

Global output growth: wage-led rather than profit-led?

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Abstract

Contrary to 'conventional wisdom' globalization seems to have been associated with slowdown of global output growth and falling share of capital formation (investment) in global output. Referring to the theory of 'demand-led growth', this Note suggests that the negative global tendencies may have arisen under systematic declines in the shares of wage incomes worldwide experienced over recent decades. Making globalization more 'productive' (and investment-friendly) may require a global rebalancing of interests of labor and business.

JEL codes F63, E25, O41

Keywords globalization, investment share, income distribution, growth

Preliminaries

Aggregate gross capital formation (*investment* henceforth) is the central determinant of economic growth. Of course, in the shorter run investment tends to be quite capricious.¹ It responds, rather unpredictably, to psychological factors (e.g. volatile sentiments of entrepreneurs) and to some possibly harder economic influences (e.g. interest rates) – as well as to the perceived opportunities generated by technical progress. Certainly, it is tempting to go beyond analyses of such short-term – accidental or exogenous – influences and attempt to gain some understanding of the factors possibly responsible for the longer-term dynamics of investment and thus of overall growth.

There has been no shortage of theories and concepts relating to the longer-term trends in investment. For this Note the starting point is the theory linking investment dynamics to the functional distribution of output: that is the proportion in which national output (or income) is divided between wages and profits. (The theory abstracts from the fact that income earned by the self-employed – for example farmers – is neither profit nor wage.)

The theory, formally initiated around 1990², assumes that in the longer run private investment is an immutable function of two 'variables': (1) the profit share; (2) the level of production capacity utilization. Each of these two variables, taken separately, is assumed to exert a positive impact on investment. However, the level of capacity utilization is higher when the *wage* share is higher (as the consumption propensity out of wage income is 'naturally' higher than the propensity to consume out of profits). Hence the profit share and the level of capacity utilization are not independent of each other – actually these two variables are 'antagonistic'. Depending on some (fairly simple) analytical considerations, it is possible – at least in theory – to identify one of the two variables in question as eventually dominant in so far as investment impacts are concerned. If a certain arithmetical inequality is satisfied then the profit share is dominant, otherwise it is the capacity utilization. In the former case investment (and overall output) growth responds positively to redistribution of income from wages to profits. In the latter case investment (and

¹ John Hicks once remarked that 'investment is a flighty bird...which needs to be controlled'.

² See e.g. Bhaduri and Marglin (1990), Setterfield et al. (2002), Bhaduri (2007), Lavoie and Stockhammer (2012).

overall output) growth responds positively to redistribution of income from profits to wages. Not surprisingly, the former case is called an instance of 'profit-led growth', and the latter a 'wage-led growth'.

The ambiguous empirics at the national level

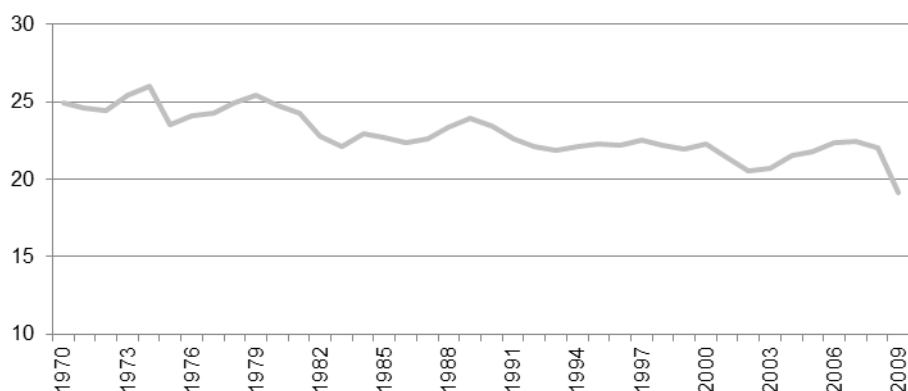
The above-outlined theory does not really allow for the existence of 'external world': hence the abstract economy analyzed does not trade with 'the rest of the world'. Nor is it linked to 'the rest of the world' via e.g. capital (including FDI) and capital-related income flows. The fact that transnational corporations' earned profit comes from activities conducted globally, and their investments also cross the borders, must be ignored. Moreover, in the context of progressing integration of national economies (globalization) growth recorded in some countries has come to depend on the net external demand these countries register – and less on what happens to the domestic demand (be it consumption or investment). In the same vein growth in some other countries could have been divorced from trends in their profit shares or capacity utilization levels as domestic consumption and investment may have been fed by growing foreign indebtedness.

