How to create more and better jobs via a wage-led recovery in Europe?

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Paper to be presented at the Euromemo Conference, 20-21 Sept 2013, London

1. Introduction

Neoliberalism led to a significant increase in the profitability of capital via a dramatic decline in labour's bargaining power and the share of wages in income in the post-1980s in Europe as well as at the global level in both the developed and developing world. Neoliberal policies imposed in both the global North and South, welfare state retrenchment, financialisation, globalization, and the fall in labour's bargaining power have resulted in a global race to the bottom. Europe has been in the forefront of this race, and has also been part of the global ruling consensus to impose these policies as part of structural adjustment programmes in the global South. Figure 1 shows the adjusted wage share in the selected countries from 1960s to 2000s. This does not even reflect the full dimensions of the loss in labour's share in some countries like the UK, with dramatic hikes in managerial wages, which makes the fall in the wage share look more modest than it is in reality for the majority of the wage earners. The decline in the share of wages has intensified once again since 2010/2011 during the new phase of the global recession (see figure 2). In the last three decades, this decline in the wage share has accompanied a poor performance in terms of investment, growth, and unemployment in most countries with the exception of a few emerging countries like China and India (Onaran and Galanis, 2012).

In the rest of the paper, Section summarizes our research findings about the effects of this race to the bottom in the wage share on growth. Section three derives the policy implications. Section four concludes with a set of proposals for a wage-led recovery to create more and better jobs in Europe.

2. What happens to growth when there is a simultaneous race to the bottom in the wage share in Europe and the rest of the world?

Mainstream economics continue to guide policy towards further wage moderation along with austerity as one of the major responses to the Great Recession, in particular in Europe. The main caveat of this common wisdom is to treat wages merely as a cost item. However, in reality wages have a dual role affecting not just costs but also demand. Hence, a fall in the wage share has both negative and positive effects.

In our recent report for the International Labour Office (Onaran and Galanis, 2012), we show the vicious cycle generated by this decades' long race to the bottom in wages. We work with a post-Keynesian/post-Kaleckian model, which allows this dual role. We estimate the effect of a change in income distribution on aggregate demand (i.e. on consumption, investment, and net exports) in Europe as well as other G20 countries. Consumption is a function of wage and profit income, and is expected to decrease when the wage share decreases, since the marginal propensity to consume out of capital income is lower than that out of wage income. Investment is estimated as a function of the profit share as well as demand, and a higher profitability is expected to stimulate investment for a given level of aggregate demand. Finally, exports and imports are estimated as functions of relative prices, which in turn are functions of nominal unit labor costs, which are by definition closely related to the wage share. The total effect of the decrease in the wage share on aggregate demand depends on the relative size of the reactions of consumption, investment and net exports. If the total effect is negative, the demand regime is called wage-led; otherwise the regime is profit-led. Mainstream economic policy assumes that economies are always profit-led, whereas in the post-Keynesian models the relationship between the wage share and demand is an empirical matter, and depends on the structural characteristics of the economy.

Next, we go beyond the nation state and develop a global model to calculate the effects of a simultaneous decline in the wage share in all these countries. We calculate the responses of each country to changes not only in domestic income distribution but also to trade partners' wage share; this in turn affects the import prices and foreign demand for each country. The results are summarized in Table 2.

