

Capital lessons

Labour, inequality and how to respond

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A sharp drop in the wage share in GDP in the UK since the 1980s has been accompanied by a jump in income share of the top 1 per cent. Rather than migration or technological change, increased capital mobility, decline in collective bargaining, labour market deregulation, austerity and rising household debt are to blame.

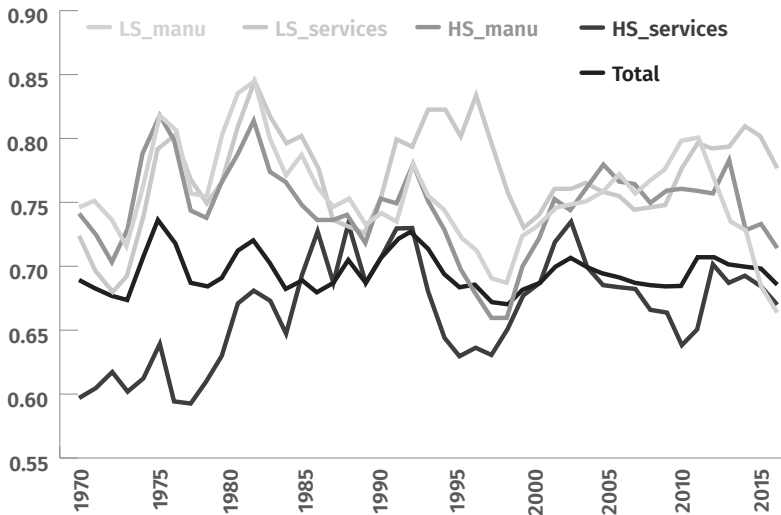
There has been a significant decline in the share of wages in GDP in the UK since the 1980s. This has been accompanied by another trend towards greater inequality in personal income distribution, particularly by increases in income shares of the top 1 per cent of the distribution. We have recently analysed the causes of the decline in the wage share in developed and developing countries for a project for the Institute of New Economic Thinking, and this paper summarises our findings for the UK.⁴²

“The fall in the share of wages in national income and stagnation in wages have been two of the fundamental flaws in the UK’s economic model”

The share of wages in GDP in the UK fell from its peak of 74.1 per cent in 1975 to 69.2 per cent in 2014 (figure 1). Low-skilled services experienced a reduction in the wage share from the mid-1990s until 2007. Low-skilled manufacturing sectors have also lost out compared to the early 1980s. The wage share in high-skilled service sectors in 2014 was still 6 percentage-points lower than its value of 74 per cent in the mid-1980s and the wage share in high-skilled manufacturing in 2014 was 10 percentage-points lower than its peak in 1981 at 72 per cent.

⁴² Full details of the research project can be found here: <https://www.ineteconomics.org/research/grants/the-causes-of-falling-wage-share-and-prospects-for-growth-with-equality-in-a-globalized-economy>

Figure 1: Wage share in the UK in different sectors (labour compensation as a ratio to value added, adjusted for self-employed labour income), 1970-2014



Source: Own calculations based on EU KLEMS. The graph for the total wage share includes all sectors. HS and LS stand for high and low skilled sectors respectively. Sector level graphs exclude: Agriculture, Hunting, Forestry and Fishing; and Mining and Quarrying; Coke and Refined Petroleum; Public Administration and Defence; Compulsory Social Security; Education; Human Health and Social Work Activities and Real Estate.⁴³

The fall in the share of wages in national income and stagnation in wages have been two of the fundamental flaws in the UK's economic model and were at the root of the Great Recession. We are far from correcting this imbalance. Real pay is still lower compared to its peak in early 2008. After the longest and most dramatic period of decline in real wages since the Victorian times, waged and salaried people in Britain are once again under pressure due to the uncertainty and higher inflation rates caused by the depreciation of the pound after Brexit.

The EU Referendum in the UK in 2016 laid bare long-existing divisions in the country. The link between the result and increasing inequality – and in particular the impact of migration on inequality – has received much

⁴³ See Guschanski and Onaran (2017) for further details

attention. Our analysis shows that inequality in the UK did not increase because of migration, i.e. mobility of labour. Instead, our analysis suggests it was caused by two related factors. The first was the increased fallback options for capital to increase its profitability through greater geographic mobility of capital in the form of foreign direct investment (FDI) and financialisation (increased options in investing in financial vs. real assets). The second was the declining availability of fallback options for labour, related to, variously, the decline in collective bargaining power, deregulation of the labour market, zero hours contracts and false self-employed contracts, austerity, the housing crisis and rising household debt (itself related to financialisation and inequality). As our data shows, this is not a new phenomenon but a process that gained momentum from the 1980s, when increased globalisation and neoliberalism initiated a poisonous mix of austerity, deregulation of product and labour markets and slashing of workers' rights.

