralised settlements with wide coverage and decentralised settlements, even after allowing for differences in inflation and unemployment (Uusitalo, 2004).<sup>2</sup>

Figure 1 shows industrial sector wages and is a representative illustration of how the income policy has worked over three decades. The wage increases have varied substantially but since the mid-1990s they have stabilised around 4%. Around half of the wage increases are due to centrally bargained wage increases and the other half due to locally (sectoral and company agreements including structural change) bargained wage increases. The wage increases agreed at the sectoral level have been quite small, apart from the years where no central agreement was reached. In addition to the agreed wage increase at the central and industry level the employers can pay a voluntary wage drift.<sup>3</sup> The decline in inflation during the 1990s was accompanied by a fall in wage drift, which in recent years has stabilised at around 1%. Non-participation in the central agreement seems to be associated with higher average wage increases than participation but higher wage drift in participating industries has compensated employees for lower bargained wages (Snellman, 2004).

Figure 1. Changes in wages of industrial workers



Source: Ministry of Labour.

## Microeconomic costs in terms of reduced flexibility

### *Centralised agreements contribute to real wage rigidities*

Recent empirical work suggests that real rigidities rather than nominal rigidities are present in Finland because of the centralised agreements (Böckerman *et al.*, 2006; Dickens *et al.*, 2006). For instance, there tends to be a peak in the distribution of wage changes for manual manufacturing workers near the level of the agreed wage increase in the contemporaneous collective agreement suggesting that the final wage outcome in collective agreements largely depends on the general wage increase stipulated in the agreement.<sup>4</sup> Moreover, there is a peak in the distribution of nominal wage changes around the current rate of inflation which is an indication of real wage rigidity.<sup>5</sup> The presence of real wage rigidities is consistent with unions striving to preserve the level of real wages of their members. This is a feature of so-called “insider-outsider” models: insiders who are employed workers are highly insulated from competition from outsiders who are unemployed workers and thus aim for preserving real wages rather than increasing employment.<sup>6</sup>

### *Wage floors result in a high minimum labour cost, thereby reducing employment*

A too high statutory or contractual minimum wage reduces employment for younger and less-productive workers and is a barrier to raising employment for this group. Employment losses due to minimum wages have been difficult to prove empirically (OECD, 2006a; Dolado *et al.*, 1996). However, some studies find a significant negative effect, particularly for young adults (Neumark and Wascher, 1999; OECD, 1998).

Although no statutory minimum wage exists in Finland, the collective agreements specify wage floors for different types of jobs and experience levels. Sometimes the collective agreements also grade the

minimum tariffs by age and some agreements make exceptions for apprentices and trainees. Labour law stipulates that the minimum provisions of the collective agreements in a sector are extended to all non-signatory firms within the same sector, provided that the collective agreement is regarded as being adequately representative. Consequently the high unionisation rate in combination with the administrative extension suggests that in practice the minimum wages cover a major share of the labour market.

Using collective agreements for a number of traditional low-wage sectors which cover a large number of workers (hotels and restaurants, wholesale and retail trade and social services), a proxy quasi “minimum wage” can be calculated.<sup>7</sup> Only the hotel and restaurant agreement makes a distinction in the wage minima for younger workers, providing a lower minimum wage equal to 80% of the specified tariff wage below the age of 18 years. However, all three agreements specify a lower wage, between 80-90% of the specified tariff for trainees and apprentices during a limited period of time, often one year. The implied minimum labour cost, which is calculated by adding employers’ social contributions to the quasi minimum wage, is high in international comparison. The cost of hiring a worker at the quasi minimum wage is 57% of the cost of hiring a worker at the median wage (Box 1). The exception for trainees and apprentices lowers the minimum labour cost to 49% of the median cost. Many other OECD countries also make a distinction for younger workers and/or apprenticeship contracts (Box 2). Considering these exceptions, the minimum labour cost is still higher in Finland than the corresponding cost in these countries.

#### **Box 1. International comparisons of minimum labour costs**

Statutory minimum wages exist in several OECD countries but for the employer the labour cost at the minimum wage level, which includes the employers’ social security contributions, is probably a more relevant measure. One way of comparing minimum labour costs across countries is to measure their value relative to some measure of average cost. The advantage of using such a ratio, beyond taking cross-country productivity differences into account, is that it provides an indication of how many employees are likely to be affected by the minima. Nevertheless, this ratio may vary substantially depending on both how the minimum labour cost and the average cost is measured.

The OECD has traditionally used a proxy of average cost based on the compensation of a full-time employed manual production worker in manufacturing (APW, average production worker) for international comparisons. In the last decade the number of people employed as manual manufacturing workers has declined as a share of total employment in most OECD countries, thus this proxy has become less representative as a measure of average compensation in a country (OECD, 2004). Therefore the OECD will start to use a broader concept of average compensation (henceforth denoted AW) which covers both manual and non-manual workers in a wider set of industries including services, utilities and construction.<sup>8</sup>

The typical income distribution in a country has a tail to the right because there are a few persons earning a lot more than what most people earn (positive skewness). This dispersion in earnings differs across countries therefore influencing the measure of average compensation and thus average cost to differing degrees. The median measures the wage at the middle in an income distribution showing that half of the population earns more than the median and the other half less. In a positively skewed distribution the median is lower than the average wage. As a measure of average compensation the median is less sensitive than the mean to outliers and is for that reason the preferred average measure for highly skewed distributions such as the income distribution.

The choice of measure of average compensation and hence average cost matters for the level of the ratio of minimum labour cost to the particular choice of average cost and thus the ranking of countries. The ratio of the minimum labour cost to the cost of an APW is highest at around 55% in France and Finland and lowest in Korea (Table 1). However, when the minimum labour cost is related to the broader concept of average cost then Finland tops the ranking with a ratio of around 50%, followed by Australia and Ireland, while France’s ranking drops to the 7th position. The ranking based on median cost ranks Australia at the top followed by Finland. The ratios tend to be higher when the average cost refers to the median because, as noted above, the wage distribution is typically skewed to the right. The rank correlation between the different labour cost ratios is fairly high; it ranges from 0.61 to 0.83. Nonetheless, the ranking of some countries and the apparent relevance of the minimum wage is significantly affected by the choice of the measure of average cost.