Overall demand in the Euro area (12 countries) is significantly wage-led; a 1%-point increase in the profit share leads to a decline in consumption by 0.44% points (of GDP), a small increase in private investment which cannot offset this decrease in consumption (by 0.28% points), and a very small increase in net exports by 0.06% points. The sum is a 0.08% decrease in private excess demand. Next comes the national multiplier effects, and the overall decline reached to 0.13% points of GDP. Unsurprisingly, Germany, France, Italy, and the UK as individual large members of the EU are also wage led. The absolute value of the effect of an increase in the profit share in Germany and France is smaller than in the aggregate Euro area; the net export effects are higher for the individual countries with a much higher export and import share in GDP due to trade with the other Euro area countries as well as non-Euro area countries. Previous studies show that small open economies in the Euro area, like the Netherlands and Austria, may be profit-led, when analyzed in isolation (Hein and Vogel 2008; Stockhammer and Ederer, 2008). However the aggregated Euro area is a rather closed economy with low extra-EU trade albeit a high intra-EU trade in which overall demand is wage-led. Thus wage moderation in the Euro area as a whole is likely to have only moderate effects on foreign trade, but it will have substantial effects on domestic demand. Second, if wages were to change simultaneously in all Euro area countries, the net export position of each country would change little because extra-Euro area trade is comparatively small. Thus, when all Euro area countries pursue "beggar thy neighbor" policies, the international competitiveness effects will be minor, and the domestic effects will dominate the outcome.

Outside Europe, in the global North the US and Japan are also wage-led; albeit the effect varies depending on the degree of openness of the economy as well as the relative strength of the consumption differentials and investment's response to profits. Overall the results indicate that large/relatively closed economies are rather wage-led. Canada and Australia are the only developed countries that are profit-led; in these small open economies, distribution has a large effect on net exports. Among the developing countries, only Turkey and Korea are wage-led. Argentina, Mexico, China, India, and South Africa are profit-led. In particular China is very strongly profit-led due to strong effects on exports and imports.

Three important findings emerge out of our research: First, domestic private demand (i.e. the sum of consumption and investment in Columns A and B in Table 2) is wage-led in all countries, because consumption is much more sensitive to an increase in the profit share than is investment. Second, foreign trade forms only a small part of aggregate demand in large countries, and therefore the positive effects of a decline in the wage share on net exports (Column C) do not suffice to offset the negative effects on domestic demand. Similarly, in the Euro area as a whole, consisting of countries with strong trade relations with each other and a low trade volume with countries outside Europe, the private demand regime is wage-led. Finally and most importantly, even if there are some countries, which are profit-led, the planet earth as a whole is wage-led. This makes intuitively sense; because what we find is that planet earth is a closed economy as long as we are not trading with Mars, not just yet! A simultaneous wage cut in a highly integrated global economy leaves most countries with only the negative domestic demand effects, and the global economy contracts. Furthermore some profit-led countries contract when they decrease their wage-share, if a similar strategy is implemented also by their trading partners. Beggar thy neighbor policies cancel out the competitiveness advantages in each country and are counter-productive. ILO (2012:60) in the recent Global Wage Report-2012/13 writes "The world economy as a whole is a closed economy. If competitive wage cuts or wage moderation policies are pursued simultaneously in a large number of countries, competitive gains will cancel out and the regressive effect of global wage cuts on consumption could lead to a worldwide depression of aggregate demand."

At the global level, the race to the bottom in the wage share, i.e. simultaneous increase in the profit share by 1%-point in the major developed and developing countries, leads to a 0.36% decline in global GDP. The Euro area and the UK contract by 0.2% as a result of a simultaneous decline in the wage share (see Column G in Table 2). Most interestingly, some profit-led countries, specifically Canada, India, Argentina, and Mexico also contract as an outcome of this race to the bottom. The expansionary effects of a pro-capital redistribution of income in these countries are reversed when relative competitiveness effects are reduced as all countries implement a similar low wage competition strategy; this consequently leads to a fall in the GDP of the rest of the world as well as import prices. The wage-led economies contract more strongly in the case of a race to the bottom. Australia, South Africa, and China are the only three countries that can continue to grow despite a simultaneous decline in the wage share; however the growth rates in these countries are also reduced.