The external impacts listed above have been of growing importance, as amply documented: since the late 1960s growth in separate national economies has been increasingly export-led, or import-fed (as the case might be), in addition to being either wage- or profit-led, while cross-border profit-earning and investment activities have been gaining in importance.³

Given the strength of internationalization of national economies worldwide, it is perhaps not quite surprising that attempts to characterize growth in *separate* countries as being led by either domestic wages or domestic profits have not produced unambiguous econometric results (see Lavoie and Stockhammer, 2012 for a recent review). Of course, the weaknesses of the available statistics may have played a role as well. The measurement of the wage (or profit) shares at the national levels is easy only in theory. In practice this measurement may be problematic if only because of the existence of the self-employed or working owners whose incomes are hard to classify. The emergence of the class of managers whose exorbitant incomes (actually rents extracted) are formally counted as wages blurs the data even further. In addition, the practices of big multinationals (and wealthy individuals) to declare their incomes (if at all) in places offering tax privileges (rather than where they are actually generated) may play havoc to the profit/wage share statistics of *separate* national economies. In consequence the national data may suggest the absence of relationships between reported national profit/wage shares, capacity utilization levels and national investment growth - even if such relationships actually exist.

³ In 1990 the worldwide stock of FDI is estimated as amounting to 11 per cent of world output – against 35 per cent in 2010. By 2010 the transnational corporations generated about a quarter of global GDP, while their foreign affiliates generated about one tenth of global GDP and one third of global export (UNCTAD, 2012, pp. 24-25).

Figure 1 Global investment as per cent of World GDP, 1970-2009

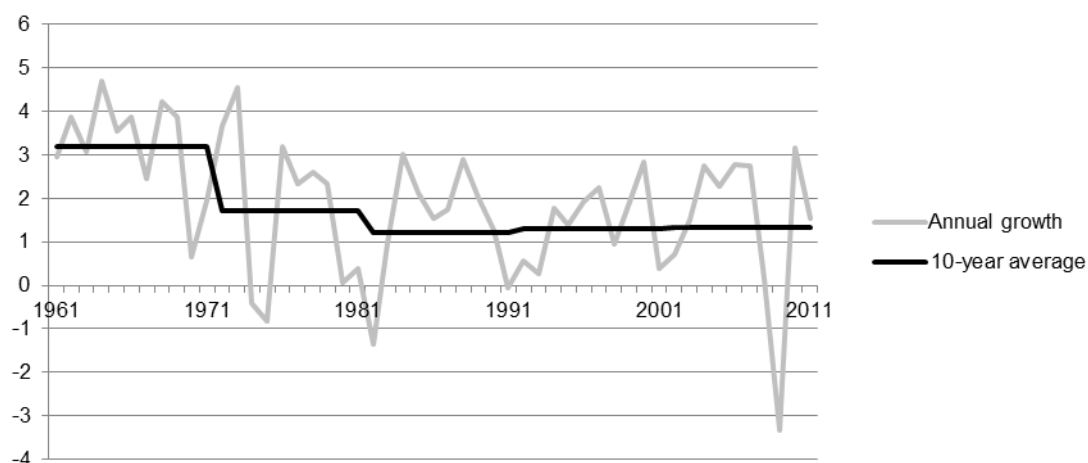


Source: World Development Indicators, World Bank

How about the character of *global* growth?

The national statistics on the shares of wages and profits for separate countries leave much to be desired, as discussed above. But there is little doubt that generally the profit shares have been on the rise – at the expense of the wage shares – in any case since the early 1970s. This fact is amply documented in the recent Report of the International Labor Organization (ILO, 2013, pp. 41-60). According to this source, the average share of labor income in 16 high-income OECD countries fell from 75% of the national income in mid-1970s to about 65% by 2010. The decline in the income share was even more pronounced in many emerging markets (including most New EU Member States⁴) – but also in China and India.

Figure 2 Global output growth rates. 1961-2011



Source: World Development Indicators, World Bank

While the precise statistics on the share of profits (or wages) for the *global* economy remain to be worked out, there is little doubt that globally the share of wages contracts⁵ while the share of

⁴ The strongest decline was registered in Poland where the GDP wage share fell from 68.3% in 1993 to 53.7% by 2011.

⁵ Rough calculations conducted at The Vienna Institute for International Economic Studies (based on Eurostat's World Input-Output Database, WIOD) suggest that the global income wage share oscillated between 53% and 53.5% over the years 1995-2000. Thereafter that share declined continually before stabilising at 51-51.5% after 2007.

profits expands. Now, the question is whether or not this 'stylized development' has been associated with investment acceleration at the global level.

As it turns out, investment growth has actually been slowing down relative to global output secularly, since the early 1970s. This fact is reflected in the falling share of global investment in global output (Figure 1).

Concluding remarks

The theory explaining investment (and output) growth by reference to the functional distribution of income (between wages and profits) – but abstracting from complications due to progressing globalization – cannot be reliably tested at the national level. However, the theory could, at least in principle, be tested more reliably at the global level. The stylized fact (rising global share of profits), coupled with a more hard fact (falling global share of investment) suggest that the global economy has been of the wage-led type.

One of the reasons why the global economy's growth has been losing momentum (while at the same time becoming increasingly volatile, as shown in Figure 2) may have been the upset balance between the interests of labor and business – i.e. between wages and profits.

The return to faster, and less volatile, growth globally – and also at the national levels – may require pronounced changes not only as concerns the introduction of regulations restricting the financial sector's disruptive practices. Also, something may have to be done – at national and international levels – to limit the downward drift in wage shares. The proven rule, once obeyed by economic policy making, that wages must move hand-in-hand with labor productivity needs to be resurrected.

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