

# Real Wage Insurance as a Compliance Incentive

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In late October 1978, President Carter announced an anti-inflation program which included future budgetary restraint, voluntary pay and price standards, and an effort to reduce the cost of regulatory actions which contribute to inflation. Included in this package was a proposal for "real wage insurance," a novel form of tax credit designed to encourage compliance with the pay standard of the anti-inflation program.

The real wage insurance proposal, which was submitted to an unreceptive Congress in January 1979, represented the first attempt to imbed microeconomic incentives for wage restraint in an incomes policy in a Western country.<sup>1</sup> The nature of the incentive, however, differed in several important respects from previously proposed tax-based incentive policies (TIP).<sup>2</sup>

This paper examines conceptual and administrative issues raised by real wage insurance (RWI). Section I reviews the changing role of incomes policies in the

context of the current inflation problem. In Section II the main features of the voluntary pay standard of the Carter Administration are outlined and the risks associated with compliance are discussed. Sections III and IV cover conceptual issues in the design of RWI and its relationship to other TIP proposals. Administrative issues are discussed in Section V.

## I. The Changing Role of Incomes Policies

Few governments during the postwar period have relied solely on demand management policies in their efforts to attain full employment and price stability simultaneously. Monetary and fiscal policy instruments have frequently been supplemented with various forms of incomes policy which specify desired wage and price behavior by economic agents and usually provide some enforcement mechanism. In the 1950s and 1960s, when inflation rates in western countries were

<sup>2</sup>See particularly, Henry C. Wallich and Sidney Weintraub, "A Tax-Based Incomes Policy," *Journal of Economic Issues*, Vol. 5 (June 1971); Arthur M. Okun, "The Great Stagflation Swamp," *Challenge*, Vol. 20 (November/December 1977); Lawrence S. Seidman, "A Payroll Tax-Credit to Restrain Inflation," *National Tax Journal*, Vol. 29 (December 1976); and Abba P. Lerner, "A Wage-Increase Permit Plan to Stop Inflation," *Brookings Papers on Economic Activity*, 1978:2, pp. 491-505. For a survey of incentive approaches, see Michael P. Fogarty, "Fiscal Measures and Wage Settlements," *British Journal of Industrial Relations*, Vol. 11 (March 1973), pp. 29-65. For a general discussion of these proposals, see the papers in "Innovative Policies To Slow Inflation," *Brookings Papers on Economic Activity*, 1978:2.

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<sup>1</sup>Hungary has used tax policy to encourage wage restraint since 1968. See R.D. Portes "The Tactics and Strategy of Economic Decentralization," *Soviet Studies*, April 1972, and Michael P. Fogarty, "Fiscal Measures and Wage Settlements," *British Journal of Industrial Relations*, Vol. II (March 1973), pp. 31-37.

generally relatively low in comparison to recent experience, incomes policies were viewed as a way of delineating rules that would prevent or retard an outbreak of wage and price inflation.<sup>3</sup>

In the past decade, however, the task accorded incomes policies has been quite different. During that period, the United States and most western nations have experienced at least two major accelerations of wages and prices—in the late 1960's and in 1973–74. The resulting inflation has influenced expectations and stimulated adaptations by individuals and institutions in a way that has reduced the sensitivity of inflation rates to monetary and fiscal policy. In the United States, both periods of accelerating inflation were followed by fiscal and monetary restraint, but in each case the increased unemployment and excess capacity failed to reduce inflation to levels that preceded the acceleration.<sup>4</sup> Unwinding the momentum of past inflation has become a central task of economic policy, and given the role of expectations in the momentum problem, incomes policy has been increasingly viewed as an instrument which might, absent excess demand pressures, contribute to a deceleration of prices and wages by altering inflationary expectations.

One peculiar feature of most experiments in incomes policy is the vague compliance incentives offered the individual economic agents whose behavior the policies seek to modify. Most policies have promised salutary macroeconomic developments to agents making microeconomic decisions. For example,

<sup>3</sup>The incomes policies of this period were not notably successful in securing that objective. See Lloyd Ulman and Robert J. Flanagan, *Wage Restraint: A Study of Incomes Policies in Western Europe*, (Berkeley: University of California Press, 1971).