The microeconomic rationale of pro-capital redistribution conflicts with the macroeconomic outcomes. First, at the national level in a wage-led economy, a higher profit share leads to lower demand and growth; thus even though a higher profit share at the firm level seems to be beneficial to individual capitalists, at the macroeconomic level a generalized fall in the wage share generates a problem of realization of profits due to deficient demand. Second, even if increasing profit share seems to be promoting growth at the national level in the profit-led countries, at the global level a simultaneous fall in the wage share leads to global demand deficiency and lower growth. What seems to be rational at the level of an individual firm or a country turns out to be contractionary at the macro or global level.

3. Policy implications

These findings have important implications for policy. At the national level, if a country is wage-led, pro-capital redistribution of income is detrimental to growth. There is room for policies to decrease income inequality without hurting the growth potential of the economies.

For the large wage-led economic areas with a high intra-regional trade and low extra-regional trade, like the Euro area, macroeconomic and wage policy coordination can improve growth and employment. The wage moderation policy of the Euro area is not conducive to growth.

Addressing the problem of income inequality is even more important today with the background of the crisis. Debt-led consumption, enabled by financial deregulation and housing bubbles seemed to offer a short-term solution to aggregate demand deficiency caused by falling wage share in countries like the US, UK, Spain, or Ireland until the crisis. The current account deficits and debt in these countries were matched by an export-led model and current account surpluses of countries like Germany, or Japan, where exports had to compensate for the decline in domestic demand due to the fall in labour's share. However this model also proved to be unsustainable as it could only co-exist with imbalances in the other European countries –an issue, which is now in the epicentre of the Euro-crisis.

A global wage-led recovery, to put an end to both the unsustainable debt-led consumption and export-led beggar thy neighbor models, as a way out of the global recession is economically feasible. Growth and an improvement in equality are consistent. This is true not only for the wage-led countries but also for those that are profit-led, although in the latter the room for improving the wage share is more limited unless the structural parameters of the countries change. We present a scenario, where all countries can grow along with an improvement in the wage share, and the global GDP would increase by 3.05% (Onaran and Galanis, 2012).

The crisis has now reached a stage of incomes and jobs crisis along with dismantling the welfare state and more regressive taxes. Unemployment has been increasing sharply since 2009 with the notable exception of Germany and Austria thanks to their subsidized short working time arrangements during the crisis. The UK and the US have experienced the highest increases in the rate of unemployment among the core developed countries; the ease of firing has increased the effect of the recession on jobs in these countries. The impact on employment is up to twice as high in situations without efficient collective bargaining and effective social dialogue.[1] Long term and youth unemployment have worsened even more. Wages are under pressure and sharp and persistent increases in unemployment are likely to have further impact. The share of wages in GDP has started to fall again since 2010 or 2011 in all the large developed countries along with a further shift of labour income towards managers. The consequences of this for demand may partly explain why the recovery is so weak or a new recession is on the way. Both the government and the opposition party of Labour in the UK agree on the public sector wage freeze with the pretext of defending jobs. However, the dilemma of pay vs. jobs is not empirically validated for the UK or other large economies as well as the global economy at large. Public sector pay freeze will have strong spillovers to the private sector. Given that these large economies are wage-led, a vicious circle of wage cuts leading to lower growth and fewer jobs may turn the problem of debt to insolvency for the private as well as the public sector. The austerity policies with further detrimental effects on the wage shares will only bring further stagnation. Growth in China and a few developing countries alone cannot be the locomotive of global growth.

A global wage-led recovery can also create space for domestic demand-led and egalitarian growth strategies rather than export orientation based on low wages in the developing countries.

Rebalancing growth via increasing domestic demand in the major developing countries, in particular China would also be helpful in addressing global imbalances. However, this rebalancing can only take place in an international environment where the developed countries not only leave space for developmentalist policies, support technology transfer, but also create an expansionary global environment by avoiding a race to the bottom.

Given the profit-led structures in some developing countries, the solution to the coordination problem requires a step forward by some large developed economies in terms of radically reversing the pro-capital distribution policies.