CAUSES OF THE FALL IN THE WAGE SHARE

We analyse the wage share (labour compensation as a ratio to value added) and real wage (labour compensation as a ratio to people engaged) in the UK using sectoral data for the period of 1970-2014⁴⁴. The mainstream argument in the literature, informed by neoclassical theory – as most prominently represented by the IMF⁴⁵, European Commission⁴⁶ and Bassanini and Manfredi⁴⁷ – is that technological change is the primary determinant of falling wage shares, followed by globalisation. On the contrary, building on the political economy approach^{48 49 50}, we analyse the potential negative effects, not only of technological change and globalisation, but also of financialisation, and the

44 We use EU Klems, OECD, and World Input-Output datasets. See Guschanski and Onaran (2016, 17) for details. The analysis is based on country specific econometric estimations based on sectoral data (Guschanski and Onaran, 2016) as well as pooled estimations of countries and sectors (Guschanski and Onaran, 2017).

45 International Monetary Fund (IMF) (2007) 'The globalization of labor' *World Economics Outlook April 2007*, pp.161-192, IMF

46 European Commission (EC) (2007), 'The labour income share in the European Union' *Employment in Europe*, pp. 237-272, European Commission

47 Bassanini A and Manfredi T (2012), 'Capital's Grabbing Hand? A Cross-country/Cross-industry Analysis of the Decline of the Labour Share', *OECD Social, Employment and Migration Working Papers No.133*

48 Guschanski A and Onaran, Ö (2016), 'Determinants of the wage share: a cross-country comparison using sectoral data', *Greenwich Papers in Political Economy*, University of Greenwich. <http://gala.gre.ac.uk/15847/>

49 Guschanski A and Onaran Ö (2017), 'The political economy of functional income distribution: industry level evidence from the OECD', *Greenwich Papers in Political Economy*, University of Greenwich

50 Stockhammer E (2016), 'Determinants of the wage share: a panel analysis of advanced and developing economies', *British Journal of Industrial Relations*

decline in government spending and trade unions on the bargaining power of labour, and hence the wage share. We analyse the effects separately in manufacturing and service industries, and also distinguish between sectors using predominantly high and low-skilled labour.

Falling bargaining power of labour has reduced the wage share

There has been a strong decline in union density (the ratio of the number of employees who are members of trade unions to all the employees) for all industries in the UK. While this is a general trend in all countries, the decline has been greatest in the UK starting in the 1980s after Thatcherite policies. Union density in aggregate in the UK decreased by 24.4 percentage points from 49.9 per cent in 1981 to 25.4 per cent in 2013. Similarly, collective bargaining coverage has seen the greatest decline in the UK, from its peak of 80 per cent in 1979 to 31.2 per cent in 2011. Union density is highest in manufacturing sectors and lowest in low-skilled service sectors.

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Our results show that collective bargaining coverage and union density have a robust and strong positive effect of on wage share in the UK, which is clearly driven by high and low-skilled manufacturing sectors.

Additionally, our results show that government social spending (on health, education, social care) has a strong positive impact on wage share. Government social spending is considered as social wage, which affects the bargaining power of labour via the provision of in-kind social services such as health, social care and education. The cuts in social spending during years of neoliberalism and austerity have had a clear negative effect on the bargaining power of labour and the wage share.

We also find a negative impact of personal income inequality on the wage share in the UK. The rise in personal income inequality, in particular, the income share of the top percentile, affects the command over resources and power relations. Increasing economic and political power in the hands of a narrow elite circle leads to regulatory capture, and limits redistribution. It also shapes the rules in areas ranging from corporate governance to product and labour market regulation in their interest.

Globalisation of capital and trade has reduced the wage share

The broad trend of globalisation has brought with it increased options for firms to relocate to other countries or offshore fragments of their value chain. The terrain on which trade unions must confront firms has altered dramatically over the last two decades as a result of changes in the way production is organised. Rather than concentrating activities under a single roof, and maintaining tight control over the whole production process, firms can now coordinate their activities in increasingly complex and dispersed ways, involving offshoring and networked collaborations. The increasing prominence of multinational companies that are structured in this way exerts further negative pressure on workers' bargaining power, for instance through the increasing use of relocation threat to gain concessions in negotiations.

Globalisation of markets for goods, services, capital and labour reduces some workers' wages by placing them in direct competition with workers around the world, creating winners and losers. There is increasing concern that this will eventually lead to political backlash and protectionism as losers cast their vote.

