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Wage-led Growth

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This report is based on Stockhammer and Onaran (2013) and Lavoie and Stockhammer (2013).

ABSTRACT

Wage-led growth is an equitable strategy for recovery that realises that wage growth can support demand via consumption expenditures and it can also induce higher productivity growth. The Research Essay provides an overview of the concept of wage-led growth, both as an analytical concept and as an economic policy strategy. It distinguishes between wage-led and profit-led demand regimes and argues that the available evidence indicates that demand in most economies is domestically wage-led. Changes in functional income distribution also have supply-side effects. Available evidence suggests that higher wage growth induces higher productivity growth. Neoliberalism resulted in an increase in inequality and a decline in the wage share, but growth has nowhere been based on the profit-led growth process. Rather, neoliberalism has given rise to either debt-led or export-led growth regimes, both of which are unstable. This Research Essay concludes by outlining a wage-led growth strategy.

INTRODUCTION

Growth in advanced economies has not fully recovered since the Great Recession that began in 2008. An increasing number of authors have highlighted that rising inequality and a redistribution from labour to capital have had profound macroeconomic effects that form part of the story (Rajan 2010, Onaran, 2011, Palley 2012, Stiglitz 2012, Stockhammer 2015, van Treeck and Sturn 2012). An important policy implication that emerges from this literature is that in addition to financial reform, there needs to be a change in distributional policy and wage policy if a viable growth regime is to be established.

This essay clarifies the concept of wage-led growth that has been put forward in the book *Wage-led Growth: An Equitable Strategy of Economic Recovery* (Lavoie and Stockhammer 2013), which offers both an analytical framework and an economic policy strategy and was based on the recent project New Perspectives on Economic Growth, commissioned by the ILO.

The Keynesian tradition in macroeconomics has long asserted that a higher wage share can have expansionary effects. For most households wages are the main source of income. Higher wages thus directly feed into higher consumption expenditures. Moreover, the poor tend to spend a higher share of their income than the rich. Higher inequality can thus be bad for demand and growth. This argument that highlights wages as a source of demand is at odds with standard (or mainstream) economics, which regards wages primarily as a cost factor: higher wages is bad news for firms and they are likely to invest less as a result. However, already in the 1930s, Keynes had pointed out a fallacy of composition in this argument: While each firm might want to pay their own workers lower wages, it is not clear whether they want wages in general to fall, because that may negatively affect the demand for their output. In short, wages are both a source of demand and a cost factor.

SEVERAL POLICY AREAS THAT MIGHT NOT APPEAR DIRECTLY RELATED TO SOCIAL POLICY CAN HAVE STRONG REPERCUSSIONS ON INCOME DISTRIBUTION

WHY HAS THE WAGE SHARE DECLINED?

Since the early 1980s dramatic changes in income distribution have occurred. There has been a substantial decline in wage shares across the world (IMF 2007, ILO 2011, Stockhammer 2013). This has been part of broader changes in income distribution that also include an increase in personal income inequality, in particular in the Anglo-Saxon countries (Atkinson et al. 2011; OECD 2008). While mainstream (neoclassical) economics typically highlights technological changes as the main determinant of income distribution, recent literature highlights that globalization has had negative effects on the wage share in advanced economies (IMF 2007, EC 2007). Stockhammer (2013) offers a panel analysis of the determinants of the wage share for 71 countries from 1970 to 2007 that takes into account changes in technology, globalization (in production and trade), financialisation and welfare state retrenchment and finds, first, that globalization has had negative effects. Interestingly, globalization has *not* benefited workers in developing economies. Second, financialisation has had a strong negative impact on the wage share in all countries. Third, welfare state retrenchment has negative effects on the wage share. For advanced economies, where better data is available, Stockhammer (2013) finds that the decline in the organizational strength of labour unions has had a negative effect. Fourth, while there is some evidence for the effects of technological change, it is clearly not the main driver of changes in income distribution.

These results highlight that governments can indeed influence income distribution, but several policy areas that might not appear directly related to social policy can have strong repercussions on income distribution. In particular financial regulation and the management of international capital flows seem to have strong effects, as does trade policy. With regard to labour and social policies, the results suggest that strengthening collective bargaining and the right of labour unions are ways to modify income distribution.

WHAT ARE THE DEMAND EFFECTS OF CHANGES IN WAGES?

In a seminal paper, Bhaduri and Marglin (1990) integrated the dual role of wages as both a source of demand and a cost in production in a macroeconomic model. The total effect of an increase in the wage share on aggregate demand depends on the relative size of the reactions of consumption, investment and net exports to changes in income distribution. Typically, there is a positive effect of the wage share on consumption, a negative effect on investment and a negative net export effect. The precise magnitude of these effects depends on the institutional setting in each country and on the degree of openness of the economy. If the total effect is negative, the demand regime is called wage-led; otherwise the regime is profit-led.