**Box 2. International comparisons of minimum labour costs (suite)****Table 1. Table 1. Minimum labour cost**

2004

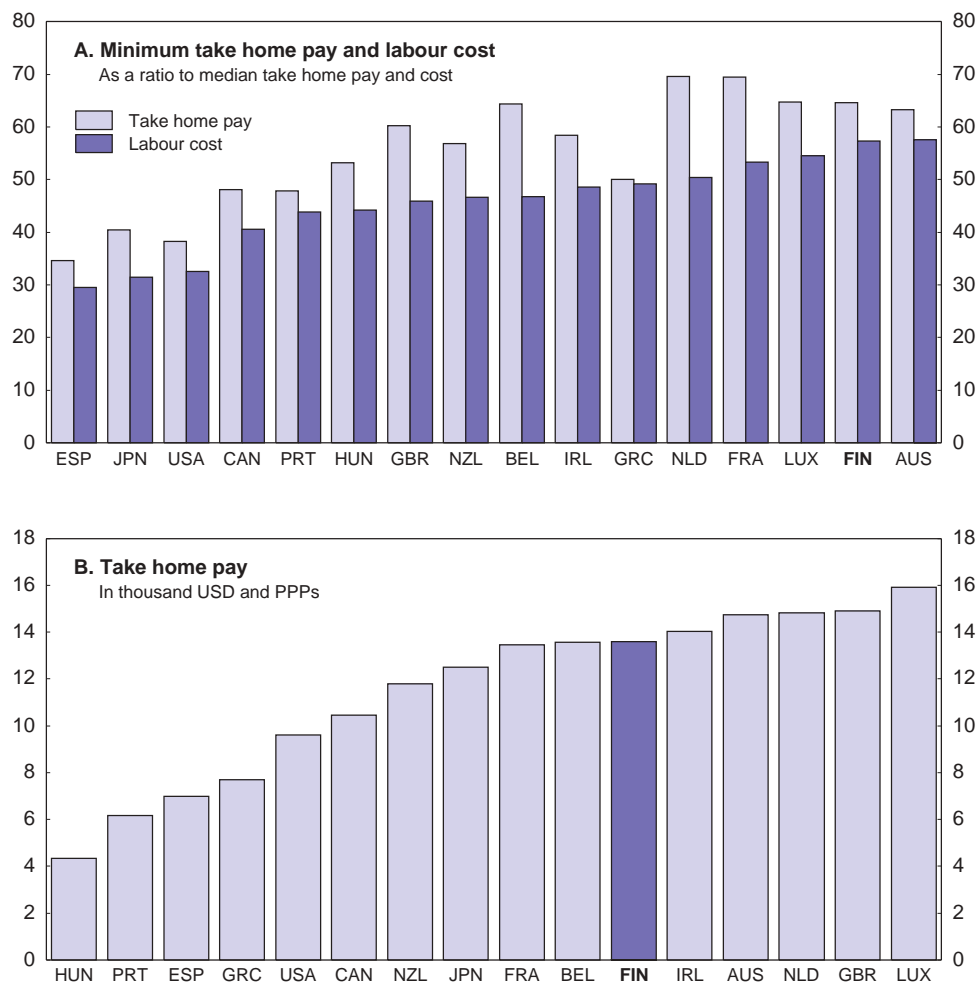
	Minimum labour cost as a ratio of the cost of an APW		Minimum labour cost as a ratio of the cost of an AW		Minimum labour cost as a ratio of the cost of a median worker	
	Ranking	Ratio per cent	Ranking	Ratio per cent	Ranking	Ratio per cent
Australia	9	45.1	2	49.1	1	57.6
<b>Finland</b>	<b>2</b>	<b>54.4</b>	<b>1</b>	<b>50.8</b>	<b>2</b>	<b>57.3</b>
Luxembourg	3	52.0	6	43.1	3	54.5
France	1	55.2	7	42.4	4	53.3
Netherlands	8	46.7	5	43.2	5	50.4
Greece	5	50.8	12	36.7	6	49.2
Ireland	7	46.9	3	46.9	7	48.6
Belgium	15	36.2	8	40.8	8	46.8
New-Zealand	10	44.0	4	46.6	9	46.6
United Kingdom	11	43.9	15	33.9	10	45.9
Hungary	4	51.6	11	37.5	11	44.2
Portugal	6	49.3	16	33.8	12	43.8
Canada	16	35.8	10	37.5	13	40.6
Poland	13	37.2	17	33.8	14	40.4
Slovak Republic	14	36.7	14	34.7	15	36.7
Czech Republic	12	37.6	9	38.4	16	36.6
United States	19	30.7	13	35.4	17	32.6
Japan	17	32.8	19	27.9	18	31.5
Spain	18	31.9	18	28.8	19	29.5
Korea	20	19.9	20	19.9	20	25.1

Source: Calculations based on OECD Taxing Wages models

The impact of minimum wages on net earnings (take-home pay) also depends on the interaction with the tax and benefit system. In some countries the statutory minimum wage is combined with in-work benefits to increase incentives to work or other benefits such as housing allowances which raise the take-home pay. Other countries have earned income tax credits at low incomes which raise net earnings above the minimum wage level. This interaction yields for some countries substantially higher net minimum earnings in relation to net median earnings and thus above the labour cost ratio (Figure 2, Panel A). For instance, in the Netherlands and Belgium the net income ratio is almost 20 percentage points higher than the labour cost ratio and in France and the United Kingdom close to 15 percentage points higher. The purchasing power of the take home pay for a single person working at the minimum wage ranged from \$4 500 per year in Hungary to nearly \$16 000 per year in Luxembourg, when measured in 2004 US dollars and PPPs (Figure 2, Panel B).

**Figure 2. Minimum take home pay and labour cost**

Single person, 2004



Source: OECD calculations based on data from the OECD Minimum Wage, Taxing Wages and Benefit and Wages databases.

### Box 3. Minimum wages: exceptions for younger workers

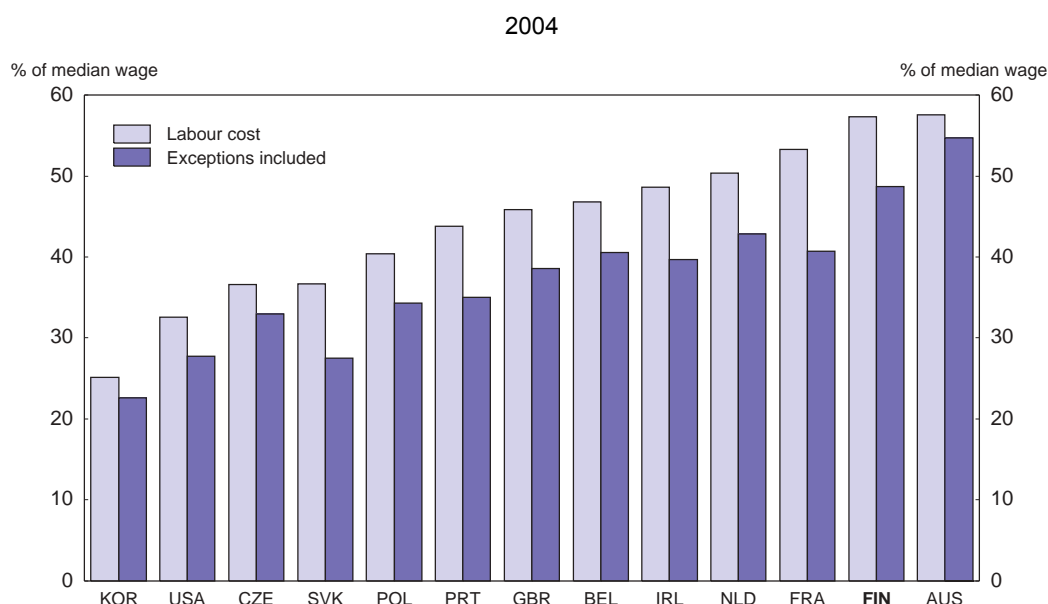
National or statutory minimum wages exist in 21 OECD countries, but there are substantial differences in the way they are set and operate. The main differences concern the level of the minimum relative to the median wage and the extent of differentiation by age, experience or region. The ratio of the minimum wage to the median wage varies from around 60% in Australia and France to less than 20% in Mexico. Many countries have exceptions for younger workers and/or apprentices and trainees.