<sup>4</sup>For evidence on this general point, see George L. Perry, "Slowing the Wage-Price Spiral: The Macroeconomic View," *Brookings Papers on Economic Activity*, 1978:2, pp. 259–291; and *Economic Report of the President*, January 1978, pp. 142–145.

compliance is said to make possible more rapid economic growth and hence more rapid real earnings growth than would a self-defeating battle over income shares. Such promises may have some appeal in economies where income determination is relatively centralized, but they are unlikely to be viewed as reliable inducements for compliance by individual economic agents in economies, such as the U.S., where wage and price determination is highly decentralized. With a relatively small sector of the economy unionized, most wage determinations occur at the company level. Even within the unionized sector, collective bargaining negotiations are relatively decentralized by European standards.

During the 1970's, several innovative proposals to provide microeconomic incentives for compliance with incomes policy guidelines were advanced.<sup>5</sup> The various proposals differ in ways that effect both the strength of the compliance incentives and the administrative costs associated with a given program result. In some plans, the size of the tax penalty or reward is roughly proportionate to the difference between actual pay increases and the pay guideline. Others simply require meeting the guideline or "threshold compliance." While providing an incentive for compliance with wage guidelines, the tax incentive plan (TIP) approach permits more flexibility in principle for relative wage adjustments than earlier versions of incomes policy, which required adherence to a single ceiling increase. On the other hand, significant questions have been raised concerning the effectiveness and administrative feasibility of earlier TIP proposals.<sup>6</sup> These have stimulated the development of the real wage insurance approach.

<sup>5</sup>See references in footnote 2.

<sup>6</sup>See particularly Albert Rees, "New Policies To Fight Inflation: Sources of Skepticism" and Larry L. Dildine and Emil M. Sunley, "Administrative Problems of Tax-Based Incomes Policies," in *Brookings Papers on Economic Activity*, 1978:2.

## II. The Pay Standard

The anti-inflation program announced in October 1978, stressed the complementarity of a demand management policy favoring slower growth (to prevent the development of excess demand pressures that would contribute to a further acceleration of inflation) and a set of voluntary pay and price standards (to unwind the momentum of inflation) in achieving a deceleration of inflation. Slower growth was viewed as essential to create a conducive market environment (i.e., free of excess demand pressures) for the operation of the standards.

Since the real wage insurance (RWI) proposal was tied to compliance with the 1978–79 pay standard, it is necessary to know the broad outlines of this standard in order to understand how RWI would have worked and what choices are available in designing an RWI plan. The 1978–79 pay standard limited the annual increase in hourly wages and private fringe benefit payments to a maximum of 7 percent for each employee unit in a company. Employee units subject to the pay standard were:

"(a) Each group of the company's employees subject to a particular collective bargaining agreement to which the company is a party. . . .

(b) All management employees (not under a collective bargaining agreement). . . .

(c) All other employees. . . ."

The use of employee units or groups in determining compliance with the pay standard was viewed as a method of securing a reduction in average pay increases while taking account of the different institutional arrangements for determining rates of pay

<sup>7</sup>*Federal Register*, December 28, 1978. The regulations also provide that "a company need not identify separately collective bargaining units accounting for less than 5 percent of its employees. However, if a collective bargaining unit is not separately identified, the workers must be included in the 'all other employees' category."

and permitting considerable flexibility in the determination of individual wage increases. Pay increases for individual workers could be distributed on the basis of merit, promotions, market conditions, etc. so long as the average increase for the employee unit met the standard. Similarly, unions were free to continue the common practice of negotiating agreements which provided equal absolute increases for workers earning different rates, so long as the overall agreement was in compliance.

Collective bargaining agreements negotiated while the standards program was in effect were in compliance if wage and fringe benefit increases averaged no more than 7 percent over the life of the contract, provided that the increase did not exceed 8 percent in any year of a multiyear agreement.<sup>8</sup> In determining compliance with the pay standard, contractual cost-of-living adjustment (COLA) provisions were evaluated on the assumption of a 6 percent rate of inflation over the life of the contract.

As in previous incomes policies in the United States and Europe, certain groups of workers were exempt from the 1978–79 pay standard. The most important of these are workers covered by collective bargaining contracts or (for nonunion employee units) by formal pay plans signed or in operation before the announcement of the anti-inflation program and low-wage workers (defined in the program as those earning less than \$4.00 per hour on October 1, 1978).<sup>9</sup>

## III. The Real Wage Insurance Proposal

Real wage insurance is predicated on the assumption that there are risks associated

<sup>8</sup>There were special regulations governing the evaluation of certain fringe benefit increases. See *Federal Register*, December 28, 1978.

