Debate

Equality-led Development and the Demand- and Supply-side Effects

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ABSTRACT

This contribution to the Forum Debate on global development focuses on the dimension of functional income distribution between labour and capital and its demand-side and supply-side effects. The article summarizes recent literature that has sought to explain the reasons behind the global fall in the labour share. It then discusses the demand-side effects of the declining wage share on growth, based on the post-Keynesian/post-Kaleckian literature. The author presents an alternative policy scenario for the G20 based on a mix of increasing wage share and public investment, before discussing the supply-side effects of rising inequality. The article concludes with some policy implications for equality-led development.

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INTRODUCTION

This article aims to contribute to the debate on global development in this Forum issue by bringing in the dimension of functional income distribution between labour and capital and its demand- and supply-side effects. The article by Horner and Hulme in this Debate section presents two important trends in terms of the changing geography of development, contrasting the fall in between-country inequalities and the rise in within-country inequalities. However, their measures of income inequality are primarily focused on personal income inequality and the striking trends in functional income distribution are mentioned only in passing.

Overall income has been growing but working people have not been getting their fair share in either the developed or the developing world. At the global level, there has been a dramatic decline in the share of wages in GDP since the 1980s. This global race to the bottom in the labour share has been a remarkably common trend across countries that are structurally very different, ranging from Europe to the USA, Japan, and emerging economies such as Brazil, Mexico, Turkey, South Africa, South Korea, India and China (Onaran and Galanis, 2014; Stockhammer, 2017). The redistribution of income away from wages towards profits has been a feature of the 'converging divergence' between labour and capital globally.

This class dimension is missing in the global convergence literature as well as in the piece by Horner and Hulme (this issue). This results in two important limitations in the policy debate on global development. First, the fall in the labour share has crucial consequences for barriers to global development and stability and is an important contributing factor to the 'converging divergence' in human development, which is not adequately acknowledged by Horner and Hulme. Wage-moderation policies have been advocated by international institutions and mainstream policy makers at the national level as a vehicle for development in both developing and developed parts of the world; however, there is a growing empirical literature suggesting that this has led not only to greater inequality but also to stagnation and volatility in demand and that it was one of the root causes of the 'great recession' that followed the global financial crisis.[1] Second, some of the major reasons behind the increasing divergence between labour and capital globally are not sufficiently addressed by Horner and Hulme, who give a brief mention to globalization, technological change, the rise in top

[1] See Goda et al. (2017) for a review of this literature.

executives' compensation and taxation and transfer policies as factors that contribute to rising inequalities, but make no reference to changes in the bargaining power between labour and capital related to institutional changes. A genuine debate about global development must go beyond these more or less obligatory remarks and must tackle the way that institutions and polices, implemented at the national level and advocated by international institutions such as the International Monetary Fund (IMF) or the World Bank, shaped the process of globalization and financialization leading to the divergence between labour and capital along with the global convergence between the North and the South. If international institutions and national governments wish to reverse the trends in economic instability that paved the way to the great recession, it is crucial to avoid technological determinism and to frame policies that tackle inequality between labour and capital. As increasing inequality and economic instability lead to growing disillusionment with political processes across the world, a broad analysis of alternative policies is essential to address the grievances of working people who feel, to an increasing extent, that globalization has not brought gains to them, but rather taken away whatever control they had over their lives.

In order to address the converging divergence between labour and capital globally, the following section summarizes the literature on the reasons behind the global fall in the labour share. The article then presents the demand-side effects of the declining wage share on growth, and summarizes the findings of an alternative policy scenario for the G20,[2] based on a mix of increasing wage share and public investment based on our previous research. Lastly, it discusses the supply-side effects of rising inequality, before concluding with some policy implications for equality-led development.

WHY HAS THERE BEEN A RACE TO THE BOTTOM IN THE LABOUR SHARE?

The literature on the causes of the fall in the wage share can be summarized around theses related to changes in technology vs. the relative bargaining power of labour and capital (Onaran and Guschanski, 2018). The former thesis suggests that changes in the production structure lie at the core of the decline in the labour share. These changes can be brought about either by technological change or globalization, and are considered to be independent of changes in the relative bargaining power between capital and labour. In contrast, the

[2] Membership of the Group of Twenty (G20) comprises 19 individual countries plus the European Union (EU).

bargaining power hypothesis, based on the political economy tradition, sees relative bargaining power between capital and labour as the determining factor of functional income distribution. Here, processes such as the erosion of labour unions, decline in public social protection spending, financialization and globalization play a crucial role.