In 13 countries, exceptions from the statutory minimum wage are made for either younger workers or for apprentices and trainees (International Labour Organisation (ILO), Minimum wage database). In about half of these countries the differentiation is by age and in the other half by the type of work contract and in some cases it is a combination of the two types. For instance, in France apprentices aged 21 to 25 years old hired under a “contrat de qualification” (training contract) are paid 78% of the minima of adult workers and for apprentices aged 16-17 years the wage rate is 30% of the adult minima. Likewise in Ireland a worker who undertakes training is paid between 75 to 90% of the adult minimum wage and exceptions are also made for youths below 18 years who are paid only 70% of the adult minima. An age distinction is also made in the United Kingdom where younger workers aged 18 to 22 years are paid 85% of the adult minima and youth below 18 years only around 60% of the minimum wage.

In Sweden and Iceland, as in Finland, there is no statutory minimum wage, but the collective agreements specify the minimum wages. In many of these agreements a separate minimum is specified for younger workers. For instance, the collective agreement for construction workers in Sweden specifies lower tariff wages for workers below the age of 18 and 19 years, and similarly in Iceland the Commercial Workers' Union of Reykjavik specifies lower tariff wages for workers below 18 years (Sveriges Bygginindustrier *et al.* 2004); ILO, Minimum wages database). This is something that should be encouraged to a larger extent in the Finnish collective agreements as well.

Using the exceptions from the statutory minimum wage specified in each country, a fictive minimum wage and labour cost, which is calculated by adding employers' social contributions to the minimum wage, for younger workers and apprentices can be calculated (Figure 3).<sup>\*</sup> The labour cost of hiring a younger worker among the included countries is the second highest in Finland at 49% of the cost of hiring a worker at the median wage and lowest in Korea at 23% of the cost of a median worker.

Figure 1. Figure 3. Minimum labour cost of younger workers and apprentices<sup>1</sup>



1. The cost of labour is the sum of the wage level and the corresponding social security contribution paid by employers for a single worker. The minimum cost for younger workers includes exceptions by age or by contract.

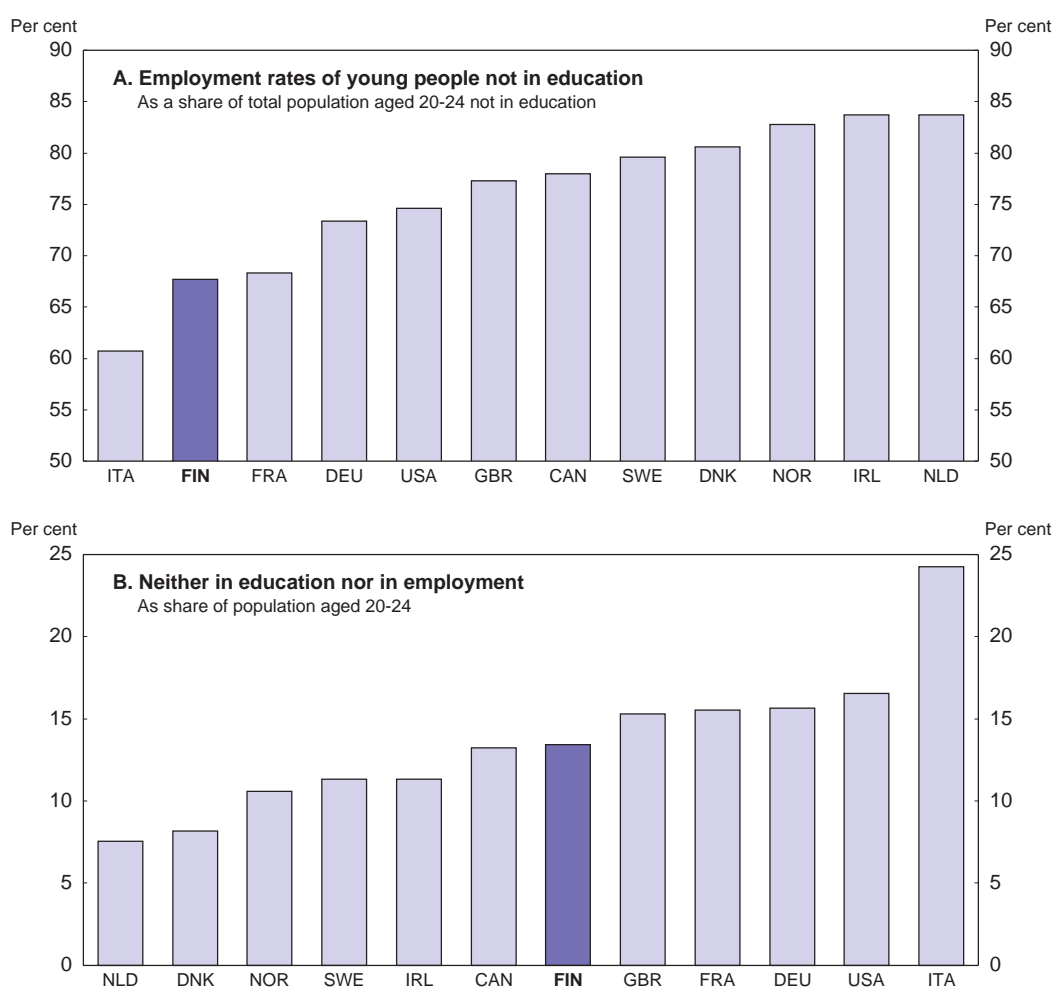
\* The calculation excludes the exceptions for workers below the age of 17.

Source: OECD, Minimum Wage and Taxing Wages databases.

International comparisons of the employment rate of young people are complicated by the fact that a large number are students works part-time to finance their studies.<sup>9</sup> In Finland a relatively large number of students are included in the employment statistics; almost 40% of the students aged 20-24 years old work while they are studying. Arguably, the part-time employment of students is less of a policy concern than the employment of other young people, particularly where there is a concern about the possible effect of high wage minima. The employment rate for the age group 20-24 excluding students entirely (*i.e.* excluding them from both employment in the numerator and population in the denominator), is only 68%, which is among the lowest in the OECD (Figure 4, panel A).<sup>10</sup> While the size of this group relative to the total age cohort is reduced by the relatively high share (around 60%) that are in education, the share of all 20-24 year olds that are *neither* in education *nor* in employment, at 13.4% in 2004, is still significantly higher than in other Nordic countries (Figure 4, panel B).<sup>11</sup> The labour market performance of this group is important since there is evidence of a scarring effect of the incidence of current unemployment on the future employability of younger workers (Hämäläinen, 2003). It might also be the case that poor employment prospects for new entrants to the labour market encourage increased participation in education and longer study times.

