The Rise Of The “Super Firms” And Inequality

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Mainstream economic thinking often tries to explain the trend of high and rising inequalities by referring to the forces of technology. Technological progress, so the argument goes, works to destroy middle pay routine jobs while at the same time creating many high skilled jobs. There is, however, increasing recognition that this ‘technology’ factor is but part of the story and there are other important forces at work. (see for example here).

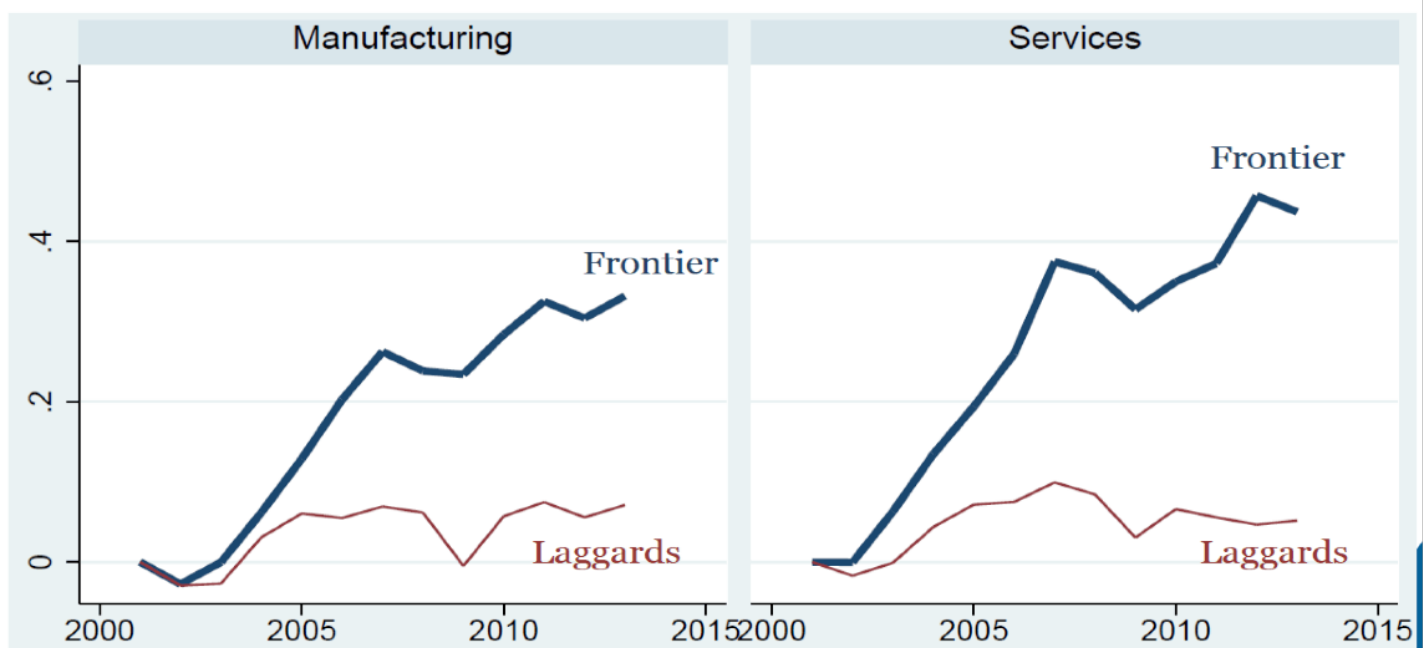
The failure of this classical skills-related argument in explaining all of the wage inequality trends has not gone unnoticed by the OECD either. In a recently published working paper from their Economics department, the authors conclude that cross-country diverging experience “suggests that longer-term trends such as technological change and globalisation cannot fully account for decoupling of wages and productivity”. Country-specific public policies are also important as these shape the effects of global trends on inequalities.

The OECD and the rise of the “Super Firm”

Related work from the OECD reveals itis indeed suggesting a new and complementary narrative besides the usual skills biased technology one.