Research by Onaran and Guschanski (2018) presents robust evidence of the effects of different measures of bargaining power on the labour share including union density, welfare state retrenchment, minimum wages, the female employment share, global value chains (trade in intermediate inputs) and financialization in both advanced and emerging economies. In contrast, the effects of measures reflecting technological change, such as capital intensity and total factor productivity, were not found to be robust: while there is some evidence for a negative impact from technological change on medium-skilled workers in advanced economies when using industry-level data, no such effect was found when using firm-level data. Furthermore, Onaran and Guschanski (ibid.) do not find a negative impact from technological change or trade-induced changes in capital intensity in emerging economies. These findings contrast with several papers in the mainstream (neoclassical/New Keynesian) tradition which emphasize the role of technological change (e.g. Bassanini and Manfredi, 2014; Bentolila and Saint-Paul, 2003; IMF, 2017; Karabarbounis and Neiman, 2014), while they confirm earlier research in the political economy tradition (e.g. ILO, 2011; Stockhammer, 2017).

The impact of the rise of global value chains on both advanced and emerging economies is particularly interesting. Indeed, at both ends of the global value chain — the offshoring of production away from advanced economies and the relocation towards emerging economies — there is a negative impact on the labour share (Onaran and Guschanski, 2018). Integration into global value chains in the form of increased exports of intermediate goods from the emerging economies to the advanced economies and increased imports of intermediate inputs by the advanced economies from the emerging economies, as well as financial globalization, led to a substantial decline in the wage share in both sets of countries. This implies that globalization has affected labour adversely worldwide through an increase in the bargaining power of capital.

THE DEMAND-SIDE EFFECTS OF WAGES AND EQUALITY-LED DEVELOPMENT

Neoliberal economic policies have seen wages as costs to businesses. The mainstream assumption is that when the wage share falls and the profit share increases, growth is boosted; investment by firms would then pick up, and exports would become more competitive thanks to lower labour costs. This thinking guides policies across the world which promote wage moderation. The main premise of these policies is to treat wages as a cost item. However, wages play a dual role in the economy: rising wages are both a cost to employers and a potential source for new sales. Post-Keynesian/post-Kaleckian models developed by Bhaduri and Marglin (1990), among others, bring the demand-side effect of wages into the analysis and allow for this dual role.

Onaran and Galanis (2014) present a global macroeconomic analysis building on this post-Keynesian/post-Kaleckian theory, and estimate the effect of income distribution on aggregate demand in the G20. Consumption is modelled as a function of wage and profit income, and is expected to decrease when the wage share decreases. As the majority of middle- and low-income people depend on wages, a decrease in the wage share implies a redistribution of income from middle- and low-income households to high-income households, who spend a lower share of their income than people at the bottom. Therefore, a decrease in the wage share decreases household consumption, which leads to a decline in the demand for goods and ultimately affects investment of the firms. Investment is estimated as a function of the profit share as well as demand: 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 labour costs, 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. Whether the negative effect of a lower wage share on consumption or the positive effect on investment and net exports is larger is an empirical question that depends on the structure of an economy, such as the difference in the propensity to consume out of wage and profit income, the sensitivity of investment to sales vs. profitability, the impact of labour costs on prices, labour intensity of production, sensitivity of exports and imports to domestic prices relative to foreign prices, and the importance of foreign markets relative to the size of the economy. If the total effect is negative, the demand regime is called wage-led; otherwise the regime is profit-led. Neoliberal 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.

Based on their global model, Onaran and Galanis (ibid.) calculate the effects of a simultaneous decline in wage share in the G20, that is, the responses of each country to changes in domestic income distribution and to trade partners' wage share. Three important findings emerge: first, domestic private demand (the sum of consumption and investment) is wage-led in all G20 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 do not suffice to offset the negative effects on domestic demand; third, even if some countries are profit-led, the global economy as a whole is wage-led. 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-neighbour policies cancel out the competitiveness advantages in each country and are counter-productive. In its *Global Wage Report 2012/13*, ILO (2013: 60) 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 national level, among the G20 economies, the USA, Japan, the UK, the Euro area as a whole, Germany, France, Italy, Turkey and South Korea (henceforth Korea) are wage-led. Canada and Australia are the only advanced countries that are profit-led. Among the emerging economies, Argentina, Mexico, China, India and South Africa are also profit-led; in these small open economies, distribution has a large effect on net exports.

At the global level, Onaran and Galanis (ibid.) find a race to the bottom in the wage share: that is, a simultaneous increase in the profit share by 1 percentage point in the major developed and developing countries leads to a 0.36 percentage decline in global GDP. Some profit-led countries, specifically Canada, India, Argentina and Mexico, also contract as a result 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. The wage-led economies contract more strongly in the case of a race to the bottom. Australia, South Africa and China are the only countries that can continue to grow despite a simultaneous decline in the wage share.