**Figure 4. Labour market performance of young people**

Aged 20-24, 2003<sup>1</sup>

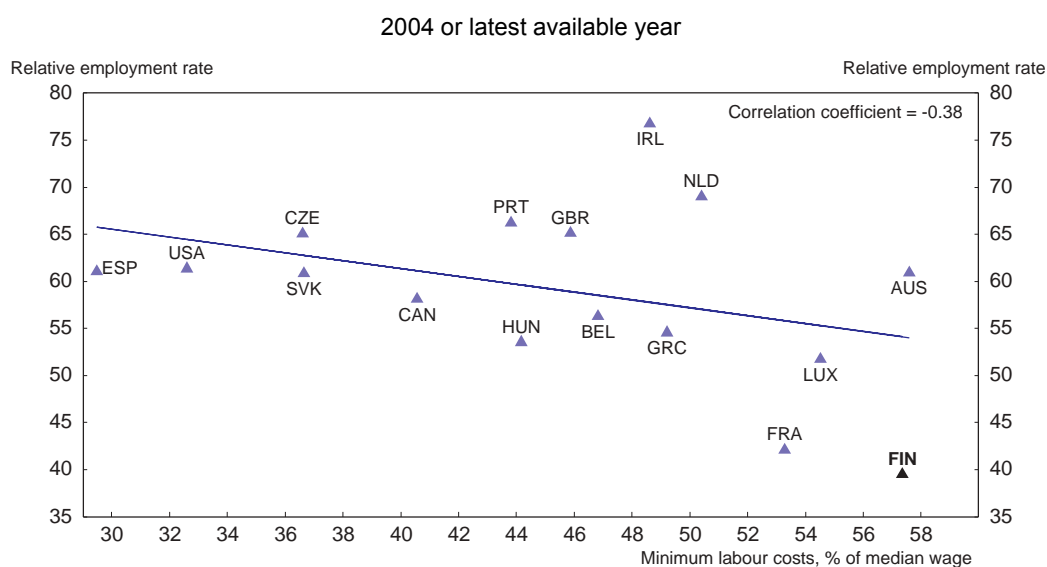


1. Data for Finland refer to 2004.

Source: OECD, Education database.

For Finland there is some evidence that the high minimum labour cost may have reduced employment of younger workers (Figure 5). The other country, where employment among younger adults is particularly low is France, where there is a fairly high statutory national minimum wage.<sup>12</sup> The relation between high minimum wages and employment may be non-linear *i.e.* at very high minimum wages such as in Finland and France, the minimum wage covers many employees thereby reducing employment while at lower levels the minima are not binding and therefore do not have a negative employment effect.<sup>13</sup>

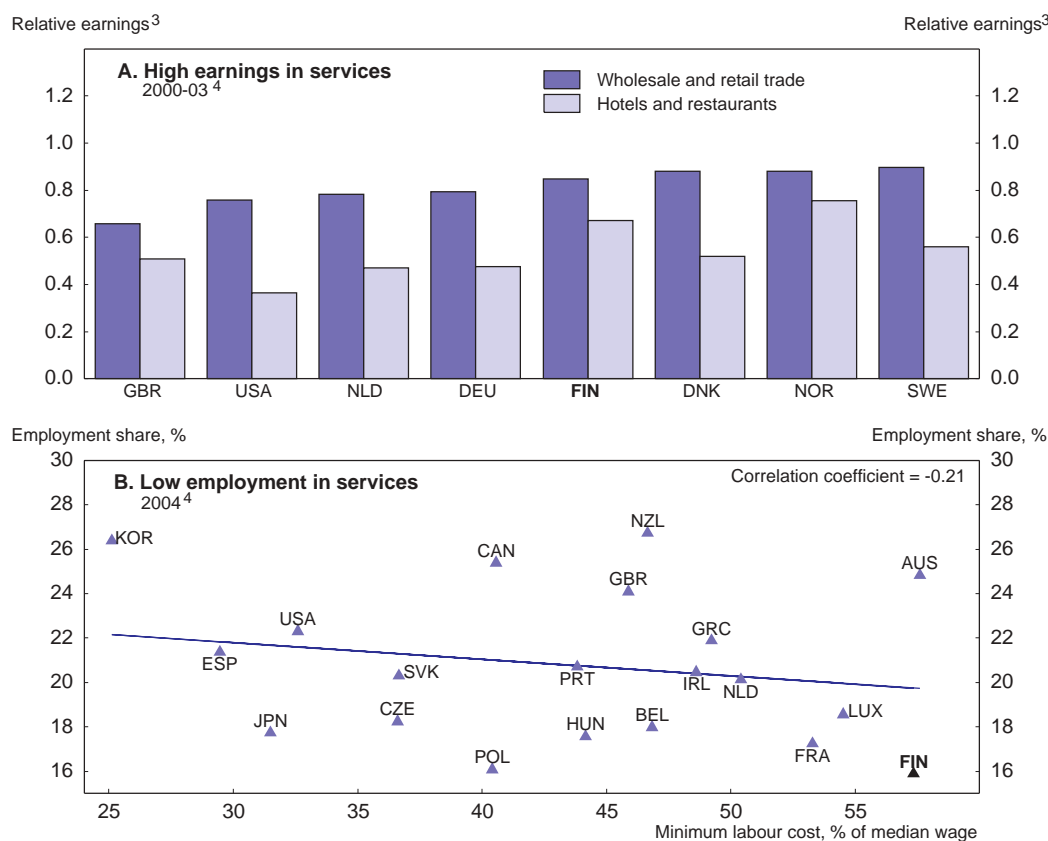
**Figure 5. Minimum labour cost<sup>1</sup> and employment of younger workers<sup>2</sup>**



1. The cost of labour is the sum of the minimum wage level and the corresponding social security contribution paid by the employers.
2. Ratio of the employment rate of the 20-24 year olds not in education over the employment rate of the 25-54 year olds.

Source: OECD, *Education at a Glance - OECD Indicators*, 2005 ed.; Minimum Wage and Taxing Wages databases; Finnish labour cost computed from data provided by national authorities.

There is also some evidence that the high wage floors result in high relative wages in typical low-skilled and low-productivity service sectors such as hotels and restaurants and wholesale and retail trade in comparison with countries characterised by more decentralised wage-bargaining (Figure 6, panel A). At the same time, employment in these low-skilled sectors is low in Finland suggesting that the minimum wages implied by the wage floors may have contributed to a shortage of low-skilled service jobs (Figure 6, panel B). The high minimum tariff wages may also deter investment of foreign firms in Finland and cause Finnish firms to increasingly outsource production to take advantage of low-cost labour thereby reducing job opportunities at home (Box 3).<sup>14</sup>

**Figure 6. Minimum labour cost<sup>1</sup> and low-skilled service sector employment<sup>2</sup>**

1. The cost of labour is the sum of the minimum wage level and the corresponding social security contribution paid by the employers.
2. Low-skill services are defined as the wholesale and retail trade, hotels and restaurants sector (ISIC 50-55) and are expressed as a percentage of total employment (ISIC 01-99).
3. The earnings were proxied by total compensation per employee. Relative earnings are defined as the ratio of earnings in each industry over the sum of the weighted average of earnings in all industries. The frequency of part-time employment differs across countries which affects this proxy. However, among the countries included in the figure the frequency of part-time employment is lowest in Finland, which if considered would work in the direction of understating the total (full-time equivalent) compensation per employee in Finland relative to the other countries.
4. Or nearest available year.