This starts from the observation that for some countries (the US primarily but also Germany and Sweden), the overall increase in wage inequality appears to be caused by wage differences *between* firms and not by different wages being paid *within* firms. “Inequality, to quote (at page69) the OECD, “has risen because some firms now pay all their employees more than other firms, not because top managers have increasingly been paid more than support staff”.

So, why have some firms raised wages for (all or most of) their staff more than other firms? Here, the OECD comes up with another phenomenon which is that some firms (the so-called ‘frontier’ firms, the 100 or 5% most productive firms in each sector across the world) have apparently been able to systematically increase their productivity performance whereas productivity growth for the rest (the ‘laggards’) is dwindling (see graph below).



‘Frontier’ firms are thus able to increase pay for their workforce substantially, whereas ‘laggard’ firms find it quite difficult to do so. In other words, rising wage inequalities are to be explained by the rise of a group of ‘super firms’.

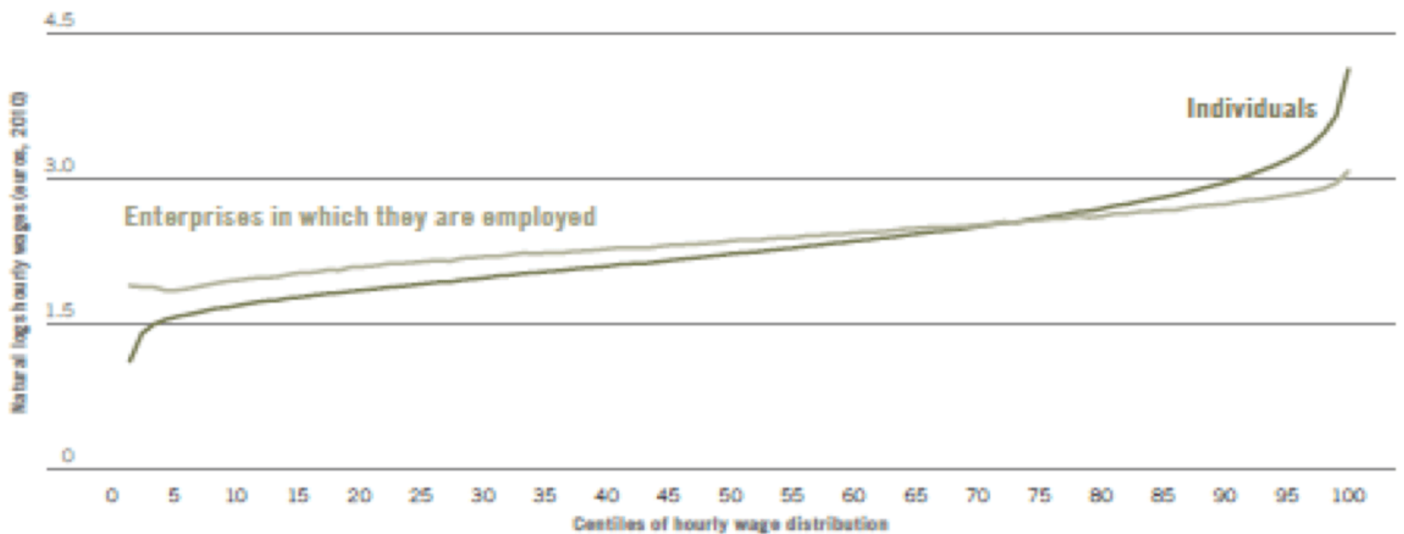
This narrative, however, sounds pretty familiar: It resembles the old neo-classical theory where the marginal productivity of individual workers determines their wage, with the theory on productivity divergences between individuals transformed into a tale of productivity divergence between firms. The practical effect of this is that the focus firmly remains on productivity performance (in this case the productivity of firms, not of individual workers) while the question of how value added is distributed remains in the background. This in turn allows one to revert to traditional policy recipes such as ease of firing to ‘liberate’ workers otherwise locked up in ‘zombie’ firms while overlooking pre-distribution policies such as robust collective bargaining that can give wage earners a fair share of the value added.