A global wage-led growth is economically feasible. Onaran and Galanis (ibid.) present an alternative scenario, in which both wage-led and profit-led countries can grow along with an improvement in the wage share, and the global GDP would increase by 3.05 per cent.

The microeconomic rationale of pro-capital changes in income distribution conflicts with the macroeconomic rationale. 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 employers, 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.

If an economy is wage-led, higher wage equality is likely to lead to higher growth. In that sense, wage-led growth can be more broadly defined as equality-led growth. Onaran, Oyvat and Fotopoulou (forthcoming, 2019) find that a higher degree of gender equality in wages and employment (that is, an increase in the female wage share in national income) leads to higher growth in the UK. Hence, growth is also gender-equality led.

What are the development policy implications of these findings? At the national level, if a country or an economic area is wage-led, such as Europe, the US, Korea or Turkey, low-road labour market policies that lead to a fall in the wage share are detrimental to growth. There is room for policies to decrease income inequality without hurting the growth potential of the economies. In economic areas with a high intra-regional trade and low extra-regional trade, macroeconomic and wage policy coordination can improve growth and employment. Europe is a good example of this, where the wage-moderation policy of the European Commission (EC, 2013) has not been conducive to growth.

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 some advanced and emerging economies including the US, UK, Spain, Ireland, Turkey and South Africa until the great recession. The current account deficits and debt in these countries were matched by an export-led model and current account surpluses of countries like Germany, Japan or China, where exports had to compensate for the deficiency in domestic demand due to the fall in labour's share. However, this model is also unsustainable as it could only co-exist with imbalances and debt accumulation in the other countries in the world.

THE ROLE OF PUBLIC INVESTMENT FOR EQUALITY-LED DEVELOPMENT

The positive effects of higher wages on demand are encouraging in the sense that equality is not an impediment to growth. However, the magnitude of the positive effects is economically small, particularly if implemented in only one country. Hence equality-led growth is not the silver bullet to achieve high levels of employment and development. The impact of policies for equality-led development would be substantially amplified if they were combined with policies to stimulate investment, in particular via targeted public investment in physical and social infrastructure — a point not discussed by Horner and Hulme (this issue).

Elsewhere (Onaran, 2014) I have presented the effects of a coordinated mix of policies in the G20 targeted to increase the share of wages in GDP over the next five years by 1–5 percentage points, depending on the country, and to raise public investment in social and physical infrastructure by 1 per cent of GDP in each country.[3] The impact of the increase in the wage share on growth varies in different countries according to the structure of their economies, notably their investment, and export and import shares. The proposed policy mix takes account of this by proposing differential increases in the wage share in GDP of between 1 and 5 percentage point according to the country over five years. Countries are subdivided into three groups, starting with countries where growth is predominantly wage-led including the Euro area, the UK, the US, Japan, Turkey and Korea. Increasing the share of wages in GDP by 5 percentage points in these countries could result in a wage-led growth offsetting any negative effects on net exports or private investment as the current characteristics of the economies indicate strong internal demand effects. The second group includes Canada, Mexico, Argentina and India, where the wage share could be increased by 3 per cent of GDP. While growth in these countries, when they are treated in isolation, is profit-led, a simultaneous increase in the wage share in the G20 (even at an equivalent amount in all countries) would lead to higher growth in these countries as well. Finally, in the third group, a modest increase in the wage share by 1 per cent of GDP in China, South Africa and Australia can be pursued as part of a coordinated policy package. In this last group, the effect

[3] The simulation in Onaran (2014) was prepared for the L20 at the G20 meeting in 2014. L20 brings together trade unions from the G20 countries.

of a rise in the wage share would have a more substantial impact on net exports, which at first sight would limit the policy space for wage increases. However, part of the policy mix is to raise public investment which in the short term would stimulate growth and in the medium term would lead to a rebalancing of these economies, making them less reliant on export demand, changing the structure of their exports towards less labour-intensive goods as well as goods with a lower price elasticity of demand in the medium term. This would help develop a more diversified economic structure, and thereby improve the potential for higher increases in living standards in the future.

The results for the G20 show that over a period of five years, an increase in the wage share by 1–5 percentage points in all G20 economies and a simultaneous increase in public investment by 1 per cent of GDP in each country could lead to GDP increases of 3.9–5.8 per cent in the G20, 9–13 per cent in Korea, and 6–8 per cent in Turkey (Onaran, 2014). The effects of both wage and fiscal policies are stronger if policies are implemented simultaneously in a large block due to strong positive spillover effects on demand.