<sup>9</sup>Other exemptions were available (1) where changes in work rules demonstrably improve productivity, (2) to preserve a close tandem relationship with another group and (3) in situations of a demonstrable acute labor shortage.

with compliance with an official pay limitation and that these risks are particularly important in countries such as the United States that have highly decentralized systems of wage and price determination. The fundamental risk faced by workers considering compliance with a pay standard is a loss of real earnings. The risk comes from several sources. First, in a decentralized system of pay determination, there is what might be termed a "first mover disadvantage." Workers complying with a pay guideline have no assurance that other workers will exercise similar restraint. The failure of others to comply will threaten first-movers with a relative real earnings loss. Second, even with widespread compliance, "exogenous" price increases in sectors which are not directly effected by the program, (e.g., agriculture, raw materials, and oil) may threaten the real earnings of those who exercise money wage restraint. Finally, there is a risk, supported by econometric estimates of the impact of incomes policies in several countries, that the incomes policy itself will be relatively ineffective in achieving price restraint because compliance with a wage guideline is easier to define and enforce.

A program of real wage insurance effectively established the Federal Government as a risk-bearing institution to which these risks of compliance with the pay standard can be shifted. As noted above, the fundamental risk associated with the exercise of money wage restraint by workers is the possibility of real earnings loss. The risk is shifted by providing tax rebates to those in compliance with the pay standard if the government fails to attain its price objectives. Thus, the risk of policy failure at the macro level is shifted from those who are asked to comply to the broader population that will benefit from reduced inflation.

Under the RWI approach, each member of

an employee unit that complies with the pay standard or guideline receives a tax credit if the consumer price index (CPI) increases by more than some specified threshold. Thus the tax rate faced by each individual who qualifies for RWI is given by

$$t = b - \alpha(\dot{p} - k) \quad \dot{p} > k \quad (1)$$

where

- $b$  = the base tax rate on labor income
- $\dot{p}$  = the actual rate of price increase
- $k$  = the threshold rate of price increase which triggers an RWI payment
- $\alpha$  = the rate at which workers are compensated for price increases that exceed the threshold.

The RWI tax credit rate,  $\alpha(\dot{p} - k)$ , is simply applied to annual earnings in order to determine the RWI payment.

In the January 1979 proposal of the Carter Administration  $k = 7$  percent and  $\alpha = 1$  for inflation rates up to 10 percent. That is, members of employee units that complied with the 7 percent pay limitation would receive a RWI tax credit if the CPI increases exceeded 7 percent over the year. However, the proposal did not provide catastrophic insurance; the rate of tax credit equaled the difference between the actual increase in the CPI and 7 percent up to a limit of 3 percentage points (10 percent inflation). Therefore,  $\alpha$  effectively declines as inflation exceeds 10 percent. Workers who qualified for RWI as members of complying employee groups would have received an RWI payment amounting to the common tax credit rate times their earnings up to \$20,000 per job. (The maximum RWI payment was therefore \$600 per job.)

While qualification for RWI depends upon group behavior, the actual RWI payout occurs on an individual basis. RWI payments would therefore vary with earnings among

members of a single employee unit. Moreover, RWI would be administered through individual tax returns, permitting more widespread application than some TIP proposals (discussed in more detail below) which would be administered through corporate tax returns.

The effect of a RWI program on inflation will be related to the fraction of the aggregate wage bill paid to employee groups whose pay increases would be above the payout threshold ( $k$ ) in the absence of the program but below the inflation cap (10% in the January 1979 proposal). Within this segment of the wage change distribution, the compliance incentive will be strongest for employee groups that expect price increases to exceed their pay increase. For those expecting a real earnings gain in the absence of the program, the compliance incentive would be much weaker since there are free-rider gains to be had from the compliance of employee groups with more pessimistic inflation expectations.