4. The policy measures for creating jobs via a wage-led recovery

The push for wage-led recovery can primarily come through a strengthening of the bargaining power of labour. This would correct the increased gap between the changes in productivity and wages in the last three decades. Strengthening the power of the labour unions via an improvement in union legislation, increasing the coverage of collective

[1] International Institute for Labour Studies/ILO, World Of Work Report, 2011

bargaining, increasing the social wage via public goods and social security, establishing sufficiently high minimum wages, regulating high/executive pay, and levelling the global play ground through international labour standards are the key elements in creating the balance of power relations in favour of a wage-led recovery.

The effects that can come from a wage-led recovery on growth and hence employment however is modest, albeit positive. We need to mobilize all the tools of economic policy and public spending with an aim to achieve full employment, ecological sustainability, and equality. This is a feasible but challenging task. First, if the use of environmental resources is to maintain a certain ‘sustainable’ level, economic growth in advanced capitalist countries, in the long term, has to be zero or low, i.e. equal to the growth rate of ‘environmental productivity’.

Second, advanced capitalist countries of Europe need to slow down to create space for development in the Global South as part of a broader strategy of climate justice. This type of low-growth or even de-growth, however, has nothing to do with the disastrous recession caused by the crisis. This is a managed low-growth economy that redistributes existing wealth, which should be sufficient to maintain a life with dignity and creativity for all, if resources were used sustainably and in accordance with the needs of the majority. Growth in past decades has not brought jobs, equality, prosperity, or happiness. We can create prosperity and equality with also low growth. Consumerism and conspicuous consumption would also decrease in a more equal society.

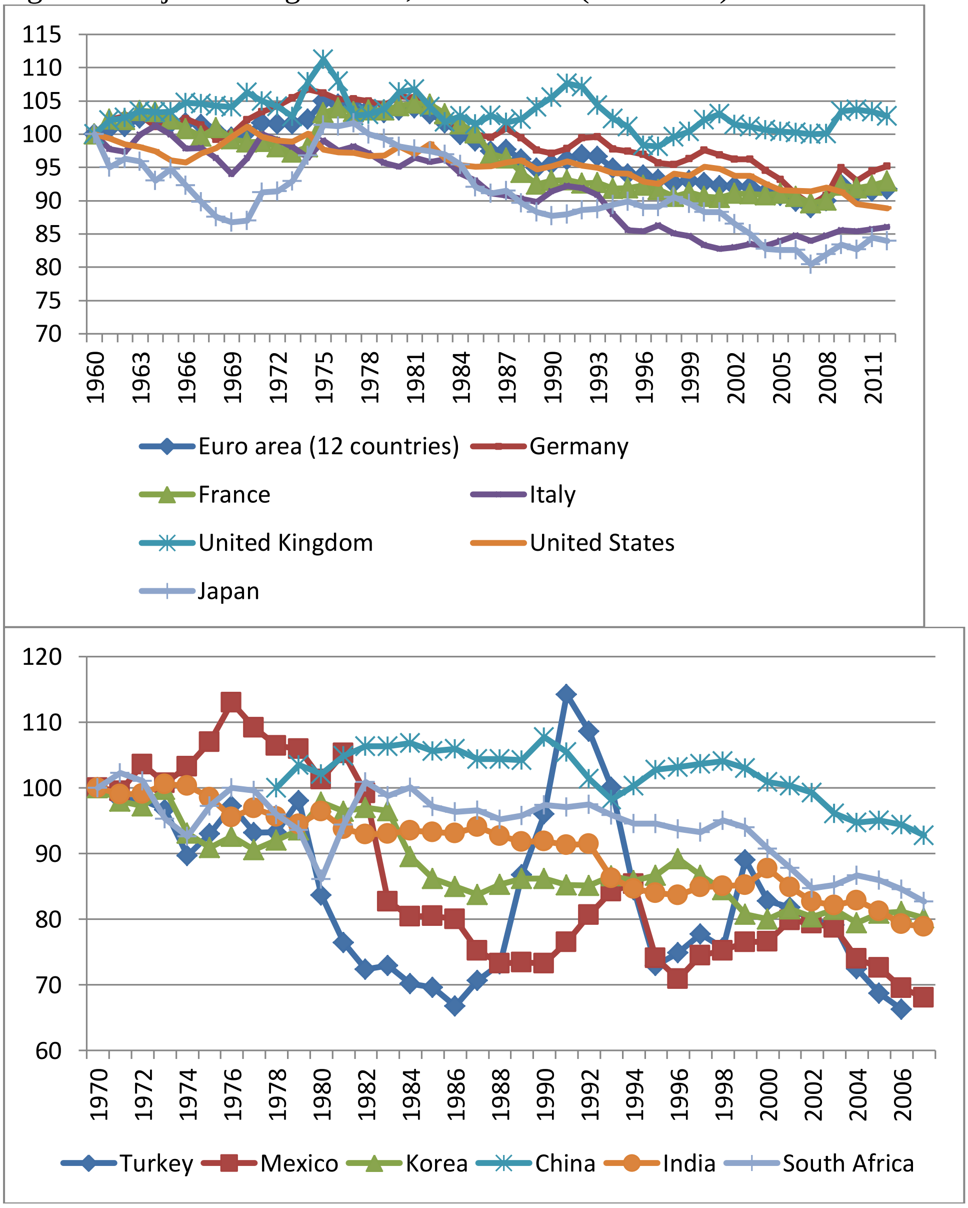
The reconciliation of full employment with low/zero growth and a low carbon economy requires three policies: creating more labour-intensive jobs, and ecological investments. First, public spending should generate public employment in labour-intensive social services such as education, child care, nursing homes, health, community and social services. The need for social services is not met under the present circumstances, where they are provided either at very low wages (to ensure an adequate profit) or as a luxury service for the upper classes or via invisible unpaid female labour within the gendered division of labour in the private sphere. To avoid this deficit they can be provided by the state or by non-profit/community organizations. This could also hit another target of increasing the female labour force participation rates via socializing the invisible care work done by women as unpaid work. Ilkkaracan (2013) calls these purple jobs. However, these jobs need to be made attractive for both men and women by improving pay and working conditions in these industries. Thus a new orientation towards high skilled decent service sector jobs should be different from the former reliance on low pay service jobs with weaker labour unions in the UK.