Exports and imports depend on relative prices, which in turn are functions of unit labour costs for a given import price. The effect of changes in the profit share on GDP via the international trade channel depends also on the degree of openness of the economy in addition to the elasticity of exports and imports to prices. Thus, in relatively small open economies, net exports may play a major role in determining the overall outcome; the effect of changes in distribution on GDP via the changes in net exports becomes much less important in relatively closed large economies.

The model has motivated a substantial literature that tries to identify these effects empirically. One striking common finding emerges: most studies conclude that *domestic* demand is wage-led, i.e. the effect of a pro-capital redistribution of income on the sum of private consumption and private investment is negative because consumption is much more sensitive to an increase in the profit share than is investment. Thus demand is profit-led only when the effect of distribution on net exports is high enough to offset the effects on domestic demand, and this is likely only in small open economies. In most of the large economies such as the US, Japan, the Euro area in aggregate as well as individual large European countries – Germany, France, Italy – the effects due to net exports are not large enough to change the nature of the demand regime to profit-led, since foreign trade forms only a small part of aggregate demand. Onaran and Galanis (2012) estimate the demand regimes for the G20 countries and find that all major advanced economies have wage-led demand regimes. Canada and Australia stand out as two profit-led countries among the nine developed members of the G20 group. This is not surprising given that these countries are relatively small and thus economically open.

It is important here to distinguish between the domestic demand regime (the effects of changes in distribution on investment and savings) and the open economy effect (the effect on net exports). Small open economies tend to have large net export effects. However, the world economy overall is a closed system, thus the net export effects offset each other. This is particularly relevant for the Euro area, which consists of many small open economies, but overall is a relatively closed, large economy. Onaran and Galanis (2012) and Stockhammer et al. (2009) show that the Euro area has a wage-led demand regime, but some of its member states (e.g. Austria or the Netherlands) have profit-led regimes. In other words, individual EU states can grow by means of wage restraint, but in the Euro area overall such a policy would have negative effects. When wages decrease simultaneously in all Euro area countries, the net export position of each country changes little because extra-Euro area trade is comparatively small. Thus, when all Euro area countries pursue "beggar thy neighbor" policies, the international competitiveness effects are only minor, and the negative domestic effects dominate the outcome.

Onaran and Galanis (2012) estimate the effects of simultaneous changes in the profit share in several countries and they simulate the effects of a simultaneous pro-capital redistribution of income, i.e. a 1 percentage-point increase in the profit share. Their results show that a simultaneous decline in the wage share in these 16 countries leads to a decline in global growth. They find that a percentage-point simultaneous decline in the wage share in the G20 leads to decline in global GDP by 0.36 percentage-points. Finally they simulate the effects of an alternative scenario of a simultaneous wage-led recovery in the G20: if all wage-led countries (Euro area, UK, US, Japan, Turkey, and Korea) return to their previous peak wage-share levels (e.g. as in the late 1970s) global GDP would increase by 3.05 per cent. To be quite clear: these effects are not huge. Wage policy alone is not sufficient to get us out of stagnation. However, wage growth can have positive demand effects; wage restraint is unhelpful.

WHAT ARE THE SUPPLY-SIDE EFFECTS OF WAGE GROWTH?

On the supply side, the key question is how changes in the wage share or in real wages affect productivity growth (or more broadly speaking, technological progress). Mainstream economists typically argue that competitive markets are most conducive to growth and, in the next step, argue for labour market (and product market) deregulation. Heterodox economists highlight that labour market institutions can not only have positive social effects in helping to overcome market failures, but they may also have positive effects on economic growth because good labour relations will improve the propensity of workers to contribute to the production process. High wages may also force capitalists to rationalize and thus speed up technological progress. Thus economic historians have pointed out the positive effects of wages in the industrialization process. Allen (2009) argues that the industrial revolution took place in England because of its comparatively high wages.

Storm and Naastepad (2012) survey recent econometric studies and conclude that a reasonable order of magnitude is that a one percentage point increase in real wage growth leads to a 0.38 percentage point increase in labour productivity growth. Higher real wage growth induces firms to increase labour productivity in order to protect their profitability. Hence, the available evidence suggests that real wage growth has a positive long-run effect on labour productivity growth. This is important for economic policy, as it suggests that excessive wage constraint is likely to lead to weak productivity performance while a wage-led growth strategy is consistent with positive developments on the supply side.

NEOLIBERALISM IN A WAGE-LED ECONOMY: DEBT-DRIVEN GROWTH AND EXPORT-DRIVEN GROWTH

In the framework sketched out above, how do we explain the actual growth performance of the last few decades? Under neoliberalism, there has been a massive redistribution of income and, in particular in the Anglo-Saxon countries, a period of growth, followed by a financial crisis. If economies were wage-led, the pro-capital redistribution ought to have dampened growth. I think that this is indeed what has happened.