The size of the ultimate RWI tax expenditure is sensitive to the rate of compliance with the standards program, increases in the prices of products not subject to the standards program, productivity growth, and the payout threshold ( $k$ ). One interesting feature of the RWI approach is that, in the absence of a strong exogenous inflation, the potential budgetary costs are self-limiting with respect to pay standard compliance. With low compliance, the standards will be relatively ineffective, and inflation will be relatively high and likely to trigger an RWI payment. Relatively few people (mainly those whose pay increases would have satisfied the pay standard in the absence of the program) will qualify for a payment. (This is the adverse selection case in real wage insurance.) With high compliance, many will qualify, but the compliance itself will lower the probability of a payout. In years with small exogenous price increases and/or relatively rapid productivity

growth, the payout would be zero with high compliance rates.<sup>10</sup>

Even with high rates of compliance, substantial increases in the prices of food, energy and other commodities that are not directly influenced by the standards could trigger an RWI payout. In this instance, however, the existence of RWI should limit the efforts of workers to maintain real earnings through substantial increases in nominal wages. By maintaining real earnings via tax credits, RWI could reduce the likelihood that an exogenous inflationary shock would spread to the rest of the economy, as occurred during 1973 and 1974.<sup>11</sup>

The payout probability is also sensitive to the rate of growth of labor productivity. A program which seeks to prevent a real earnings loss to workers in compliance with a pay standard is least likely to result in a payout when productivity growth—which defines the general scope for real earnings gains—is high. Unusual short-run price increases may be "absorbed" in the productivity wedge between increases in compensation and the underlying rate of inflation. When productivity growth rates are low, this wedge is small, and the probability of an RWI payout rises.

In distinction to the preceding factors, the payout threshold,  $k$ , is a variable that, in principle, is subject to policy choice. In practice, however, there may be little scope for variation. In choosing a 7 percent threshold, the January 1979 legislative proposal adopted the highest value of  $k$  consistent with a

<sup>10</sup>For a discussion of the cost estimates for the recent Carter Administration proposal, see *Economic Report of the President*, January 1979, pp. 83-84 and the testimony of Charles L. Schultze in U.S., Congress, House of Ways and Means Committee, *Real Wage Insurance: Hearing on The President's Anti-Inflation Real Wage Insurance Tax Rebate*, 96th. Congress, 1st. session, 30 January 1979, pp. 96-97.

<sup>11</sup>For a discussion of this point see Charles L. Schultze, *ibid.*, pp. 97-98.

concept of *real* wage insurance. The proposal would have maintained the real earnings of members of employee units that barely complied with the pay standard, while those that exercised greater restraint would suffer some real earnings loss if inflation exceeded their rate of pay increase. This particular choice of  $k$ , in effect, assumes that the pay standard is both a ceiling and a floor for employee groups that would have received higher increases in the absence of the standards program. While these units may have an incentive to exercise sufficient restraint to meet the ceiling imposed by the pay standard, lowering  $k$  does not provide them with an incentive for *further* restraint. At any lower value of  $k$  the real earnings position consistent with compliance will be maximized by just meeting the standard. Since reductions in  $k$  are unlikely to induce significant additional compliance, the main result will be an increase in the payout probability.

In principle, policy-makers concerned with potential budgetary costs could introduce a "deductible" into the real wage insurance policy by choosing a  $k$  that exceeds the pay standard. Qualified workers would have to absorb a certain fixed amount of real earnings loss before collecting RWI. The deductible feature would make explicit the unavoidable real earnings decline faced by workers on average during periods of accelerating food and energy prices and slower productivity growth and would reduce the potential budgetary cost.

However, it will have complicated effects on the compliance incentives of the policy. Workers who would have received pay increases just over the standard still have an incentive to comply if they expect inflation to exceed their potential pay increase by more than the amount of deductible. The compliance incentive for union workers covered by collective bargaining agreements that provide for cost-of-living adjustments

(COLAs) should not be substantially weakened when COLA provisions are evaluated by assuming an inflation rate at or below the pay standard (as in 1979). But the deductible feature is unlikely to induce compliance by other employee groups who are able to protect their real earnings via large nominal wage gains.