Source: OECD, Minimum Wage, Taxing Wages and STAN databases; Finnish labour cost computed from data provided by national authorities.

#### **Box 4. Integration of the European labour market: a challenge for the Finnish labour market relations**

At the moment transitional arrangements restrict immigration of workers from the new EU member countries except for subcontractors which is particularly important in the construction sector (OECD, 2006). The subcontracted workers are covered by the Posted Workers Directive and are therefore subject to the same working conditions as domestic workers specified in the collective agreements. In 2006 an act (1198/2005) to strengthen the supervision of working conditions for posted workers was implemented. The transitional restrictions on immigration have been relaxed in May 2006. In the future the free movements of persons may alleviate problems due to the shrinking working-age population and also have beneficial effects through enhanced competition. But at the same time the future free movement of persons could potentially imply that local workers would have to compete for jobs with foreign workers with lower wage claims which may put stress on the institutional framework of collective agreements. This raises the issue of how the Finnish labour and industrial relations should adapt to take advantage of the potential benefits of an integrated labour market in Europe.

The increasing pressure of globalisation and integration of the European labour market on labour market regulations has recently been seen in Sweden, which did not impose transitional restrictions on immigration from the new EU members. During the first year an estimated inflow of 22 000 workers from the new EU countries entered Sweden, which is double the previous year's inflow, yet it is only 0.5% of the labour force (Pettersson *et al.*, 2004). The current debate is whether it is sufficient that foreign workers are covered by their own national collective agreements or whether they have to sign a Swedish collective agreement, and if so what wage should be paid, the average wage or the minima in the agreements. In the event that foreign workers can work in Sweden under national (home country) collective agreements, then an increased inflow of workers may be expected in the future as Swedish firms increasingly take advantage of low-cost labour. If the Swedish collective agreement overrules the foreign agreement, then increased outsourcing of jobs to low-cost countries may occur, thus reducing the work opportunities at home. Court proceedings are currently ongoing in the European Court of Justice to decide if any breach of community obligations has been made in the case of a foreign construction company that was locked-out by the Swedish construction trade union as they had not signed a Swedish collective agreement. The ruling will have implications for the pay of foreign firms and workers in the Swedish labour market.

The United Kingdom and Ireland, the other two countries that also opened their borders, have different labour and industrial relations compared with the Nordics and wage setting mostly takes place at the firm level. Labour regulations in these countries are less stringent and both countries have a statutory minimum wage which regulates the lowest wage a worker, foreign or national, needs to be paid. The advantage is that it is easier for firms to hire low-cost workers and compete with foreign firms on a more equal basis, reducing the threat of outsourcing, but there is always a risk that firms take advantage of low-cost workers, pushing domestic workers into unemployment. However, the re-flagging of Irish Ferries to Cyprus with the purpose of bringing in Latvian workers to crew the ferries on wage rates less than half of the national wage shows that even statutory minimum wages may not be enough. The following agreement by the Labour Relations Commission allowed Irish Ferries to outsource its crew to an agency and introduce a two-tier pay and work condition system with current staff remaining on the same conditions and wages but all new staff being paid only slightly above the minimum wage and having different working conditions. This transitional arrangement will be in place for three years.

The issue for Finland is how to combine the current framework of centralised bargaining that specifies high minimum wage floors that are extended by law to all workers and open borders with the new low-cost EU members without risking job opportunities at home. The collective agreements protect local workers against competition from foreign workers with lower wage claims but at the same time they deter foreign investment in Finland and may also induce Finnish firms to move abroad. One possible solution is to impose a low statutory minimum wage where the level is set such that it does not price less-skilled workers out of the market but at the same time safeguards the earnings of workers.

In Sweden minimum wages are also subject to bargaining between employers and unions and are part of the collective agreement. A study based on six collective agreements in Sweden found that sectoral minimum wages are high in international comparison at between 60-70% of the median wage (Skedinger, 2005).<sup>15</sup> However, there would appear to be greater flexibility in the way in which these minima are applied. In general, the minimum wages are industry-specific and are differentiated by occupation, experience and age. The minimum wage is not administratively extended by law to firms that are not members in an employer association, as in Finland, but can be extended by separate agreements. Most of

these agreements specify different minimum wages for workers below 18-20 years and there is a tendency towards more differentiation of the minimum wage by age in all contracts. For instance, in the hotel and restaurant sector the minimum wage of an 18 year-old worker was lowered by almost 20% compared to a 20 year-old worker in the mid-1990s and in the construction sector the minimum wage of an 18 year-old worker is 40% less than for a 20 year-old worker. Thus, even though the level of minimum wages is high in Sweden, greater differentiation in the rate for younger workers may have contributed to a higher employment among them.