So how could neoliberalism have led to growth at all? Neoliberalism is a policy package that encompasses an attack on organized labour, a deregulation of the financial sector and privatization of public services (Glyn 2006, Harvey 2003). In my view it is the deregulation of the financial sector that generated boom-bust cycles rather than generating a sustainable growth pattern based on the profits-investment nexus of a profit-led demand regime; two unsustainable growth patterns, one based on debt growth and another one based on export surpluses, have emerged (Stockhammer 2012b, Stockhammer and Wildauer 2015).

In a wage-led demand regime, higher aggregate demand is possible if either the wage share rises or if some of the other exogenous factors change accordingly. Two of these processes have been particularly important in practice. First, there is a group of countries where household debt has been rising and has financed a consumption boom. This process is inherently unstable. While it may be difficult to assess what level of debt is unsustainable, continuous increases in debt-to-income ratios clearly are. The actual relation between the debt ratio and aggregate demand is a complex one, as the link is mediated by rising asset prices or property prices and by credit creation mechanisms. The details of these vary country by country, with property bubbles playing a prominent role in the 1990s and 2000s in the advanced countries. In many cases, credit expansion was financed by capital inflows. Once the credit expansion stops, the growth model is in crisis. As credit expansion typically relies on some form of a financial bubble, one would expect the link between the debt ratio and aggregate expenditures, mediated by asset prices and credit creation, to be highly non-linear.

THERE IS A GROUP OF COUNTRIES WHERE HOUSEHOLD DEBT HAS BEEN RISING AND HAS FINANCED A CONSUMPTION BOOM. THIS PROCESS IS INHERENTLY UNSTABLE

A second unstable growth mechanism has been rising export surpluses. A group of countries has relied on rising net exports as a stimulus for economic growth. While such an export-driven growth model seems intuitively unsustainable as it relies on ever growing external demand stimulation, the mechanism that generates the crisis is less straightforward. Since the export-driven country is accumulating foreign assets, it is not likely to be the victim of currency crises. Rather the instability is likely to occur in the countries with current account deficits. In some senses, the export-driven regime externalizes the crisis. In particular, if the export-driven country is wage-led, as in the case of Germany, growth along with suppression requires ever stronger export stimulus based on increasing deficits and fragility in those countries which grow via debt-driven consumption.

Hein and Mundt (2012) classify growth regimes empirically based on a decomposition of the contributions of aggregate demand growth for the period 2000-08. They distinguish between debt-driven consumption boom (the Anglo-Saxon countries) and strongly export-driven mercantilist regimes (Germany, China, Japan, Korea) as the extreme cases, and propose domestic demand-led regimes (France and Italy) as intermediate cases. Domestic demand-led regimes were characterized by negative growth contributions of net exports, but these countries did not experience a debt-fuelled consumption boom despite, in some cases, increasing levels of household debt. Stockhammer (2012b) offers a simpler classification and Stockhammer and Wildauer (2015) offer an econometric investigation of debt-driven growth.

A WAGE-LED GROWTH STRATEGY

A wage-led growth strategy aims at establishing a full-employment growth model in which sustained wage growth drives demand growth via consumption growth and via the accelerator effects of investment growth as well as productivity growth via labour-saving induced technological change. A wage-led growth strategy will result in stable or rising wage shares. How can changes in income distribution be achieved? The starting point for pro-labour distributional policies are minimum wage policies in combination with legislation that strengthens the status of labour unions and collective bargaining institutions. While the motivation for strengthening unions and minimum wage policies here is a macroeconomic one, it would be naïve to assume that they are likely to be implemented for macroeconomic purposes. If such policies are implemented, it is more likely that they are motivated by distributional goals of the labour movement. For example, for the European Union, a system of European minimum wages has been suggested as a strategy for labour unions to pursue and campaign around (Schulten and Watt 2007).

A wage-led growth strategy includes measures to restrict financial speculation, encourage a more long-term view in corporate governance (such as strengthening the role of stakeholders) and reining in excessive pay in the financial sector; these are complementary with the distribution goals of such a strategy. A restructuring of the financial sector is needed to prevent or reduce the frequency and severity of financial crises. Such measures are likely to include restrictions on bank bonuses, financial transaction taxes, pro-cyclical credit management, regulation of the shadow banking industry, closure of secrecy jurisdictions (tax havens) as well as the establishment of a sizable not-for profit segment within the banking industry. There could also be a strengthening of stakeholders within corporate governance that will also lead to an enhancement of labour's bargaining power and the wage share.

How much can a wage-led growth strategy contribute to economic recovery? The results of Onaran and Galanis (2012) indicate that the effects are substantial, particularly if implemented simultaneously at the global level, but certainly too small in magnitude to be sufficient as stabilization policy in the medium term. The wage-led growth strategy is a medium-term one that ensures that over longer periods consumption expenditures can grow without rising debt levels. However, fiscal and monetary policy is required to restore full employment alongside such a strategy.

Finally, a wage-led growth strategy is open to the ecological criticism that it neglects ecological limits to growth and aims at restoring full employment via more growth. To make wage-led growth strategy consistent with ecological constraints it will have to be complemented by a reduction in working time and a shift in taxation towards non-renewable resources and pollution rather than value added.

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