

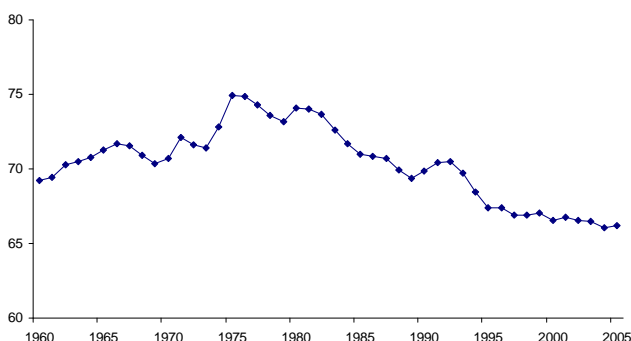
Explaining Labor's Declining Share of National Income

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Until recently, there has been a general acceptance among economists of Nicholas Kaldor's 'stylized fact' that distributive shares were broadly constant¹. Even the rise in labor's share in the 1960s and 1970s in many OECD countries – notorious as the 'profits squeeze' – was often written off as just a temporary blip resulting from oil and other 'shocks'.

Suddenly, however, labor's share has re-entered current policy discussion with a vengeance. Ben Bernanke, Chairman of the US Federal Reserve, last summer expressed the hope that 'corporations would use some of those profit margins to meet demands from workers for higher wages' (*New York Times*, 20 July 2006). More recently, Germany's finance minister called on European companies to 'give workers a fairer share of their soaring profits' or risk igniting a 'crisis in legitimacy' in the continent's economic model (*Financial Times*, 28 February 2007). When the economic leadership in the OECD countries calls for redistribution from capital to labor, something must be afoot.

Figure 1 Labour's Share - average of 17 OECD countries 1960-2005
(employee compensation adjusted for self-employment as % of GDP)



Source: author's calculations from OECD Economic Outlook Database

Figure 1 shows that since around 1980, there has indeed been a rather steady slide in labor's

share of GDP in the average OECD country. There is no shortage of candidates to explain the decline in labor's fortune – mass unemployment throughout much of Europe, a weakening of the organizational strength of unions, technical progress reducing the demand for unskilled labor and the impact of globalization. Until very recently, there have been few attempts to disentangle the impact of these factors, so the authors of the IMF's April 2007 *World Economic Outlook* chapter on 'The Globalisation of Labor' are to be commended for tackling this important question.

The chapter begins with a striking measure of the 'Global Labor Supply'. By weighting the working age population in each country by that country's export share of GDP, the IMF shows a quadrupling since 1980 of the number of workers competing in the global market. By simply adding the labor forces of China, India, former USSR and other countries newly integrated into the world market, Richard Freeman, from Harvard, had earlier suggested a doubling of the global labor force. However measured, this unprecedented expansion is far from completed as the continued absorption of workers into the 'modern' capitalist sector of the economy shows, above all in China.

Increasing opportunities for capital to shift production overseas has given a huge bargaining advantage to employers in most of the OECD manufacturing sector and in business services. Foreign direct investment (FDI) from North to the whole of the South is still tiny, only about 4% of Northern investment at home. However, companies can also outsource from Chinese or other Southern suppliers. Moreover, even where production has not yet shifted to lower wage countries, the employers have an increasingly credible threat to do so. Wages are so low in China that even if they grow 6% per year faster

than in the USA in dollar terms over the next two decades, they would still only be *one tenth* of the US level. As infrastructure improves, skill levels in the labor force rise, and competition from Southern producers heats up, the relative attractions for many more Northern companies of investing there could become irresistible.

Disentangling the various factors impacting on labor's share is very tricky and criticizing details of the IMF's attempt to estimate the relative contributions of globalization and technological changes would be tedious. However, there is one aspect of their chapter which cannot go unchallenged.

The IMF's econometric study suggests that labor's share has fallen more in countries where the levels of taxation on labor have risen more (fallen less), or where unemployment benefits have risen more (fallen less). This is a startling result. The IMF, along with the OECD, has been in the forefront of arguing that reducing benefits and taxation is the route to reducing unemployment. Now, they are arguing that cutting the welfare state will also prevent falls in labor's share – it sounds like a classic case of 'having your cake and eating it.'

For such a result to occur requires two things to happen. First of all, the cuts would have to reduce unemployment and increase employment. The econometric results which claimed to identify such effects across OECD countries have recently come under close scrutiny and the OECD is now more cautious in its claims. But even if some employment effects are granted, as labor supply is increased and wages reduced by the cuts, could this really also raise labor's share? Technically this is not impossible – if the impact of a small cut in wages is a very large employment response, then labor's share would rise. However the econometric evidence is quite overwhelmingly in the opposite direction (an elasticity of substitution between labor and capital of around one half is the consensus estimate). In this case, even if there was some employment response, it would be too weak to prevent labor's share from falling.

The IMF emphasizes that the USA and UK, leading deregulators, have witnessed a smaller decline in labor's share than most European

economies. However, there are two much more plausible explanations than greater deregulation to account for this. Firstly, the currencies of both countries have been grossly overvalued. This puts very heavy pressure on the profitability of traded good sectors, helping labor to maintain its share. Secondly, both countries have witnessed an extraordinary rise in the share of the very top 'wage-earners' (CEOs and the like) in total labor compensation. This is really part of profit incomes masquerading as wages; if excluded, labor's share in the UK and USA would show a much greater fall.

The downward trend in labor's share has significant and worrying implications for welfare and for macroeconomic functioning. However, the proposition that labor market deregulation, a feature of the period when labor's share has indeed been falling, is precisely the way to stop further declines, would have amazed the classical economists. Much more convincing policies and strategies are required to meet this challenge.

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ⁱ The 'functional' distribution of national income between wages, profits and rents was a major preoccupation of the classical economists, being described by David Ricardo as 'the principal problem in Political Economy'. Karl Marx believed that the ratio between surplus value and wages (the rate of exploitation) had a fundamental tendency to rise in capitalism, as the reserve army of the unemployed held down any growth of real wages below the growth rate of labor productivity.