### ***Centralised wage setting compresses the wage distribution***

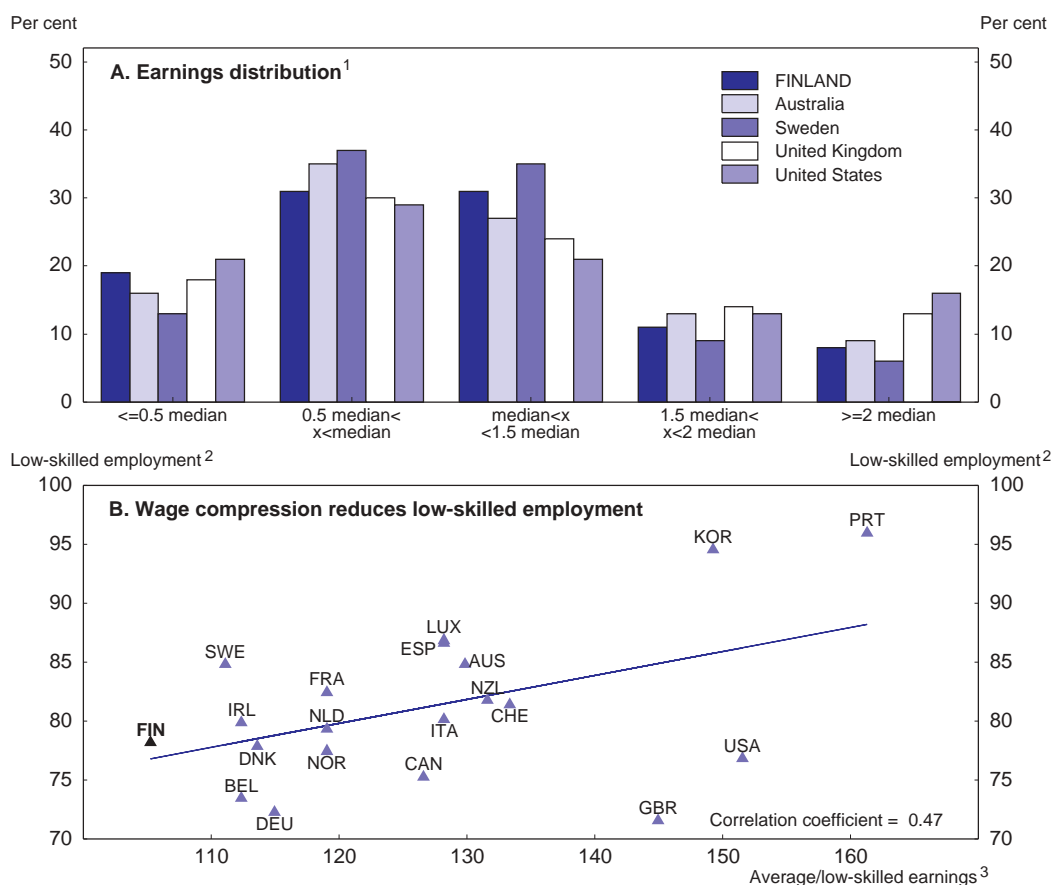
High unionisation, high coverage of collective agreements and highly co-ordinated collective bargaining tend to reduce wage dispersion and mainly so at the bottom of the wage scale because unions pursue a policy of compressing wage differentials for equity reasons (OECD, 2006a; Blau and Kahn, 1999). If wage compression is strong enough, significant numbers of low-skilled workers and workers living in low-productivity regions may be excluded from employment. In Finland there is some evidence that wage dispersion is greater in periods when agreements have been concluded at the union-level while in the periods of centralised agreements wage dispersion is more compressed (Uusitalo, 2002).

A histogram of the earnings distribution of the employed population shows a clustering in the Finnish distribution around the level of median earnings while in countries with a more decentralised wage setting, for instance in the United States and the United Kingdom, the tails of the distribution are more pronounced (Figure 7, panel A). Likewise, the ratio of the earnings of employed with upper-secondary education relative to earnings of employed with less than upper-secondary education is 1.05, which is among the lowest in the OECD and lower than in all other Nordic countries. Thus it seems that the wage floors in the collective agreements result in high relative earnings of low-skilled workers thereby compressing the wage distribution. At the same time in countries with a compressed wage distribution, the employment of low-skilled workers is lower than in countries with a limited importance of collective bargaining and decentralised bargaining at the firm level, which results in higher earnings inequality (Figure 7, panel B).



**Figure 7. Wage compression**

2003 or nearest available year



1. Gross earnings distribution of full-time dependent employment aged 25-64.

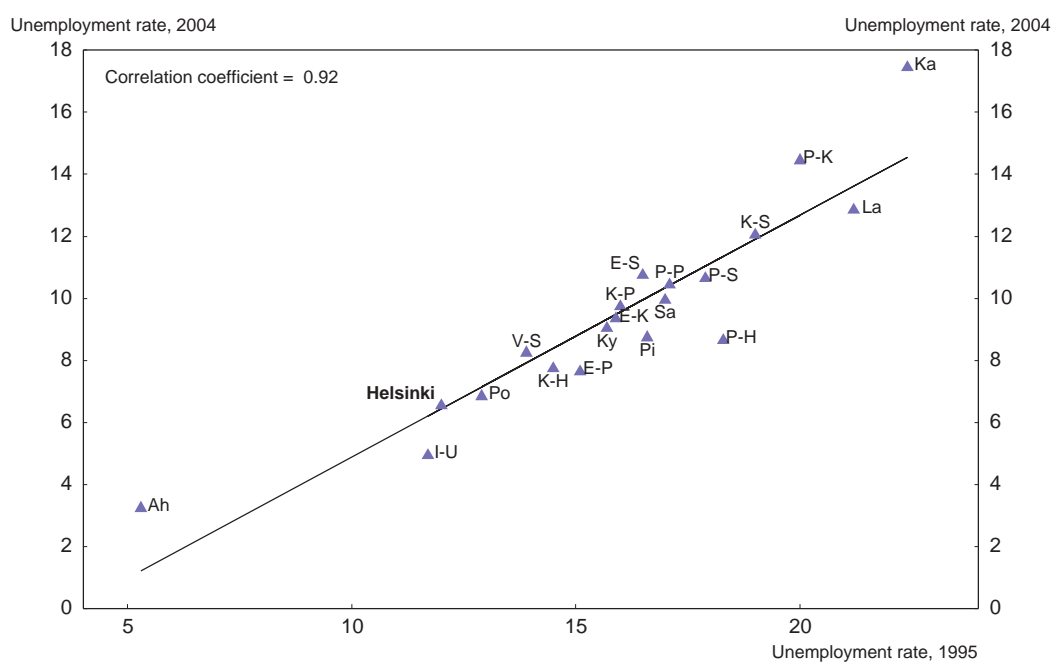
2. Employment rate of the 25-64 year olds with below upper secondary education (average) relative to the total employment rate of the 25-64.

3. Earnings of upper secondary and post-secondary non-tertiary education relative to below upper secondary.

Source: OECD, *Education at a Glance - OECD Indicators*, 2005 ed., Tables A8.3a, A9.2a and A9.4a; *Labour Force Statistics* database.

### ***Regional wage flexibility is also low***

There are signs of increasing mismatch in the Finnish labour market with the same number of unfilled vacancies being associated with a higher unemployment rate in recent years compared with the 1980s and 1990s. The differences in unemployment rates across regions are persistent and the differences have even increased over the last decade (Figure 8). The relative unemployment rate measures the ratio of unemployment in one region to the corresponding national rate and the variance in this measure has increased since the mid-1990s, which suggests that regional imbalances have worsened (Table 2). Regional differences in unemployment may persist because wages are not in line with local labour market conditions. In regions with low productivity, labour cost cannot adjust due to national wage floors and returns to investments in these regions may be too low, thus reducing investment inflows and job creation. Furthermore, social transfers and increasing house prices in growth areas may create disincentives to move from regions with high unemployment. National wage floors in combination with low labour mobility imply that some regions may end up growing more slowly than others.

