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POLICY BRIEF

GREATER INCOME SHARE FOR LABOUR - THE ESSENTIAL CATALYST FOR GLOBAL ECONOMIC RECOVERY AND EMPLOYMENT

The persistent weakness of the advanced economies poses a threat to prospects for recovery of the world economy, as developing countries' domestic demand is not strong enough to sustain their recent growth path. For some time now, developing countries have been the engine of the global economy, but in the absence of a revival of demand from traditional markets in the North, the decoupling effort is running out of steam. In most parts of the developed world, fiscal austerity, despite being patently unsuccessful so far, is considered to be indispensable for medium- and long-term success. However, factors that are darkening the immediate and medium-term prospects for the global economy will not automatically brighten the long-term prospects. In fact, it is just the other way round: the darker the short term, the bigger the negative impact for the future and the negative spillover to other countries, both large and small.

The exhaustion of monetary policy and the political blockade against deploying fiscal policy to stimulate growth demands new analysis and new instruments to break the impasse. In its Trade and Development Report 2012, UNCTAD has shown that the current deadlock is mainly the result of dysfunctional labour markets in major industrialized economies. Unemployment is sky high, but wages are low. Private households under pressure from high unemployment and falling wages are unable to consume more; companies, despite sitting on high profit and cash levels, are unwilling to invest more, given that there is low utilization of capacity, coupled with a feeble outlook. With the highest unemployment rates and the lowest share of wages in national incomes since the Second World War, the widespread mantra of going for "more flexible labour markets" in an effort to revive ailing economies is discredited, and governments should instead enact active income policies.

Key points

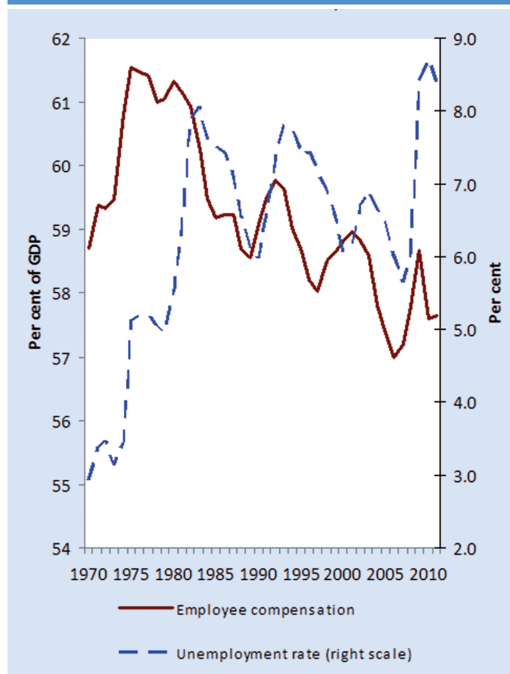
- The share of wages in national income is at its lowest level since WWII and unemployment at its highest.
- Working families' households are the economy's most important consumers, but under this pressure they cannot consume enough to support economic recovery.
- Governments should resist the mantra of "flexible labour markets" and instead enact active income policies.
- Countries' attempts to improve competitiveness by cutting wages in relation to productivity can only end in general impoverishment - a true race to the bottom.

Diminished income expectations hold back domestic demand

Wage compression and real wage growth lagging behind productivity gains has been a salient feature of economic development in most countries in the world during the last thirty years, especially in developed economies. However, mega-salaries for a few, as part of a general trend towards higher profits and more inequality, has not led to more and more sustainable investment in fixed capital, as economic theory would suggest. In developed countries, the share of labour income fell by 5 percentage points or more between 1980 and the onset of the global financial crisis. In some major economies, this amounted to an explicit overturning of the post-war social contract and consensus with organized labour, which had been based on the idea that real wages would move in parallel with productivity growth, thereby sustaining domestic demand by private households.

Hence, according to the theory that dominated economic thinking for decades, the combination of sharply rising unemployment with low or falling wages was not supposed to occur. However, during the financial crisis of 2008 and 2009, that is precisely what happened. As wages in the developed economies have fallen to their lowest levels in six decades, unemployment has surged to a new post-Second World War high of 9 per cent (see chart 1).

Chart 1. EMPLOYEE COMPENSATION AND UNEMPLOYMENT RATE IN DEVELOPED COUNTRIES, 1970-2011



Sources: UNCTAD secretariat calculation, based on OECD Stat Extracts database; European Commission, Annual Macro-economic (EC-AMECO) database.

Note: Developed countries exclude Eastern European countries. Employee compensation is calculated as a percentage of GDP at factor costs. There is a break in 1991 due to German reunification.

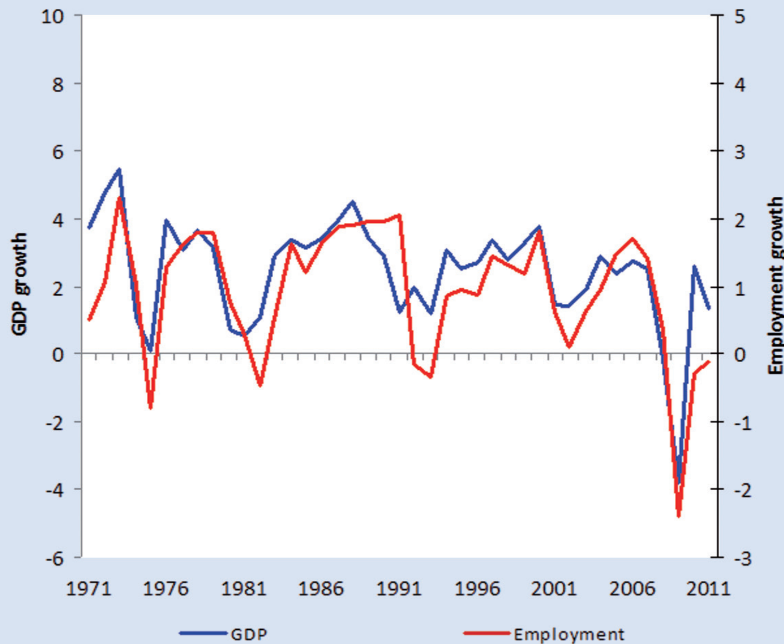
Take, for example, the United States, where wages have been lagging behind productivity for many years but unemployment rose at least as sharply when the financial crisis hit in 2008 as in former recessions, and is more persistent than ever before. However, if unemployment can rise sharply despite real wages lagging far behind productivity, then the simple market nexus of lower wages supposedly eliciting demand for labour does not apply. In fact, high unemployment is putting pressure on wages, but lower wages are prompting further cuts in employment, as lower wages diminish consumption and final demand. It is counterproductive to allow the pressure from high unemployment to depress wages further, because the immediate effect of falling nominal wages is a fall in the demand from private households.

