

The Labour Market in Cyprus: Is it as Flexible as we Claim?

Louis N. Christofides*

Department of Economics, University of Cyprus

“The labour market in Cyprus can be considered to be relatively flexible and well-functioning ...” The Republic of Cyprus, Planning Bureau, Revised National Reform Programme of Cyprus - Progress Report (2009)⁵.

1. Introduction

Reviewing the major challenges facing the economy of Cyprus on June 28, 2011⁶, I noted that they included (i) the level and form of the remuneration paid by and the supervision of the commercial banks in Cyprus (indicating that stock distributions in lieu of salary and salary increases would reduce wage costs and increase the internal supervision of these banks), (ii) the remuneration of individuals in the public sector (suggesting that a total freeze of nominal rewards would both reduce real earnings and have favourable spillovers in the private sector), (iii) the number of programmes offered by the public sector (implying that the structure of the public sector might be scaled down and simplified), (iv) the viability of our pension arrangements (arguing that this should be improved using all available levers, including an increase in the retirement age for all but dangerous and physically demanding professions), and (v) the system of property taxation (which burdens transactions rather than ownership with many undesirable side effects).

Regrettably, these remain major issues still to be tackled satisfactorily. Nevertheless, the structure of today’s presentations allows me to focus narrowly on an issue that lies behind many of the concerns above, namely the extent to which the labour market does indeed function flexibly and sensibly – as we claim in our own official documents.

* Corresponding address: Department of Economics, University of Cyprus, P.O. Box 20537, 1678 Nicosia, Cyprus. E-mail: louis.christofides@ucy.ac.cy.

⁵ See page 113, available at:

http://www.refernet.org.cy/publications/Ministries/publicationsPlanning_en.htm

⁶ Speech at the Prize-Giving Ceremony, School of Economics and Management, June 28, 2011. See <http://www.ucy.ac.cy/goto/ecoman/el-GR/HOME.aspx>

I conclude (section 3) that matters are not as rosy as we claim. While the labour market has many good features (section 2.1), a number of institutions and practices prevent it from allocating resources efficiently and expeditiously (section 2.2). These difficulties have been latent while growth was strong and unemployment low. However, the harmonized unemployment rate (seasonally adjusted, October 31, 2011 release) increased from 4% in January 2008 to 7.8% in September 2011, unleashing the forces that international organizations, the EU, and academics have warned us against.

2. Features of the labour market in Cyprus

2.1. Favourable characteristics

The first social contract between the government, employers and the unions was signed in 1962 and secured the right to organize, negotiate, sign collective agreements and strike. It was replaced in 1967 by the Industrial Relations Code, an agreement between the social partners that adopted the main conventions of the International Labour Organization. The Code still governs the collective bargaining and dispute resolution processes. Despite a very high degree of union membership and coverage (order of 70%), a high level of tripartite cooperation generally exists and disputes are relatively rare and resolved quickly. These are obviously desirable features of the labour market.

Also generally well-designed are labour market institutions such as unemployment insurance, social welfare, and hiring and firing conventions and legislation. In general, unemployment insurance and welfare settings do not provide incentives for inactivity and do not encourage major poverty traps. At the same time, the incentive to hire is not blunted by excessive firing costs. These features have also stood us in good stead.

Serving the country well has also been the strong culture of entrepreneurship. This part of the private sector is versatile, and flexible. Earnings, hours of work and profits decline during crises and rise in booms, shifting resources intertemporally as well as sectorally and regionally. Complementing the flexibility that arises from the higher than the eurozone average (15.6% in Cyprus and 14.6% in the eurozone) degree of entrepreneurship has been the very high proportion of foreign nationals who now work legally in Cyprus. In 2010Q4, 12.5% of the employed were EU nationals and a further 8.7% were third country nationals. This, apparently very elastic, labour force has flowed where needs arose at short notice and relatively low cost.

