The role of firms in wage inequality: Policy lessons from a large-scale cross-country study

Executive summary

Over the past few decades, policy makers in many OECD countries have been grappling with low productivity growth and rising income inequality. At the same time, gaps in business performance in the form of productivity have widened, with a small number of high-performing businesses thriving while others falling further behind. High-performing firms have also been pulling away in terms of sales and profitability, and industry concentration is on the rise in many countries. The COVID-19 crisis could reinforce these trends, as the digitalisation of business models has accelerated in a way that has favoured large tech-savvy firms. However, while there is growing evidence that widening gaps in business performance contribute to low aggregate productivity growth, little is known about its implications for wage and, ultimately, income inequality.

This volume presents comprehensive new evidence on the links between firm performance, wage-setting practices and wage inequality, and discusses their implications for public policies. It exploits new harmonised linked employer-employee data spanning 20 OECD countries, representing the most ambitious effort to date in this area to make use of administrative data in a cross-country context.

The main finding is that **one-third of overall wage inequality can be explained by gaps in wage-setting practices between firms**, rather than differences in workers' skills. For the typical country covered by this report, high-wage firms pay about twice as much as low-wage ones for comparable workers. When workers cannot easily move from one firm to another, e.g. because of job search and moving costs, wages are not only determined by workers' skills but also by firms' wage-setting practices.

To some extent, wage setting is determined by productivity, with high-productivity firms generally offering higher wages to attract the workers required to grow their businesses. Policies aimed at promoting productivity in low-performing firms – e.g. helping them to adopt new technologies, digital business models and high-performance management practices – would therefore not only promote economic growth by raising productivity and wages, but also reduce wage inequality.

Low job mobility reinforces the link between productivity gaps between firms and pay gaps, since workers facing high barriers to mobility cannot easily quit their jobs in low-paying firms to take advantage of better opportunities in higher-paying ones (even when pay gaps are large). In contrast, high labour market mobility ensures that productivity gaps mainly translate into differences in employment rather than wages, and therefore reduces wage inequality. An increase in the level of job mobility from that of a low-mobility country such as Italy to that of a high-mobility country like Sweden is associated with a 15% drop in overall wage inequality. To put this reduction in perspective, the median increase in wage inequality across countries over the period 1995-2015 was around 10%. The same increase in job mobility would also raise average wages by strengthening competition for workers in low-wage firms and allowing high-wage firms to expand their workforces more easily. Policy options to enhance job mobility include strengthening adult learning and activation policies, reforming labour market regulation and reducing barriers to geographical mobility (e.g. via transport and housing policies).

Gaps in firms' pay practices also reflect disparities in their wage-setting power, which is partly shaped by the degree to which employment is concentrated in a small number of large firms. Approximately 20% of the workforce are employed in markets with high employment concentration and concentration is particularly high for low-qualified workers in manufacturing and rural areas. Estimates suggest that workers in labour markets with high concentration experience a wage penalty of around 6-7%. Labour market concentration has tended to decline over the past two decades in the OECD countries covered in this volume. But negative wage effects from labour market concentration have become stronger, which could reflect the weakening of workers' bargaining position due to the gradual erosion of wage-setting institutions such as minimum wages and collective bargaining in some countries, or increased exposure to domestic and international outsourcing. Excessive concentration in specific labour market segments and for specific groups of workers could be addressed by promoting competition among employers, e.g. by requiring competition authorities to take account of the labour market implications of mergers and combating the excessive use of non-compete and non-poaching agreements. Promoting worker representation in the workplace and collective bargaining could also help counter the disproportionate wage-setting power of some employers.

Firms' wage setting practices also play an important role in determining the gender wage gap. About three-quarters of the wage gap between similarly-skilled women and men reflects pay differences within firms, mainly due to differences in tasks and responsiblities but also, to a lesser extent, due to differences in pay for work of equal value (e.g. bargaining, discrimination). One quarter of the gender wage gap is explained by differences in pay between firms due to higher employment shares of women in low-wage firms. The gender wage gap within and between firms tends to increase over the life-course and particularly during to the initial phase of women's professional careers due to the role of motherhood. This reflects to an important extent gender differences in mobility between and within firms and the effect of career breaks at the age of childbirth on the career progression of women. Consequently, to tackle the gender wage gap, policy makers should take steps to make good jobs more accessible to women (e.g. through measures on childcare, working-time flexibility and parental leave), while ensuring that women are paid the same as men for work of equal value (via anti-discrimination laws, pay transparency measures and social dialogue).

The COVID-19 crisis has lent the policy recommendations in this volume new urgency. The crisis has hit low-qualified workers particularly hard since they tend to be concentrated in sectors that have been most affected by social distancing restrictions and are less likely to be able to work from home, with possible adverse consequences on their wages in the long term. The crisis may also widen gaps in business performance by exacerbating the digital divide between firms and winner-takes-all dynamics. In this context, many of the policies discussed in this volume would not only contribute to reduce wage inequality, but also strengthen the economic recovery by supporting job creation and productivity growth.