The crucial point is the sequence of events: in the course of wages falling, domestic demand would clearly fall before any other positive effect, such as the substitution of capital against labour, had time to come into play. Not even profits would rise as a consequence of falling wages if demand fell first and reduced the utilization of capacities. Only the government, by applying demand-stimulating measures, can compensate for falls in demand stemming from the labour market as a result of “flexible wages”.

Paradoxically, while governments have frequently acted as banker of last resort, many not only reject the role of employer of last resort, they go in the opposite direction, recommending cuts or caps to the wage bill. Since the crisis began, UNCTAD has warned that job creation is incompatible with fiscal tightening. This message has been reinforced recently by many others, including UNICEF (2012), which fears that the austerity measures being discussed by governments worldwide will delay labour market recovery and exacerbate the tremendous human costs of the economic crisis. UNICEF’s review of International Monetary Fund (IMF) country reports finds 73 developed and developing countries considering wage bill cuts or caps over the years 2010 to 2012. Alongside this, 133 countries were expected to cut public expenditure, and this could have further direct and indirect effects on employment and wages.

Such measures are often associated with attempts to improve the “international competitiveness” of countries. However, competitiveness is a concept to be applied at the level of companies, and even more importantly, it is a relative concept. While all countries can improve their productivity performance and increase the incomes of their population, the attempt by everyone to improve competitiveness by cutting wages in relation to national productivity can only end in general impoverishment – a true race to the bottom.

Chart 2. GROWTH OF EMPLOYMENT AND REAL GDP IN DEVELOPED COUNTRIES, 1971-2011 *(Per cent)*



Sources: UNCTAD secretariat calculation, based on OECD Stat Extracts database; European Commission, Annual Macro-economic (EC-AMECO) database; and Historical Statistics of Japan, Statistical Bureau.

Note: Developed countries exclude Eastern European countries.

Sadly, global economic policymaking has not learned the lesson yet. In the Trade and Development Report 2011 and Policy Brief No. 24 (2011), UNCTAD warned of excessive optimism about the rebounding capacities of private-sector investors and consumers in the case of fiscal contraction amidst a very fragile economic climate. The latest series of painfully downgraded GDP forecasts and the prospect of a return to global recession proves that some constructs, such as the "non-Keynesian effects" of austerity, reflect wishful thinking rather than a plausible theory and convincing empirical evidence. As far as employment growth is concerned, the relevant evidence points to a strong correlation with overall income growth, and also to a correlation between growth in gross fixed capital and in employment (UNCTAD, 2012; and see chart 2). In the real world, labour and capital are complements but not substitutes. Companies invest in both labour and capital in times of rising demand, and disinvest in both in times of falling demand.

This evidence clearly refutes the conventional argument that employment can be high at any growth rate if the labour market is flexible enough. At the current point in time, however, flexible labour markets would imply falling wages and lower overall demand – a course of events that without any doubt would further destabilize the economy. It would induce a deeper recession, and lead to less employment and renewed pressure on wages. Excluding demand as a decisive factor for entrepreneurial investment is a grave error, and signifies a systematic failure of economic policy. In a similar vein, when corporate taxes fell between the years 1982 and 2005, gross fixed capital formation did not rise, but rather fell. Companies awash with profit and capital but facing a lack of demand do not increase their engagement in productive and job-creating activities.

Rebalancing and boosting demand, including through wage and labour market policies

Rebalancing income distribution must be a leading policy objective for developed and developing countries alike. Growth that is inequitable in its balance between labour and capital, or that results in extremely high rewards for a fortunate few and very low rewards for the many (the so-called 99 per cent), cannot be sustainable in the long term. Working families' households are the

most important consumers, and private consumption is the core component of sustainable domestic demand; these households cannot be systematically left behind. Therefore, employment- and growth-supporting wage policies are indispensible. Monetary and fiscal policies need to be complemented by incomes policies if the balance of powers in the labour market is not equitable. This is even more important in developing countries. Their potential for enhancing productivity growth can only play a beneficial role for the economy as a whole if all parts of society have a chance to benefit from the proceeds of improved division of labour.

Relevant policy principles include:

- Governments should resist the mantra of "flexible labour markets" and instead enact active income policies.
- Provisions are needed so average nominal wages rise at the same rate as average productivity plus the inflation target set by the government or central bank.
- Collective bargaining mechanisms can contribute to achieving this, complemented with government recommendations or general guidelines for wage adjustments, through minimum wages for example.
- Other instruments can also be used to correct the balance of market outcomes, including creating additional public employment opportunities, and progressive taxation.
- Public spending designed to improve the provision of essential goods and services can also help, by providing a secondary channel for redistribution.

Fur further details see UNCTAD 2012

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