Are wages in Eastern Europe undervalued relative to economic fundamentals?

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INTERNATIONAL CONFERENCE: REASSESSMENT AND PERSPECTIVES OF LABOUR POLICIES, University Roma Tre, 14-15 December 2017

Research area C: Policies for productivity and wages

Abstract

Wages in Eastern Europe are much lower than wages in Western Europe. The large differences remain also if we adjust for differences in price levels. The differences are commonly explained by a much lower productivity (i.e. value added per hour worked). This paper assess the extent to which wage differences can be explained by differences in productivity and other economic fundamentals in individual East European countries. We compare the residual country-effects on wages, including also effects of wage setting institutions, that remain once we control for labour force compositions and differences in economic structures

Using European Working Conditions Survey data for 2010 and 2015, we find that negative country-wage effects in Eastern European countries in fact increase once we control for labour force compositions and differences in economic structures. More specifically, once we compare similar workers (taking into account skills and demographic characteristics), doing similar jobs, in similar companies, and similar sectors, the average returns on skills in a country appears even lower than what comparison of aggregate wage levels suggests.

We then decompose the returns effect for occupational groups and sectors, distinguishing the interaction between occupation and sectors and (group of) countries. The interaction effects revealed that the public sector and private sectors with higher skill intensity are among sectors with particularly low returns on worker endowments. Finally, we relate the differences in returns in individual sectors to the differences in profitability and FDI- and trade- intensity.

Overall, the evidence supports an institutionalist, path-dependent model of wage-setting. We conclude by discussing implications for productivity and wage policies to support convergence in wages and living standards in the EU.