An alternative approach to reducing the potential budgetary payout of RWI would be to reduce  $\alpha$ , the compensation parameter in equation (1). This option would require qualified workers to absorb or "coinsure" against some fraction of inflation in excess of the threshold. Compliance incentives are presumably lowered, although by an unknown amount. For example, if  $\alpha = .7$  the RWI tax credit would provide at least as much real earnings protection as the average union COLA arrangement. This coinsurance rate is also larger than the adjustment of nonunion wages to inflation that has been measured in econometric analyses of nonunion wage behavior.<sup>12</sup>

The final approach to limiting potential RWI payout is to set an aggregate annual budgetary cap of \$X billion. This would improve the Congressional prospects for RWI, since legislators find proposals with uncertain but possibly large revenue cost implications very resistable, particularly in years of balanced budget enthusiasms. Unfortunately, the budget cap approach is likely to be very damaging to compliance incentives. The basic problem is that workers would not know the rate of RWI tax credit at a time when it could influence their pay behavior. With an absolute budget limit, the credit rate could not be announced until the rate of inflation and the rate of compliance with the pay standard were known, but neither could be ascertained until near the end of the

<sup>12</sup>See Robert J. Flanagan, "Wage Interdependence in Unionized Labor Markets," *Brookings Papers on Economic Activity*, 1976:3.

program year. In effect, this alternative amounts to a "coinsurance" variant on RWI with an unknown rate of coinsurance that declines as the inflation rate rises.

#### IV. RWI vs. TIP

The real wage insurance concept differs in several important respects from earlier TIP proposals, which generally impose a tax penalty or reward on firms or workers that comply with a wage guideline. In many of the earlier proposals the size of the tax incentive varies with the difference between the guideline and actual pay increases.

Following the notation used in equation (1), the tax rate faced by the  $i$ th firm or individual under a reward TIP would be

$$t_i = b - \alpha(g - \dot{w}_i) \quad \alpha > 0 \quad (2)$$

In this instance,  $g$  represents the wage guideline or standard,  $\dot{w}_i$  is the percentage change in wages for employee group  $i$ , and  $\alpha$  is the incentive parameter, which is subject to policy choice. Similarly, the tax rate faced by the  $i$ th firm or employee group under a penalty TIP would be given by

$$t_i = b + \alpha(\dot{w}_i - g) \quad \alpha > 0 \quad (3)$$

From this sketch of alternative approaches to inducing compliance with a wage guideline, it is clear that there are several significant differences between RWI and earlier TIP proposals. There is a very basic difference in the way the alternatives operate. RWI reduces the risks associated with compliance but otherwise offers no direct compliance incentive. The TIP approach provides direct compliance incentives in an effort to "internalize the externality" of inflationary wage behavior. But the TIP approach does not remove the basic risk of real earnings loss associated with compliance. In fact, a penalty

TIP applied to firms granting wage increases that exceed a guideline may add to inflationary pressure if the penalty is passed through into prices.<sup>13</sup> On the other hand, the structure of the RWI incentive encourages only threshold compliance with a wage guideline by those who could have received larger pay increases, while TIP provided incentives for more extensive wage restraint. Conceptually, the TIP approach might achieve a greater deceleration in wages and the underlying rate of inflation than RWI. But a TIP does not offer reliable real earnings protection and may be a relatively ineffective compliance incentive when workers expect a significant exogenous inflation (e.g., from food and energy prices).

RWI and TIP also differ in both the complexity of their impact on tax rates and in their cost implications. Under RWI there is a single rate of tax credit (given by  $\alpha(\dot{p} - k)$  for all who qualify. Under TIP proposals, the tax credit rate varies with the extent of compliance (see equations (2) and (3)), which may be defined with respect to the individual, employee unit, or firm. Whichever level of aggregation is chosen, the large number and variation of tax rates that result will increase the administrative complexity of the TIP approach relative to RWI. RWI has a further advantage relative to TIP proposals in which the incentives would be administered through corporate taxes. The use of individual tax

<sup>13</sup>This risk might be reduced if there were tax incentives for compliance with a price standard. However, the administrative problems associated with defining and monitoring price changes have discouraged proponents of both TIP and RWI from extending these policies to prices. For some discussion of the difficulties, see Dildine and Sunley, *op. cit.*, pp. 378-384. Just one difficulty present in the first year of the Carter Administration policy was the fact that there were alternative price standards with a lengthy list of exceptions in contrast to the single-valued wage standard. Also, Okun notes that "... statistical evidence from the past demonstrates that a slowdown of wages slows down prices commensurately but suggests that a price slowdown is not translated fully into a wage slowdown." Statement by Arthur Okun in *Real Wage Insurance*, *op. cit.*, p. 334.

returns greatly extends the potential scope of the policy beyond the corporate sector (e.g., to workers in the nonprofit and public sectors).