Second, for the purpose of ecological sustainability, there is need for a shift in the composition of aggregate demand towards long-term green investments; this cannot be achieved without new strategic tasks for active public investment. Public investment in ecological maintenance and repair, renewable energy, public transport, insulation of the existing housing stock and building of zero-energy houses can create jobs as well as a low carbon economy.

Third, a key policy measure to maintain full employment with low growth and a more equal income distribution is a substantial shortening of working time in parallel with the historical growth in productivity is also required. Reduction in weekly working hours should take place without loss of wages in particular in the case of low/median wage earners, which means an increase in hourly wages as well as wage share. Again this is not unrealistic. Compared to the 19th century, we are all working part-time today. But the shortening of working hours has slowed down since the 1980s, with the notable exception of France. More equal countries have shorter working hours (Schor, 2010). The shortening of hours over the past decades has also been associated with higher hourly productivity (Bosch and Lehndorff, 2001). Shorter working hours do not only create more growth but increase the job creation potential of a given rate of growth. The UK and the US have much longer hours than Germany and Netherlands (Schor, 2010). This means that an employer in the UK needs more demand than the German employer to create an additional job, which is particularly an issue in the post-crisis era of high and persistent unemployment. This is also the way to break the illusion among working people of the need for growth and to make a zero-growth economy socially desirable by guaranteeing work with dignity and an equitable distribution of income. The minimum wage should also be adjusted upwards to a living wage level, and a basic income for all residents should be introduced.

