

## **Competitiveness and unit labor cost**

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A measure of international competitiveness of the manufacturing sector focuses on the differences in unit labor costs (ULC) among countries. ULC is defined as the cost of a worker's compensation per unit of output produced. In other words, ULC is the ratio of workers' compensation to labor productivity. Lower ULC means that one country's manufacturing sector is more competitive than another country's manufacturing sector. Alternatively, the slower the rise of ULC or the faster the decline of ULC, the more competitive is the manufacturing sector.

There are three ways to keep ULC lower. One is to keep wages low -- the so-called low road. Firms on the low road seek competitiveness through low labor cost. Wages are kept low, benefits to a minimum, and little training and opportunity for advancement are provided to the workers. These firms use cost-minimizing measures such as employing casual workers who receive lower wages and fewer benefits. Some firms resort to labor-only subcontracting despite prohibitions imposed by labor laws. Firms on the low road are found in lower value-added production and they compete on price.

Another option to keep ULC lower is to increase productivity or the so-called high road. Firms on the high road are found in higher-value added production and compete more on quality rather than on price. These firms invest more in new machineries that enhance workers' productivity. They seek competitiveness based on efficiency enhancement and innovation. Firms on the high road also focus on human resource development, investing in workers' training and skills enhancement to increase productivity.

The third option is for the peso to depreciate, making Philippine exports more competitive in the world market. However, this option depends on the macroeconomic fundamentals and policies of a country and is beyond the control of firms. Moreover, this option is highly improbable as the Philippines adopts a fairly flexible exchange rate regime and the government only intervenes in the currency market to moderate large swings of the peso.

How do wages, labor productivity, and unit labor cost move in the last two decades? From 1980 to 1997, wage rates increased around 6.1% on the average, labor productivity improved by 8.9%, and unit labor costs slightly rose to 0.2%. During the last 6 years of Marcos administration (1980-85), wage

rates grew more slowly than labor productivity, at a ratio of one is to four. Unit labor cost in this period increased by 7.8%. Real wage deteriorated in this period as nominal wage grew by mere 2.5% while inflation rate averaged 21%. This partly explains the pressure for successive wage increases during the Aquino administration.

During the Aquino administration (1986-91), wage rate and labor productivity grew at a similar pace at around 7%. Unit labor cost increased moderately at 3%. Inflation was contained at 9.8%. But looking at the sub-period from 1987 to 1989, wages grew 14% annually while labor productivity grew by only 3%. Interestingly, one study notes that after 1989, China overtook the Philippines in terms of lower relative unit labor cost.

During Ramos administration (1992-97), wage rate and labor productivity grew at a similar pace at around 8%. Inflation was reined in at 8.1%. Only during the Ramos period did the Philippines experience a significantly falling unit labor cost at 10.4%.

Declining unit labor cost in recent years has been attributed more to declining labor compensation rather than increase in labor productivity. In other words, competitiveness is enhanced by keeping wages low rather than increasing labor productivity. It seems that Philippine firms, in general, take the low road of flexible production. This is not sustainable in the long-run as workers would eventually clamor for higher wages to compensate for higher inflation and the erosion of their purchasing power. In addition, the Philippines will find it difficult to compete against low-cost countries such as China and Vietnam. Labor cost per worker in the Philippines is 3.3 times more expensive than in China. The Philippines minimum wage is five times higher than that of Vietnam.

The Philippine manufacturing sector has to take the high road to flexible production. Industrial upgrading through increase labor and capital productivity is the road for firms to survive. Capital productivity can be enhanced through increased spending in innovation and research and development. Labor productivity can be improved through workers' training and education. Lastly, government policies must be crafted to help firms move up the value chain.

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