Obst, Onaran and Nikolaidi (2017) take this analysis further by estimating the impact of a coordinated policy mix of a simultaneous increase in public investment by 1 per cent of GDP, along with more progressive taxation (increasing the effective tax burden on capital by 1 per cent and decreasing the tax burden on labour by 1 per cent), and an increase in the wage share by 1 per cent of GDP in the EU15. The result is 6.72 per cent higher GDP in the EU with positive effects in each country. Private investment also increases by 2.3 per cent as a ratio of GDP; that is, overall public spending does not crowd out but rather crowds in private investment despite a rise in tax rates on profits. Despite the rise in public spending, the budget balance in Europe as a whole improves (by 0.86 per cent as a ratio of GDP) because of the beneficial fiscal effects of higher economic growth and higher tax rates. Growth, private investment and budget balance improve both in the periphery and core countries of Europe. Hence, expansionary fiscal policy is sustainable when wage and public spending policies are combined with progressive tax policy; the impact is stronger when these policies are implemented in a coordinated fashion. Such a coordinated policy mix, along with a properly designed industrial policy, can ensure genuine regional convergence and social cohesion and open up space for equality-led development in the global economy overall.

EQUALITY-LED GROWTH, PUBLIC INVESTMENT AND THE SUPPLY SIDE

The negative effect of inequality on growth is also confirmed by recent research by international organizations such as the OECD and the IMF (Dabla-Norris et al., 2015; IMF, 2009; Foerster and Cingano, 2014; Ostry et al., 2014). The IMF, after promoting 'trickle down economics' for several decades, recently became outspoken in terms of its research, if not its policy position, about the negative impact of personal income inequality on growth. However, like Horner and Hulme (this issue), the IMF's focus is on personal income distribution, neglecting the inequality between labour and capital. Moreover, the effects work only over longer periods of time through supply-side effects. For example, increasing inequality is linked to lower growth via a worsening of access to education for low-income households, growing trade imbalances and a higher probability of financial crises. In contrast, the positive effect of higher equality (that is, higher wage share) on demand, as emphasized by post-Keynesian research, could boost growth immediately, demonstrating the importance of demand effects of wages.

The demand-led growth literature traditionally does not focus on supply-side factors. Hein and Tarassow (2010), Naastepad (2006), Seguino (2012) and Storm and Naastepad (2012) are notable exceptions, integrating the interaction of income distribution and productivity into demand-led growth models. Onaran et al. (forthcoming, 2019) integrate both the demand and supply sides, based on a two-sector model with social (health, social care, education, child care) and physical sectors, and analyse the short- and long-run impacts of income distribution, gender pay gap and fiscal policy on growth and employment in the UK. Changes in productivity in the long run depend on both supply- and demand-side factors, including private investment, public investment in physical infrastructure such as transport or information and communication technology and social infrastructure in education and health, household spending in the social sector, growth, and wages. Changes in productivity have crucial supply-side effects on profitability, investment, output and employment in the long run, while demand plays a role in affecting output and employment in both the short and the long run.

Neoliberal policies consider public spending as undesirable, even when financed by increased taxation, based on the myth that it leads to low private investment and low productivity in the long run. This assessment is both static and short-sighted as it ignores the positive impact of these policies on demand, productivity and investment. According to Onaran et al. (ibid.), a policy mix of increasing the share of wages in national income together with decreasing the gender pay gap via an upward convergence in women's and men's wages, along with increased public spending and progressive taxation, leads to very strong increase in employment of women as well as men in the UK. The multiplier effects of higher public spending, that is, the effects on GDP, are higher in the long run than in the short run. This is because, in the short term, the economy benefits from only the demand effects; productivity gains kick in only in the long term, further increasing profitability and stimulating investment and demand.

However, there is one crucial issue in the long term: as productivity increases, the demand for labour and thereby employment decreases for a given level of economic activity (Onaran et al., forthcoming, 2019; Storm and Naastepad, 2012). The impact of wage increases on growth is relatively small, albeit positive, while the impact on productivity is relatively large; therefore wage increases on their own without further demand-side policies are likely to lead to lower employment in the long run. For a significant impact on employment, public spending is likely to be the key to demand stimulus when the long-run effects on productivity are taken into account. Hence, we need to return to fiscal policy to make sure that demand is consistent with full employment. Additionally, to maintain high employment along with increasing productivity, policies to reduce weekly working hours and cut historical rates of productivity growth are the key for equitable development. The consequences of shorter working hours for equality are twofold. First, shorter hours — if implemented with wage compensation for lower wage earners (which means an increase in their hourly wages) — would entail a narrowing of wage gaps, including gender gaps. Second, a real shortening of working hours should help address domestic care needs and enable a better work–life balance with greater gender equality.