Finally, the weakening of productive investment has been detrimental for job creation. Among the developed countries, UK has one of the lowest private investment/GDP ratios. If private sector investment had grown at the same pace as GDP during the period 2000 to 2009, private sector employment in the advanced economies would have been higher by 5.8 million in 2009 (IILS/ILO, 2011). This has been also related with financialisation and the short-termism orientated towards the maximisation of the dividends to the share holders along with managerial bonuses. A pro-jobs strategy needs to break this orientation and put investments in line with profits as well as stimulating investments via higher demand. Public investment, in particular in new green industries like renewable energy, infrastructure, public transport, housing would not only make up for the missing investment but also meet the most needed emission targets to address the ecological crisis.

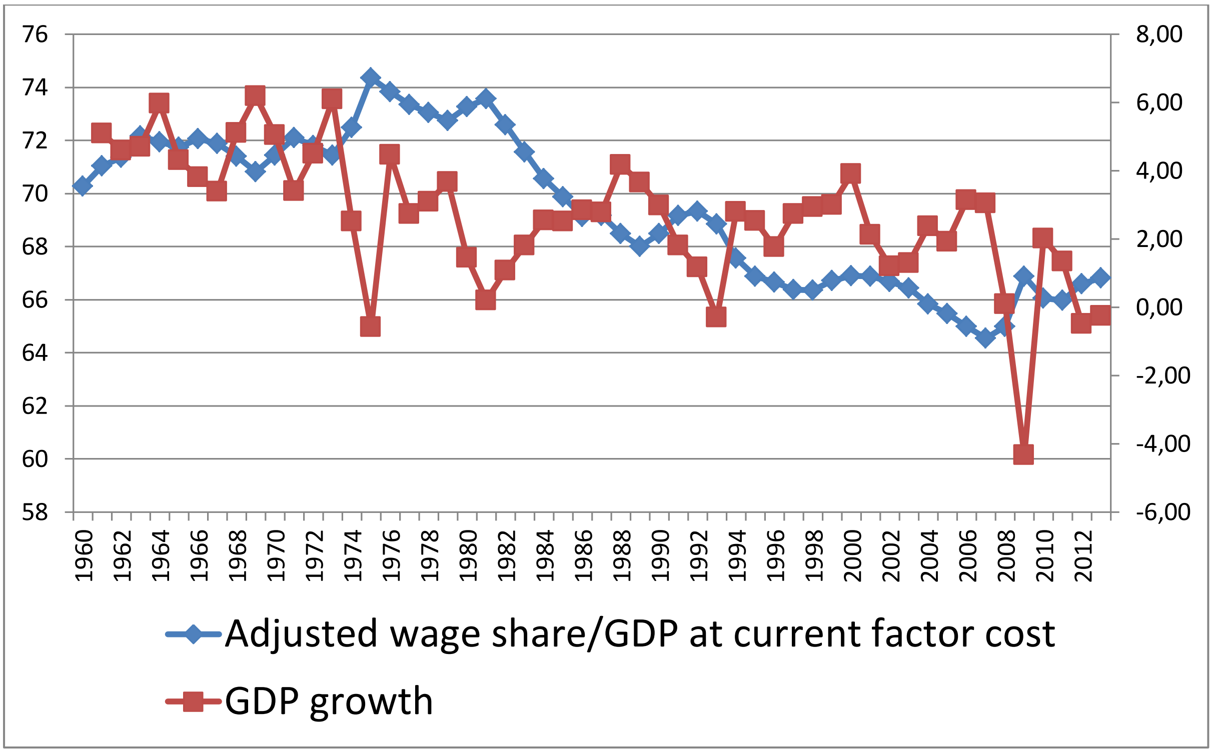
Figure 1. Adjusted wage share*, index value (1960=100)



*Adjusted wage share = Compensation per employees * number of employed/ GDP at factor costs other than in China and India.

Source: AMECO and Onaran and Galanis (2012)

Figure 2: Adjusted Wage share vs. growth, EU15, 1960-2013



Source: AMECO, May 2013

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