In considering potential budget costs, it is easiest to compare RWI with a reward-TIP. In general, increases in compliance will raise the tax expenditures associated with a reward-TIP and lower the tax expenditure associated with RWI, assuming that wage restraint is passed through into prices. (As noted above, the RWI tax expenditure could be zero with a high rate of compliance.) With significant inflation from exogenous factors, however, the ranking could be reversed, since only the RWI payout would be directly influenced.

RWI (as well as TIPs directed at individuals) has an important advantage over a TIP directed at business firms in terms of its implications for the climate of industrial relations during a period of incomes policy. The latter approach seeks to achieve compliance via employer resistance to wage claims that exceed the pay guideline. In collective bargaining situations, increased employer resistance is likely to attain wage restraint at the expense of increased strike activity.<sup>14</sup> Approaches, such as RWI, which offer protection against the very risks which may in part account for strike pressures may be able to achieve the desired compliance with less disruption to the economy.

Perhaps one should note, in contrasting alternative approaches, that RWI is not a proposal to index the General Revenue Code in such a manner that the connection between inflation and tax revenues would be reduced or eliminated. RWI is contingent upon compliance with a specific wage guideline whereas general indexation proposals insulate individuals from the effects of inflation but contain no mechanism to reduce inflation.

<sup>14</sup>For a discussion of this point, see Rees, *op. cit.*, pp. 464-467.

### V. Design and Administrative Issues in the Recent Legislative Proposal

Once the basic principle and outlines of an RWI program have been stated, there are several issues of design which influence the ultimate equity, strength of the compliance incentives, potential budgetary cost, and administrative complexity of the program. This section discusses some of the major design issues faced in the development of the January 1979 legislative proposal.

The basic administrative arrangements in the RWI proposal were straightforward. At the end of the year employers would report the RWI credit in a special place on the W-2 form of each member of an employee unit in compliance with the pay standard. Since the RWI credit is intended to supplement wages for those groups foregoing wage increases above 7 percent, the tax credit is treated as an additional wage payment which is subject to the federal income tax (but not subject to FICA or FUTA taxes). Therefore, the employer would also add the credit to the other amounts reported as wages on the W-2 form. One additional line on the federal income tax return would be required for the amount of the RWI credit, which would either increase the taxpayer's refund or reduce taxes owed.<sup>15</sup>

Employers would have the responsibility for dividing their employees into groups and determining whether each group qualifies. Computations of pay rate increases would not

<sup>15</sup>One group that could make out rather well under this particular administrative arrangement is multiple job holders. Since a worker with several jobs might not always be the member of a complying employee unit, only earnings from jobs with qualified units would be applied to the tax credit. The more difficult question concerns the treatment of multiple job holders whose qualified earnings exceed \$20,000 in total, although not on any one job. Despite the possible incentive for turnover, considerations of administrative simplicity favored equal treatment for each W-2 form received by an individual and an earnings limit of \$20,000 per qualified job.

be reported, but would be subject to verification by the Internal Revenue Service (IRS). The rules for grouping and qualification under the RWI proposal generally followed the standards and regulations administered by the Council on Wage and Price Stability. In a few respects, however, the rules for RWI were simplified in order to reduce the calculations and records required of employers and to facilitate IRS verification. Qualification for RWI would be determined at the close of the program year for all employee units with the exception of workers covered by collective bargaining agreements. Agreements of more than 15 months duration negotiated during the program year would be evaluated at the time of settlement so that the parties covered by the agreement would be assured in advance of RWI coverage. In the event of an IRS audit of a collective bargaining agreement, COWPS would determine whether the contract was in compliance.

The ex ante evaluation of collective bargaining agreements but ex post evaluation of pay increases for all other groups offers the potential for more favorable treatment of union over nonunion workers in the program. With an ex post evaluation, promotions and any other elements of "wage drift" will be counted against nonunion compliance with the 7 percent pay limitation. With ex ante evaluation, the wage drift factors are not counted against the pay standard, and may even be encouraged, as they have been in many European countries during periods of incomes policy. The treatment of COLA arrangements also favors union workers. For compliance purposes, collective bargaining agreements with COLAs are evaluated assuming a 6 percent rate of inflation. If inflation rises over 7 percent workers could collect COLA payments and RWI. This "double dip" results largely from considerations of administrative (computational) convenience, although it also provides stronger

incentives for union compliance. (Alternative approaches to COLA situations are covered in the discussion of the treatment of exempt groups.)