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We find a negative effect of outward Foreign Direct Investment (FDI, as a ratio to the number of employees) on the wage share driven by manufacturing and service sectors. Outward FDI has a positive impact on average wages, but the negative impact on the wage share indicates that the wage increases fall behind the rise in productivity. There is also some evidence of the negative effect of international outsourcing (intermediate imports as a ratio to domestic demand) in manufacturing, but the effect is rarely statistically significant. Both FDI and offshoring relocate the whole production chain, or segments of it, abroad, putting domestic workers in direct competition with workers in other countries, where labour costs can be much lower. FDI can improve the global market share for multinational firms; but gains in profitability seem not to be shared by their workers at home.

The globalisation of labour: more migration need not lead to lower wage share if unions and regulations are strong

The impact of labour migration on wages is theoretically ambiguous. It depends on whether migrant labour takes the place of native labour, pushing down wages, or acts as a complement to local labour, not a direct competitor. The channels through which migration affects wages can, very broadly, be differentiated between the impact of migration on productivity and employment. Previous research has shown that migration is related to increased innovation (measured by the registration of patents) and is therefore positively linked to productivity in the UK. Migrants to the UK also have a higher education qualification than the average British worker^{51 52}. Depending on the nature of the technological advancement and the bargaining power of labour, this could lead to an increase in both wages and the wage share. Migrants might increase the overall skill level of the workforce and open up new business areas. Technological advancement and new business opportunities might increase demand for domestic workers. Furthermore, migrants often bring knowledge about markets and economies in their home countries and therefore open the possibility for expansion to new export markets, which might have a positive impact on the wage share^{53 54}. Low-skilled migrants do not always replace domestic labour if their labour supply as well as demand increases the overall demand for labour in the economy.

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In the UK, the share of foreign workforce (by nationality) as a part of the total workforce increased from 2.8 per cent in 1984 to 7.6 per cent in 2010⁵⁵.

51 Rolfe, H, Rienzo C, Lalani M, and Portes J (2013), *Migration and productivity: employers' practices, public attitudes and statistical evidence*, National Institute of Economic and Social Research.

<http://www.niesr.ac.uk/publications/migration-and-productivity-employers%E2%80%99-practices-public-attitudes-and-statistical#.V3wx8-srKUK>

52 Saleheen J and Shadforth C (2006), The economic characteristics of immigrants and their impact on supply, *Bank of England Quarterly Bulletin*, 4:374-385

53 Huber P, Landesmann M, Robinson C and Stehrer R (2010) 'Migrants' Skill and Productivity: A European Perspective.' *National Institute Economic Review*, 213(1), 20-34

54 Rolfe et al

55 Guschanski and Onaran (2016)

We find a very robust positive impact of the foreign workforce on the wage share as well as real wages in both manufacturing and service sectors alike. The econometric estimation indicates a positive after controlling for all other potential factors that may have an impact on the wage share and wages, in particular union density, imports, FDI, and technological change. Most importantly, contrary to common wisdom, the impact is especially significant and positive in the low-skilled service sectors, again on both wages and the wage share. Despite academic evidence⁵⁶ regarding the positive impact of migration on productivity in the UK, it is interesting that the increase in wages seems to be strong enough to more than offset the impact of migration on productivity and lead to a rise in the wage share as well. Obviously, there is need for more research on the reasons why increased immigration is associated with a higher wage rate, as well as the impact of migration on different types of native workers, using sectoral average wage data and individual household labour force survey data. We would rather not draw too strong conclusions about the positive impact of migration on wages in particular; however on a cautious note, evidence based on our results as well as literature indicate that if unions and regulations are strong, migration need not lead to lower wages, lower wage share and worse working conditions.

Financialisation has had a negative impact on the wage share

Financial activities and the prominence of financial institutions have gained momentum since the 1980s. Similar to globalisation, this process of financialisation has increased the fallback options for capital, which can now be more easily invested in various financial assets. Furthermore, financialisation changed industrial relations and led to a ‘shareholder value orientation’ as a consequence of hostile takeovers of listed companies. Financialised firms adopt a ‘downsize and distribute’ strategy, which reduces prospects for labour to agree on a beneficial compromise. Financialisation, coupled with house price bubbles, has also had important impacts on households, above all through a remarkable rise in household debt.

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56 Rolfe et al

In the UK, we find a robust negative effect of household debt and financial payments of non-financial corporations (dividends and interest) on the wage share in both manufacturing and service sectors alike. This finding complements recent research that finds a negative impact of financialisation on investment of non-financial companies⁵⁷. Financial income of non-financial corporations, on the other hand, has a positive impact in some specifications.

Technological change has not been the main driver of rising inequality in the UK

Recent mainstream literature emphasises how technological progress in the last decades was driven by Information and Communication Technology (ICT), that allowed workers to be replaced by machines carrying out easily automatised tasks. Technological progress contributed to a decline in the price of capital relative to labour, leading to an increase in the capital-output ratio, and has led to a fall in the wage share, particularly of the unskilled workers. In the UK, as elsewhere, there has been a significant increase in the ICT capital across all sectors. However, we do not find a significant negative effect of ICT or non-ICT capital on the wage share in the UK when other factors mentioned above are controlled for. Hence, technological change has not been the main driver of rising inequality in the UK.