**Figure 8. Persistent differences in unemployment across regions**

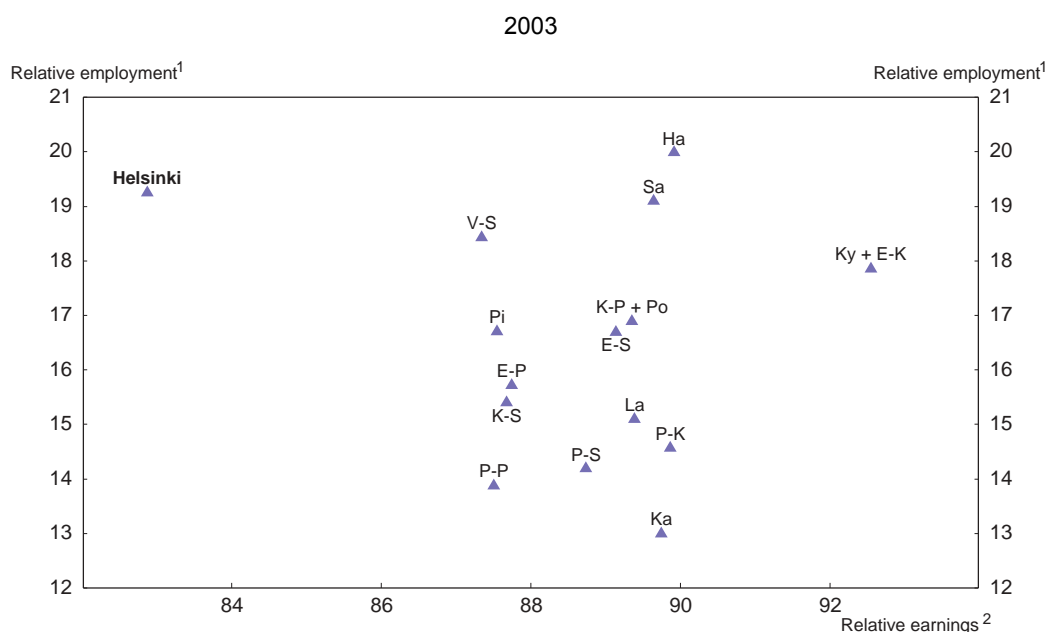
Source: Ministry of Labour.

**Table 2. Table 2. Variance in the relative unemployment and employment rates**

	Unemployment	Employment
1990-94	0.099	0.0048
1995-99	0.105	0.0068
2000-04	0.155	0.0074

Source: OECD calculations based on data from Statistics Finland.

Despite fairly large differences in relative employment of low-skilled workers across regions, corresponding relative wages across regions are similar with the exception of the Helsinki region and south-eastern Finland (Figure 9). Centralised wage agreements with specified minimum tariff wages imply that there is little room for downward relative wage flexibility at the regional level, which can be problematic as relative wage differentials are one way of attracting investment thereby creating new work opportunities. Wage differentials between regions may also help to induce labour mobility to more dynamic regions.

**Figure 9. Regional wage flexibility is low**

1. Employment of persons with lower secondary education relative to all employed.

2. Mean earnings of persons with lower secondary education relative to mean earnings of all workers.

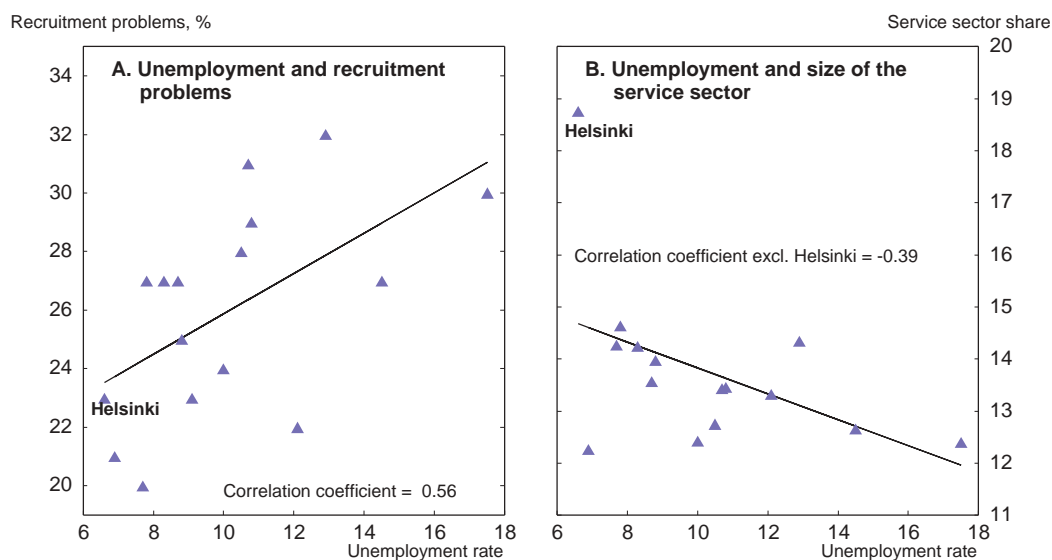
Source: Ministry of Labour; Statistics Finland, *Wage and Salary Statistics*.

### ***Few low-skilled service jobs may contribute to perpetuate regional differences***

In recent years the number of workplaces that experience recruitment problems has increased, notably in certain occupational groups such as construction, transport, agriculture and forestry and public services. There is a marked difference between regions. Hiring difficulties are more pronounced in the north and in some eastern regions (Lappi, Pohjois-Savo, Kainuu) and less pronounced in the Helsinki area and central Finland (Uusimaa, Kaakkois-Suomi, Keski-Suomi, Pohjanmaa). Recruitment problems tend to be more severe in regions that suffer from high unemployment indicating that even though there is a large pool of unemployed workers the supply of workers does not match demand (Figure 10, panel A). At the same time the unemployment rate is higher in regions with a smaller low-skilled service sector (Figure 10, panel B) suggesting that the recruitment problem is more pronounced in regions with a small service sector. Thus regional disparities may partly be explained by a large supply of low-skilled workers in regions with relatively few low-skilled jobs. One possible explanation for the shortage of the supply of low-skilled jobs is that the nation-wide wage floors deter investment and reduce job-creation in low productivity regions.

Figure 10. Low-skilled service jobs and regional differences

2004



1. Recruitment problems measure the percentage of firms having problems of hiring workers.
2. The size of low-skilled services is measured by employment in trade, hotels and restaurants as a share of total employment in each region.

Source: Ministry of Labour.

### Increasing wage flexibility in the current system

The Finnish model of centralised wage setting has yielded macroeconomic benefits but at the cost of reduced relative wage flexibility. Nevertheless, in the current framework there are ways of achieving flexibility through that part of wage changes that can be decided at the local level and through various bonus schemes. The union allowance in the income agreement allows part of the general wage increase to be negotiated at the firm, municipal or industry level and enhances wage flexibility. If no agreement on the use of the union allowance is made, then the amount is paid as a percentage-based general increase. In 2005, 69% of the private sector's union allowance was paid as a general increase while only 14% was used at the local level (Confederation of Finnish Industries). In the 2003-04 income policy agreement, the share negotiated at either firm or industry level accounted for 31% and 23%, respectively, of the actual total wage increase (Heikkilä and Piekkola, 2004). Estimates for industrial workers based on the current income policy agreement for 2005-07 suggest that the share negotiated at either the firm or industry level accounts for around 30% in 2005 and 2006.<sup>16</sup>

A recent survey among Finnish employees and employers found that there exists a trade-off between wage flexibility and income safety. Employers would like to see greater freedom in wage setting and employees, particularly workers, emphasise the role of an earnings guarantee provided by the minimum wage tariffs specified in the collective agreement (Peckkarinen and Alho, 2004). Another study based on the same survey suggests that Finnish employers want the locally-bargained wage share to be approximately half of the total wage increase, which is significantly more than the locally-bargained share in the current centralised agreements (Heikkilä and Piekkola, 2004).

