Pay inequalities and economic performance

Greater pay inequalities within firms seem to be related to better business performance

What is the relationship between the structure of earnings within firms and their business and employment performance? A major CEP project led by **David Marsden** has been using new European data to examine the role that firms' performance management systems play in the macroeconomy. In particular, the project has explored the ways in which these systems interact with institutional features of the labour market to produce different outcomes in different regional and industrial contexts.

The research finds that greater pay inequalities within firms seem to be related to better business performance. But the relationship appears to weaken as inequality levels increase, and their incentive effect appears to depend on the type of work organisation and human resource management approach adopted by the firm. The effect of greater pay inequalities on performance may be related to the slow diffusion of newer, more team-based, methods of work organisation within the EU.

The greater pay inequalities in some countries – Ireland, Spain and the UK compared with Belgium, Denmark and Italy – do not systematically give rise to higher employment rates in these countries. In 1995, Denmark and the UK had the highest ratios of employment to population, and Spain and Italy the lowest ones.

The greater inequality in the first three countries appears to be linked to a greater degree of labour market segregation of low paid groups and by gender. This segregation goes beyond the familiar industry concentration and emerges as a phenomenon associated with employment in certain kinds of firms. Hence, more attention should be given to their human resource policies with regard to low pay and gender. Youth employment appears segmented along similar lines.

National and sectoral pay agreements do not uniformly restrict employers' pay policies across countries more than single employer agreements. Whereas single employer bargaining has been associated with greater earnings variation compared with national bargaining in the UK, the opposite appears to hold for Belgium and Italy. There, enterprise bargaining is associated with less inequality than national or sectoral bargaining. The reason for the smaller variation in Belgium and Italy seems to lie in the greater degree to which single employer bargaining is coordinated across firms.

Finally, pay inequalities at firm level have to be considered in conjunction with other human resource management and work organisation policies. The beneficial effect of greater pay variability on performance depends on there being an appropriate work environment for such incentives.

The project has been conducted by a multidisciplinary team of researchers with support from the European Commission and in close collaboration with Eurostat and the national statistical institutes. At the core of its empirical research programme is the 1995 European Structure of Earnings Survey, which provides rich data on key micro-level variables on a comparable basis across Europe.

The beneficial effect of greater pay variability on performance depends on an appropriate work environment

This article summarises ‘Pay Inequalities and Economic Performance’ by David Marsden (http://cep.lse.ac.uk/piep/papers/Final_Report_V5.pdf), the final report of a project funded under the EU’s fifth framework programme. The CEP team also included Tanvi Desai, data manager, and Richard Belfield, researcher.

David Marsden is Professor of Industrial Relations at LSE and an associate in CEP’s labour markets programme.