2.2 Sources of inflexibility and difficulties

2.2.1 Cost of living allowances (COLA): Automaticity, degree and mechanisms at work

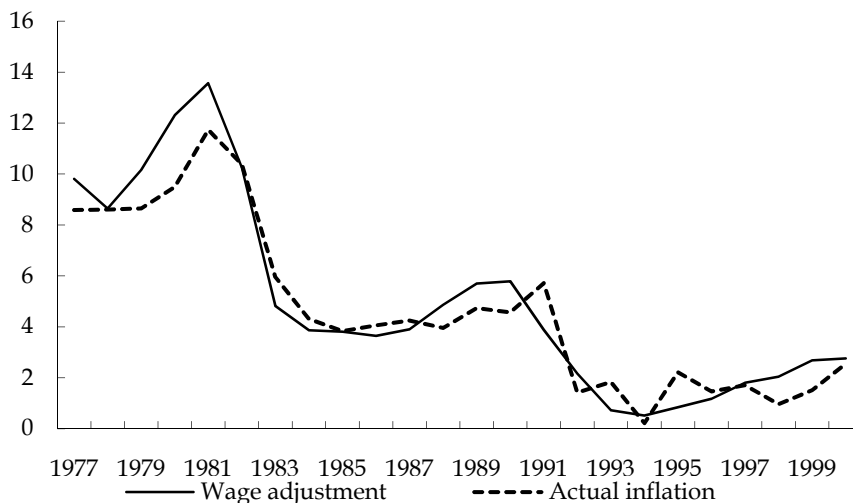
Currently, most increases in the Consumer Price Index (those not caused by increases in indirect taxation) are fed twice-yearly into nominal wages. This essentially unitary elasticity of wage indexation with respect to the price level has been criticized by the IMF and the EU. Extensive academic literature supports these criticisms.

Before discussing these concerns and some counterarguments, it is important to deal with the fear/argument that, in the absence of wage indexation, inflation would necessarily erode real wages. Figure 1 relates increases in nominal base earnings in Canadian collective bargaining agreements (averaged annually for all contracts drawn over the years 1977-1999 for which this information is available) to CPI inflation. It should be noted that, less than 20% of these agreements have COLA clauses and, when they do, the average elasticity (the percentage increase in nominal wages divided by the percentage increase in the CPI) is about 0.5, half that prevailing in Cyprus. While many factors (including productivity increases and unemployment) determine the nominal wage increases shown, it is clear that nominal wage increases track CPI increases closely. This correlation is not perfect, not even at the average levels shown. At the level of individual agreements it is far from perfect: Some wage settlements exceed and some fall short of CPI increases because the individual outcomes are determined by the circumstances that face the firm and the union as they bargain over CPI increases and other developments. This imperfect correlation is a strength, not a weakness, of the Canadian bargaining process for reasons which are now explained.

Suppose a country and the bargaining firm and union all face a sharp oil price increase which feeds into other prices. The firm may itself be using oil in its productive processes as well as other goods whose price may increase following the oil price shock. It would be natural for the union to demand a nominal wage increase to cover the CPI increase but equally natural for the firm to resist further increases in its costs. Depending on the financial health of the firm, this particular increase in the CPI may not be fully covered in a wage agreement. The implied moderation in the real wage costs of the firm will allow it to compete better and to maintain its workforce, moderating the unemployment increase that might have resulted from the oil price shock.

FIGURE 1

Increases (%) in basic nominal wage rates in Canadian collective bargaining agreements for available years



Source: Human Resources Development Canada.

By contrast, under full indexation (i.e. nominal wage elasticity with respect to prices equal to unity) nominal wages will rise to reflect the CPI increase and the firm's wage costs will be higher in nominal and constant in real terms. In addition to the rise in the price of oil that it itself must absorb directly (if it uses oil) and indirectly (as the prices of other inputs rise), the firm gets no relief on the wage side. This makes absorbing the oil price shock more difficult.

There is no escaping from the fact that, given how inelastic the demand for oil is, the increase in its price will transfer wealth from us to the countries that we buy oil from. We must lose and they must win. The argument often heard is that there is no reason why wage earners should be the ones to absorb the wealth transfer to the oil exporting countries. But this is a spurious argument. They are not the only ones affected. Capital loses too, given that firm costs rise and that profits decline. Moreover, failure to reduce the real wages of the employed workers (this reduction is their 'share of the payment' for the oil price increase) means that firms may be forced to lay off people; the real incomes of the unemployed will decline substantially more than the real wage loss of the employed under incomplete indexation. Our system of indexation leads to unemployment and a much more unequal distribution of the burden of the oil price increase.