As noted earlier, virtually all guideline-based incomes policies have exempted certain groups from compliance. Therefore, the treatment of workers who are explicitly exempted from compliance with the pay standard (low-wage workers and those covered by pre-existing collective bargaining agreements) must be addressed in the design of RWI. Since, by definition, there is no compliance issue for these groups (and, in any event, their increases are largely mandated by legislation or collective bargaining contracts), the treatment of the exempt groups mainly raises a conflict between the potential budgetary payout and notions of equitable treatment under RWI.

On the grounds of general equity, it seems desirable that the criterion by which groups exempted from the wage standard qualify for RWI be applied consistently across all exempted groups. Nevertheless, there are at least four major options reflecting variations in the rules governing qualification for a payout of RWI. (1) Groups which are exempt from the pay standard do not qualify for RWI. (2) All workers exempted from the pay standard qualify for RWI, which will be paid if the CPI increase exceeds 7 percent. (3) All exempted workers qualify for RWI, but insurance will be paid if the rate of CPI increase exceeds (a) 7 percent, or (b) the actual pay increase of the exempt group, whichever is higher. In the case of option (3b) payment would be based on the difference between the CPI increase and the actual pay increase. (4) Exempt employee groups qualify for RWI only if their 1979 pay increases happen to be less than 7 percent.

The argument for the first option is that no compliance can be induced from employee groups that are exempt from the pay stan-

dard. In the case of low-wage workers and employees covered by existing collective bargaining increases, there is little scope for choice over whether or not to exercise the exemption: Pay increases for the former groups would be dominated by government-mandated minimum wage increase of 9.4 percent on January 1, 1979, and the latter groups would have to break and renegotiate the terms of earlier labor agreements. On the other hand, if disqualified, the very groups which had been offered preferential treatment in the nominal wage standards would suffer a relative real earnings disadvantage as a result of the overall program (including RWI). From the budgetary perspective, however, this option is obviously the cheapest.

By qualifying all exempt workers and using the 7 percent inflation threshold for payment of RWI, the second option moves to the opposite extreme and becomes the most expensive option for the treatment of exempt employee groups. It also guarantees real earnings gains for those exempt workers whose nominal wage increases exceeded 7 percent whereas the program merely maintains the real earnings position of nonexempt groups who comply with the pay standard from erosion of inflation in excess of 7 percent.

The third option would be more neutral in its real earnings implications for exempt and nonexempt workers. Exempt workers receiving pay increases under 7 percent (mainly workers receiving deferred increases from collective bargaining contracts that do not have COLA provisions) would receive RWI for CPI increases over 7 percent. But workers receiving increases in excess of 7 percent (most low-wage employees and workers receiving deferred increases from labor agreements that included COLAs) would receive RWI for the excess of the CPI increase over the actual pay increases. This option results in

a more limited budgetary payout than option (2), and does not guarantee real wage increases to any employee groups. Moreover, the payout principle could be applied to nonexempt workers covered by new collective bargaining agreements containing COLAs. (Given the evaluation of COLAs under the pay standard, such contracts can be in compliance and still yield increases in excess of the standard when inflation exceeds 7 percent.) Thus option (3) treats both exempt and nonexempt groups similarly for purposes of RWI payout, although the qualification rule differs.

Option (4) provides similar payout treatment, but also similar eligibility rules for nonexempt and exempt workers. Because relatively few exempt employee groups were likely to receive pay increases under 7 percent during 1979, this approach would also have a relatively low cost if RWI payments were triggered, although with inflation rates significantly above 7 percent, some exempt employee groups would suffer real earnings losses, as in Option (1). In fact, this option was adopted in the RWI legislative proposal, although the choice was dominated more by administrative simplicity afforded by identical qualification rules than by considerations of equity.

## VI Concluding Comments

Real wage insurance is a novel approach to introducing microeconomic compliance incentives into incomes policy. In many respects, the incentives offered economic agents for at least threshold compliance appear to be stronger than in earlier TIP proposals. This is largely because of the protection offered against exogenous inflation (an important source of compliance risk in the 1970's) and the possibility that one group's

compliance will not be matched by others. But the protection that strengthens the compliance incentive may be a political liability in a legislative climate in which the size of the tax expenditure is of more concern than

the extent of compliance. Certainly this appeared to be the case in 1979 when legislative progress on the RWI proposal essentially halted with the arrival of the inflation statistics in the early months of the year.