These findings have important policy implications if global development is to address some urgent, destabilizing economic and social issues in the world such as stagnation in productivity, unemployment, unhealthy growth driven by private debt, or demographic and care crises. An appropriate mix of labour market and fiscal policies tackling the multiple dimensions of inequalities can help to achieve a stable macroeconomic environment and genuine convergence.

POLICIES FOR EQUALITY-LED DEVELOPMENT

A new global development strategy that defines equality-led development as a key pillar can create a win-win situation, characterized by a radically fairer global economy and increased employment as well as productivity. This contribution has built on previous empirical research to conclude that increasing equality would lead to higher global growth and, when mixed with adequate public investment policies, higher employment and human development.

Changes in institutions and the bargaining power between capital and labour have been crucial in determining the fall in the wage share globally. Without acknowledging this global race to the bottom and its vicious consequences for development and stability, it is not possible to develop a comprehensive policy framework for global development. Rising inequality is not an unavoidable consequence of technological change and globalization. In particular, evidence of the negative impact of global value chains in both advanced and emerging economies has important policy implications, hinting at the importance of international coordination of labour unions and international organizations in creating a level playing field and achieving international labour standards across global value chains, to rebalance the bargaining relations between labour and multinational corporations (Onaran and Guschanski, 2018).

Bargaining institutions and policies can offset the negative impact of technological change and globalization on inequality and are key to reversing the global race to the bottom. If we ignore a major trend in the converging divergence between labour and capital globally, we cannot fully address the institutional and policy aspects behind the rise in inequalities within countries. This leaves policy makers with an agnostic and fatalist understanding of the impact of technology and globalization. An equality-led development model first requires stronger bargaining power for labour via an improvement in union legislation, regulating the labour market to tackle casualization and growing precarity, widening collective bargaining, and ensuring an active role for the state in institution building to facilitate sectoral bargaining structures (Onaran and Guschanski, 2018). At the bottom of the distribution pyramid, increasing statutory minimum wages and putting processes in place for the incremental increase of those minimum wages to the level of a living wage are crucial; this process can be facilitated further through the use of public contracts. As wage-led growth is also gender equality-led growth, improving and enforcing equal pay legislation and women’s representation in collective bargaining is key to leading this process through an upward convergence of income and employment. Finally, at the top of the distribution pyramid, enforcing pay ratios via public procurement criteria between top pay and the lowest paid at companies, in order to moderate excessive pay levels, is also an important ingredient of equality-led development.

All these labour market policies are more effective if they are embedded in macroeconomic policies aimed at ensuring full employment in order to rebalance both power relations and the structure of the economy. Increasing the social wage through higher public spending in public services and social security, restoring and strengthening the welfare state, supporting job creation and restructuring with a large public investment programme centred on physical investments and social infrastructure, are all key aspects of an equality-led macroeconomic strategy. The role of public investment for human development is remarkably notable by its absence, both in the global development debate and in the piece by Horner and Hulme (this issue).

Rebalancing growth via increasing equality and domestic demand in the emerging economies would also help to address global imbalances. However, this rebalancing can only take place in an international environment where the advanced countries not only leave space for developmentalist policies, and support technology transfer, but also create an expansionary global environment. Given the profit-led structures in many small, open developing countries, an equality-led development strategy could more easily be triggered by some large economies radically reversing their low-road labour market policies. While a coordinated global boost to wages might seem like wishful thinking, it is within the power of the advanced economies. The exact opposite has been happening in the last four decades of converging divergence between labour and capital globally, largely following coordinated policies by international institutions such as the IMF, World Bank or the EC. The research results discussed in this article clearly highlight the limits of strategies of international competitiveness based on wage competition in a highly integrated global economy. It is now incumbent on the advanced countries to reverse this trend. Global policy coordination for equality-led development can create space for domestic demand-led egalitarian growth rather than narrow export orientation based on low wages in the developing countries. If the developed countries fail to make such a move, South–South cooperation may offer an option for developing and emerging countries to thrive in a large bloc and avoid wage competition.

Last but not least, without moderating the process of financialization, the impact of policies as well as the policy space for global development will be limited. Implementing appropriately designed taxation and corporate governance that create incentives to decrease dividend payments and share buybacks, such as higher taxation of dividend payments and capital gains, and decoupling of executives' remuneration from share prices, are key policy tools for creating a more level playing field. Globally, taming financial globalization through adequate capital controls and a coordinated financial transaction tax would contribute to rebalancing the bargaining power of capital and labour.

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