The argument above was a macro one. But just as macro shocks such as an oil price increase affect firms, so do sectoral shocks. As an example of a sectoral shock, tourism may decline as other, cheaper, destinations open up in our neighbourhood. The needed adjustments are similar to those described above. The firms in the affected sector must absorb an adverse development and this may require real wage decreases. These can be more easily effected under incomplete indexation than under the full and automatic system that we currently have. The reason for this is that real wage decreases can be brought about through inflation, even when nominal increases (but lower than the rate of inflation) are awarded. Inflation can 'grease the wheels of the labour market' is the name of the mechanism used to describe this process. The mechanism that involves inflationary erosion of real wages is particularly valuable when nominal wages are rigid downward.

A further difficulty that can arise is that sectoral wage increases may be granted, even when they are not justified by productivity increases in the sector, because general productivity awards are not calibrated to reflect sectoral circumstances and productivity increases. Such unwarranted increases would exaggerate any adverse shocks that a firm must absorb at the sectoral level.

Perhaps because of the problems with complete and automatic indexation noted above, a discussion is currently under way to reform the wage indexation system in Cyprus. An extreme position is to make COLA always subject to negotiation. I reject this view under current circumstances because it would be too abrupt a change and may entail substantial industrial relations difficulties. In addition, it may not be always needed. In good times of strong growth and no adverse circumstances that need to be absorbed, covering inflation completely and automatically may be 'costless'. Our system is particularly problematic when adverse shocks need to be absorbed. *A solution that suggests itself is to deactivate COLA under broadly agreed circumstances.* What these circumstances might be would need to be discussed and accepted.

It is also worth noting that another proposed 'solution' is to maintain the automatic COLA below a certain earnings level and to abolish or deactivate it above the threshold. This policy is very problematic: (i) Below the threshold all the problems mentioned above would continue to hold. (ii) Especially difficult would be the fact that current public-private wage differences (which are greatest at the junior levels and smallest at the senior levels) would be maintained where they matter the most, namely for the bulk of the workforce whose skills in the public and private sector are most comparable (a director in the public sector does a very different job than one in the private sector, whereas the skills required of a secretary

are very similar in the two sectors). (iii) The extent to which real wages above the threshold decline when COLA clauses do not operate is stochastic, depending on inflation. Even if we felt that directors were overpaid, do we not know by how much? Do we want to reduce their real remuneration by the throw of dice? (iv) We do not know how, if at all, we want to change the relativities within the high and low paid in the public sector. Do we want managers and secretaries to be much more equal as time advances? This needs to be studied. (v) The argument is sometimes heard that fairness requires high and low earners to be compensated equally for increases in the price of a chosen basket of basic goods. This notion suggests that individuals should not be free to use their earnings as they see fit. A particular individual may not consume the chosen basket. COLA clauses are not a good vehicle for redistribution. For all these reasons, this 'solution' and variants of it should be rejected.

2.2.2 Competitiveness

For many years, real wages have been increasing much faster than productivity increases (the problem is more acute for certain sectors where adverse shocks also had to be absorbed). For instance, between 2005-2009, real earnings increased by 11.6% while productivity by only 4.2% (Cyprus Statistical Service and the EU). In 2009, in the middle of a deepening crisis, real earnings increased by 4% while productivity declined by 1%. Although productivity estimates are generally difficult to obtain with precision and wage data are not always useful, it is difficult to escape the conclusion that our competitiveness has been slipping. The trade balance attests to that and international competitiveness rankings show that, between 2009-2010 and 2010-2011 our position slipped from 34th to 40th.

This erosion in productivity is especially important in the context of the fixed exchange rates mechanisms within which we operate. Competitiveness is the building block on which a country's long run prosperity is based. Many of the concerns expressed above about wage rates have to do with our ability to compete internationally. It is worth noting that the measures recently taken to contain the fiscal deficit involve taxes and various charges which reduce disposable incomes, *not pre-tax incomes*. The latter have remained largely unchanged. The government would have given a much stronger message if it had frozen nominal wages in as wide a circle as possible (no general or COLA increases and no progress through the rank), in the hope that the private sector would have followed suit. Such an approach would have not only addressed the fiscal deficit but also strengthened the competitiveness of the private sector. It is this sector that trades and competes internationally and it is a mistake to ignore its cost structure.