ILO: Do not underestimate wage inequalities within firms

The new OECD narrative is, to large extent, based on research for the US (with one paper fittingly called ‘firming up inequality”). The International Labor Organisation’s 2016/2017 Global Wage report focusses on Europe. Using similar techniques to those used in the US research, it reveals that there is a significant degree of wage inequality in Europe that is explained by wage differences *within* firms.

In the next graph hourly wages earned by individual workers are ranked from the lowest to the highest centile on the horizontal axis. The wage of workers in each centile (the thick line) is then compared with the average wage that is paid by the firms where each centile of workers are employed (the thin line). While low/high wage workers do tend to work in companies that pay on average a low/high wage to their staff, the graph also shows that the majority of workers (up to the 80th centile) are actually paid *below* the average wage that is paid by their company. It’s only among the top 20% wage earners where individuals are paid more than their firm average. And among this 20 percent, wages grow exponentially while workers at the bottom of the wage distribution are falling off a cliff compared to average pay in their company. For example, the very 0.1% bottom of wage earners in Europe is receiving €2.50 per hour but is working for companies that pay, on average, €10.20. With numbers such as these, the claim that company-level productivity is key to achieving higher wages for the lower-paid is undermined. Or, as the ILO report puts it, “ a more compressed distribution of average wages across enterprises might not necessarily reduce overall wage inequality unless it benefits those at the lower end of the wage distribution within these enterprises”.

Figure 48 Average hourly wages, individuals and enterprises, by centile ranking of individual wages



Notes: The horizontal scale shows the centile distribution of individuals' gross hourly wages. See box 9 for more details. The vertical scale shows the natural logarithm of hourly wages; the scaling helps fit the information into the graph while preserving the perspective that would otherwise be lost if the extreme values at the tails were to be shown in absolute values.

Source: ILO estimates based on SES database.

Super Firms or Super-fragmented Workplaces?

A second key argument the ILO report makes about this theory of ‘superfirms’ working to increase firm level productivity and wage dispersion is that this phenomenon may be more a symptom than the driving force. Indeed, over recent decades it has become standard management practice to split up company activity by keeping the core business while outsourcing the rest to all sorts of service companies. The latter then mainly use precarious work contracts or succeed in opting out from collectively bargained wages.

It is this process of workplace fragmentation that may be behind this rising dispersion of both wages and productivity between companies. For example, one piece of research finds that the trend towards increasing heterogenity across newer workplaces in Germany started to take off just as there was a rupture in the system of collective bargaining, with coverage falling from 50-55% to 30% for the group of newly entering firms.

However, and as the ILO report correctly observes, if the rising wage and productivity dispersion *between* firms is being driven by the fragmentation of the workplace then the scope for improving productivity in those firms where work has been outsourced will be limited.The low or stagnating productivity performance among these firms will be structural since it results from a deliberate strategy of outsourcing the production of low added value goods and services to peripheral firms.

Conclusion: Putting collective bargaining back in the center

While the insight is gaining ground that inequalities are more than just about technological change and skills, the OECD’s new narrative on the ‘rising superfirms’ paying (most of) their workers super pay is not entirely satisfactory either and is confusing the phenomenon (‘dispersion of wages and productivity between firms’) with the underlying cause (‘management strategy to fragment workplaces’).

What is missing here is alink with, say, minimum wages and collective bargaining. As the ILO report says, these can reduce wage inequality between and within firms at the same time. In particular, a collective bargaining system with a wide coverage will push up wage floors across a wide range of firms, thereby reducing wage inequality both within as well as between firms. Moreover, in the case of fragmented workplaces, such collectively bargained wage floors will raise standards for competition when peripheral companies are bidding for

the product and service orders from the core company. Peripheral firms, no longer facing the possibilty of getting undercut by others, will be able to raise prices to pay better wages.