One obvious option to enhance wage flexibility would be to decentralise wage bargaining to firms, as in many English-speaking countries and in most other Nordic countries, especially Denmark, where wage-setting is far more decentralised than in Finland. But also in the current wage setting arrangements there are some possibilities to raise wage flexibility. Introducing more profit and performance-related pay schemes at the firm level allows for a higher degree of relative wage flexibility by permitting wages to reflect local conditions and skill levels. This is consistent with an increase in the share of the overall wage increase that is decided at the industry or firm level. In Finland various “bonus” systems are used fairly frequently as there has been some decentralisation of wage setting in recent years. For example, performance-related pay and profit sharing schemes have become more common (Snellman, Vartianien and Uusitalo, 2003) and this has been accompanied by an increased dispersion in the wage drift across industries (Piekkola and Marjanen, 2003). In 2003 payment by results was common, especially in the private sector where 43% of firms or workplaces used some form of payment by result. Some workplaces paid bonuses to individuals, others to groups of workers or to all employees and around 95% of those who were covered by the bonus system received a bonus. Generally the bonuses were larger in the private sector compared with the state and municipalities, but overall the amount of the bonuses was small (Table 3). Another possibility is to promote the use of “opt-out” clauses allowing for local wage agreements at lower wages than the centralised agreement if employers and employees agree on it. This has recently been used frequently in Germany.

**Table 3. Bonuses in 2003**

In per cent

	Under € 500	€ 500-1 000	Over € 1 000
Private sector	30	26	44
State	52	27	21
Municipalities	49	33	18
All sectors	33	26	41

Source: Ministry of Labour.

### **The government’s role in the next wage agreement**

The government’s role in the income policy agreements has most often been the role of a broker or mediator in the wage negotiations. The government has encouraged moderate wage settlements by offering tax cuts and social policy enhancements. Moreover, the state and local governments are also important employers but they have not in general assumed a leading role in the wage bargaining rounds (Vartianien, 1998). If the government is involved in wage setting then it is legitimate that it is concerned with improving certain features of the current agreements, especially those that limit flexibility and may reduce employment (Box 4).

**Box 5. Box 4. Recommendations concerning the next wage round**

The wage setting system with centralised income policies concluded by the social partners with the support of the government has moderated wage increases but at the cost of reduced wage flexibility. In future wage bargaining the social partners should pay attention to the following considerations:

- Encourage the increased use of the part of the overall wage increase (union allowance) that can be negotiated at the industry or local level.
- Promote the differentiation of minimum tariff wages by age and experience in the collective agreements, in particular for younger workers.
- Promote the use of individual performance and profit-based pay systems by trading off overall wage increases against profit- and performance-related pay at the firm level.
- Promote the use of opt-out clauses allowing for local wage agreements with lower wages than the centralised agreement if employers and employees agree on it.
- Restrict the use of indexation clauses on consumer prices given the potential negative employment effects of such a clause in cases of large supply shocks and in times when output price inflation is below consumer price inflation.
- With the opening of the labour market to immigration from the new EU countries, the introduction of a low statutory minimum wage should be considered.

## Notes

1. Theory suggests that in cases of nominal demand shocks, wage setters prefer full indexation to the price level as this stabilises the real wage and thus employment. In the case of real supply shocks, wage setters want lower indexation because this leads to real wage changes that offset the direct employment effect of the shocks. When both types of shocks occur partial indexation is optimal.
2. This does not conclusively prove that centralised wage agreements have had a beneficial effect on inflation. If for example they led to strains, either because the aggregate increase in wages was too low or because relativities were squeezed, they may have made it difficult to reach a subsequent central agreement and hence ultimately have been the root cause of a (more) inflationary period of subsequent catch-up when there was no agreement. Moreover, during the 1990s unemployment was high which also should have restrained wage increases irrespective of what level wages were bargained at.
3. In future wage agreements the concept of “wage drift” is problematic because in the current tripartite agreement a part of the wage increase is reserved for local negotiations.
4. The distribution of wage changes for manual manufacturing workers also seems to be more concentrated around the modal in the years when an income policy agreement was reached, particularly in the second year of the income agreement.

5. There is some evidence that this pattern broke down at the beginning of the 1990s during the recession suggesting that wage rigidities were less prevalent under extreme circumstances (Böckerman *et al.*, 2006).
6. The insider-outsider theory dispenses the traditional assumption that union members' employment probabilities are a random draw. If the turnover cost is taken into account, which mostly falls on the firm, the probability that an unemployed person will be hired tends to be significantly less than the probability that an employed person will be retained. Thus, the interest of employed union members is substantially different from the ones of the unemployed union members (Lindbeck and Snower, 2002). In practice, the unions are primarily concerned with the employed since they tend to be far more numerous than the unemployed.
7. The minimum wage is a weighted average of the lowest monthly tariff wages in the Helsinki area weighted by the employment share of each sector in total employment of the sectors concerned. The tariff wages in wholesale and retail sale, hotels and restaurants and social services are € 1 335, 1 311 and 1 322 per month, respectively. Using tariff wages for other regions in Finland only changes the minimum wage marginally. The minimum labour cost is calculated by adding the employers' social contributions at the minimum wage to the wage cost based on OECD's Taxing Wages models.
8. More specifically, the sectors included are C to K according to ISIC Rev 3 classification.
9. A further complication in international comparisons of activity rates of young people is accounting for those conscripted to do military service. In the calculations reported here such military conscripts are excluded both from the employment and population data.
10. The numbers are also affected by people on parental leave, where persons stay home and are thus not included in the labour force, but have a job to which they can return.
11. A part of this difference may be explained by young people taking time out to prepare for specialised university entrance exams (which often differ between universities) after completing secondary education, although many of these people might be expected to be at least part-time employed. This would further argue for streamlining and speeding up an overly bureaucratic university selection process.
12. France has recently reduced the employers' social contribution on low-wage earners implying that the labour cost of hiring a worker at the minimum wage is only 53% of the cost of hiring a worker at the median wage, while the minimum wage is 61% of the median wage.
13. Excluding Finland the correlation coefficient in Figure 5 drops from -0.38 to -0.22.
14. A Finnish study found that industrial activity of Finnish firms in the new EU member states tends to be labour intensive in its nature; the cumulative share of industrial investment between 1998 and 2002 was 3.6% of total overseas investment while the share of employment was nearly 10% of total overseas employment (Teollisuuden ulkomaantoiminta, Kilpailukykyä EU:n laajentumisesta, 2004).
15. The sectors included in this study are the metal industry, construction, butchery, bakery, wholesale and retail trade and hotels and restaurants.
16. The estimates are calculations by the Ministry of Labour based on the current collective agreement.

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