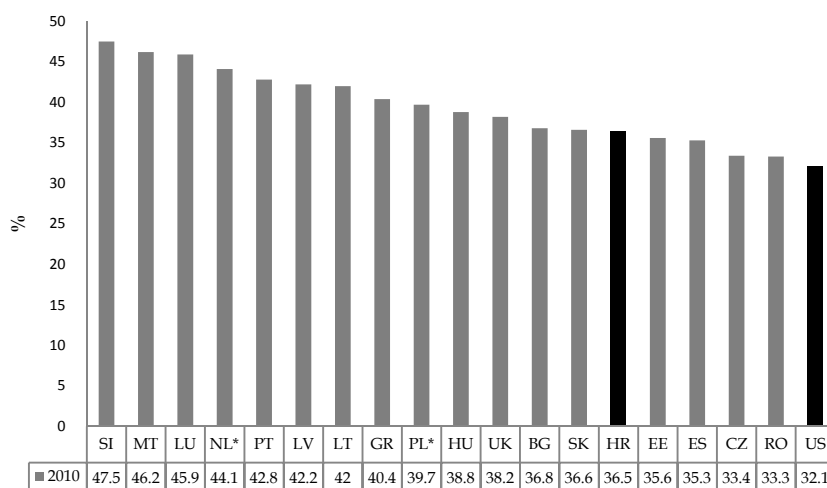
2.2.3 Minimum wages

Minimum wages are specified for, generally low-skilled, occupations (salespersons, clerks, auxiliary health care, nursery school, crèche, school staff, caretakers in clinics, cleaners in commercial premises, and guards) which are not covered by collective bargaining agreements. The intent is to raise the minimum wage to 50% of the median wage. The minimum wage is currently €855 per month for experience up to six months and €909 thereafter.

This minimum wage target is high relative to what prevails in a number of countries in the EU (Figure 2), where the highest percentage of the (mean) wage is above 45% in only two cases. It should also be born in mind that the occupations for which the minimum wage applies in Cyprus are generally low-skilled ones, while in many of the countries included in Figure 2 it applies more widely. Thus the minimum wage in Cyprus seems high.

FIGURE 2

Minimum wage as a percent of average wages



Source: Eurostat

It should be noted that the recent increases in the minimum wage may lead to employment losses in the nine covered sectors listed above, weakening the intent of the law. In addition, the minimum wage may act as a benchmark for the uncovered sectors, resulting in higher wages there. All these mechanisms affect competitiveness adversely. The argument is sometimes heard that €909 per month is not a living wage. While this may be true under current circumstances, what is needed to remain competitive

is keeping price and wage increases in check so as to achieve a generally lower price level.

2.2.4 Education, training and part-time and flexible work

It is well-known that Cyprus has one of the highest proportions (among the employed) of tertiary education graduates in the world. Given this, the strategy articulated in Planning Bureau documents to re-orient the economy towards the provision of high value-added services, including tertiary education, research and innovation dovetails with available skills. Regrettably, much inconsistency can be found in the support of these sectors as the budgets of the public universities are being cut (contrary to the strictures of the European Economic Recovery Plan) by amounts in the region of 20%.

The problems at the other end of the education and training spectrum are different. Technical education is not valued, in part because, until recently, no system of professional qualifications (SPQ) was available and learning was on the job and by doing. In addition, since many of the professionals in these trades are self-employed and underreport their income, the messages to prospective new entrants to these areas are blunted, making these professions apparently less attractive. What is needed is the completion of the efforts to develop the SPQ and the New Apprenticeship Programme, introducing them into the technical training venues both initial and continuing, and enhancing societal acceptance of these professions.

Finally, Cyprus is behind its EU partners as far as the prevalence of part-time work (18.5% in the EU and 8.9% in Cyprus) and flexible work arrangements.

3. Conclusion

Thus, the labour market in Cyprus is not as flexible and competitive as we say in our official documents. Real wage setting does not ensure competitiveness and the structure of real wages does not help transfer resources across sectors and time as needed. Instead of real wage declines, the crisis has brought about quantity changes, i.e. increases in unemployment. Government policies have been too oriented towards fixing the fiscal deficit, rather than the efficient operation of the labour market and competitiveness.