LESSONS FOR POLICY

Negative effects of openness or global integration are not an unavoidable destiny, rather an outcome of current domestic and international policies. Since the 1980s, the UK has been the leader in damaging austerity, low-wage and precarious employment practices in the name of flexibility, and financialisation. The fall in the wage share has been a deliberate outcome of policies that led to the fall in the bargaining power of labour, welfare state retrenchment and financialisation.

“Both the UK and its trade partners in Europe as a whole are strong enough to pursue an egalitarian, wage-led growth strategy and would benefit from a coordinated boost to the wage share”

57 Tori D and Onaran Ö (2015), ‘The effects of financialization on investment: Evidence from firm-level data for the UK’, *Greenwich Papers in Political Economy*, University of Greenwich. <http://gala.gre.ac.uk/14068/>

The combination of these policies has led to the vicious circle of rising inequality, financialisation, chronically low demand, a slowdown in accumulation and productivity, and low growth and fewer or bad quality jobs^{58 59 60}. The empirical evidence shows that to break this vicious circle we need alternative economic policies based on a coordinated policy mix of equality-led development and public investment. We have strong empirical evidence to reject the myth that we cannot have pro-labour policies in the age of globalisation. Both the UK and its trade partners in Europe as a whole are strong enough to pursue an egalitarian, wage-led growth strategy and would benefit from a coordinated boost to the wage share. As such, the UK and other progressives in Europe could, and should, take a step forward in terms of radically reversing the fall in the wage share globally.

The strategy of a wage-led development requires labour market policies aiming at pre-distribution as well as redistribution. These include strengthening the bargaining power of labour, ensuring higher collective bargaining coverage, increasing the statutory minimum wage to the level of a living wage, enforcing gender equality, ending public sector pay freezes, banning zero hours contracts, enforcing pay ratios between companies' top paid and lowest paid to moderate high pay, and restoring a progressive tax system. Furthermore, income distribution policies need to be embedded into a broader macroeconomic and industrial policy mix targeting equality, full employment and ecological sustainability. This requires regulating finance and implementing a public investment programme centred on substantial public investment in green physical infrastructure in renewable energy, public transport and housing and social infrastructure in care, education and health. Free movement of labour in this context is much more likely to positively contribute to the local communities. Appropriate public infrastructure ensures that there is an adequate supply of health, education and care services and housing in a vibrant community.

There is no evidence migration has increased inequality

The quick conclusions related to the impact of immigration on inequality, without adequately decomposing the impact of all other factors, misses

58 Ibid

59 Onaran Ö and Obst T 2016 'Wage-led growth in the EU15 Member States: The effects of income distribution on growth, investment, trade balance, and inflation', *Cambridge Journal of Economics*, Oxford University Press. <https://doi.org/10.1093/cje/bew009>

60 Obst T, Onaran Ö and Nikolaidi M (2017) The effect of income distribution, public spending and taxes on growth, investment, and budget balance: The case of Europe, *Greenwich Papers in Political Economy*, No 43, University of Greenwich. <http://gala.gre.ac.uk/16088/>

the point that correlation is not causation. The simultaneous rise in immigration and inequality does not mean that the former causes the latter. After accounting for the impact of reduced union power, cuts in social spending, imports and FDI, we fail to find a negative impact of migration on the wage share. This debate on migration based on myths also misses how migrants contribute to overcoming the care deficit in an ageing society, an especially striking fact given that a majority of voters over 65 years voted to leave, and that migrants are net contributors to the social security system. Migrants are visible to the people, but what firms and offshore tax havens do is less visible and comprehensible. The real solution to inequality requires focussing on the real causes of the problem. In an alternative economy where the balance of power shifts in favour of labour and unions have a strong voice, if migrants come to work, it is possible for the terms and conditions under which they work to be set by the local workforce. Conversely, in the current situation where the bargaining power of workers has been dramatically eroded with respect to capital, high capital mobility and low wages in Eastern Europe and worldwide, firms will relocate or offshore parts of their production abroad, even if migration can be limited after Brexit. If migrants are not allowed to come, firms will go to them, and it is a lot harder to set conditions of work abroad to avoid a global race to the bottom in wages.

Openness and regional integration can be managed to benefit both the richer and poorer partners if trade and investment flows are designed as part of an egalitarian and growth-oriented international economic policy aiming at high road labour market policies. In the European context, labour movements have more common ground than they currently exploit. There is scope for international cooperation to overcome the coordination failure.

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