Why Workers Lose*

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A long-acknowledged feature of global development since the 1970s is that in many countries—advanced and poor—those at the bottom of the income pyramid have benefited little, if at all, from whatever growth has occurred. One empirical outcome of that tendency has been a decline in the shares of labour in national income over time. While this has been noted earlier, it has become the focus of attention recently because of evidence of a popular backlash against globalisation as reflected in the Brexit vote in the United Kingdom, the Donald Trump victory in the United States, and the rise of Far-Right parties in Europe with an isolationist and xenophobic agenda.

With that backlash attributed, among other factors, to the asymmetric distribution of the benefits from growth, votaries of globalisation have been keen on disassociating trade and financial integration from distributional outcomes, ostensibly to stall a potential protectionist wave. In the words of International Monetary Fund (IMF) chief Christine Lagarde, there is a "sword of protectionism hanging over global trade", though "restricting trade would be a 'self-inflicted wound' that disrupts supply chains, hurts global output and inflates the prices of production materials and consumer goods".

But, something, everybody says, needs to be done to address gross inequalities. In a show of its own concern, the IMF, in a chapter of its latest World Economic Outlook, prepared for the spring meetings of the IMF and the World Bank, has attempted an analysis of the factors that underlie a long-term decline in the share of wages in national income in many countries since the 1980s. According to the data the IMF collated: "The global labour share of income began a downward trend in the 1980s, declining 5 percentage points to its trough in 2006. It has since then trended up by about 1.3 percentage points, which may reflect either cyclical or structural factors associated with the global financial crisis."

Thus, between 1991 and 2014, labour's share declined in 29 of the largest 50 economies, which accounted for about two-thirds of world gross domestic product (GDP) in the latter year. This decline need not have been worrying if productivity had been rising. If output per worker was rising fast, even a fall in wage share in output could be compatible with a rise in wage rates and earnings, though at a pace slower than productivity increase. But despite the much-proclaimed information and communications technology revolution, productivity growth has been low for decades in advanced nations, with occasional periods of growth being all too short. As far back as 1999, economists such as Robert Gordon had argued that in the U.S. there was "no productivity growth acceleration in the 99 per cent of the economy located outside the sector which manufactures computer hardware", and "when computers are stripped out of the durable manufacturing sector, there has been a further productivity slowdown in durable manufacturing in 1995-99 as compared to 1972-95". This trend has continued since then. Although between 1996 and 2004 productivity growth rose from a trend rate of 1.4 per cent in the immediately preceding period to 2.5 per cent a year, that revival did not last. According to Gordon, during 2004-12, labour productivity growth "slowed again to almost exactly the same rate as 1972-96, a mere 1.3 per cent per annum". Thus, to use the words of the IMF, "in a number of economies, declining labour shares result from the failure of product wage growth to keep up with weak productivity growth".

Capital replaces labour

At the centre of the IMF's analysis of the factors explaining this trend is a change in the relative price of capital and labour, encouraging the substitution of the latter with the former. To quote: "Technological progress, embodied in faster productivity growth in the capital goods sector relative to the rest of the economy, lowers the price of investment goods and thus induces firms to substitute capital for labour." If that happens, employment growth will fall short of output growth, leading to a decline in labour share.

This tendency is seen as more prevalent in developed countries because they are the sites for rapid advance of information and communications technology. That is seen as reducing the price of investment goods and affecting other sectors, contrary to what Gordon found. It is also seen as facilitating the automation of routine tasks as it "induces firms to disproportionately substitute capital for labour where the exposure to such tasks is larger". The two mechanisms are likely to interact: "[A] decline in the relative price of investment goods will trigger greater substitution away from labour, and this impact is likely more pronounced where labour performs more routine tasks." According to the IMF's analysis, about half of the total decline in labour shares can be traced to the impact of this substitution of labour by capital facilitated by technology. The tendency, it is argued, is more marked in advanced economies than in emerging markets and developing economies because "the former were more exposed to automation of routine tasks and experienced a larger fall in investment good prices than the latter".

Another factor explaining the decline in labour shares in developed countries is, of course, the offshoring of production to exploit locational advantages, especially lower wage costs in developing countries, facilitated by the segmentation of production processes and the collapse of communication and transportation costs. But this ostensibly occurs primarily in those industries where retaining production in high-wage economies is difficult because the potential for substitution of capital for labour is low and in which tasks have not been routinised in ways that encourage automation. It is the relocation of this set of relatively labour-intensive industries to lower-wage developing economies that accounts for offshoring's contribution to the reduction of the share of labour in national income.

Moreover, the IMF admits that relocation weakens labour's bargaining power, depresses wages and contributes to the fall in labour shares. Since the liberalisation of foreign investment rules facilitates global integration, this aspect of globalisation does have a negative impact on labour shares. But too much should not be made of this, says the IMF. Its decomposition exercise suggests that globally (with a few exceptions such as China) 90 per cent of the decline in labour shares is the result of within-industry declines rather than a shift in production in favour of industries with lower labour shares. That is, processes within individual industries seem to be depressing the share of wages and benefits to workers in the value of the product.

This could happen because of two kinds of influences. One is technological change and structural change, which can reduce the labour input required for the production of a commodity, contributing to a fall in the wage share in value. The other is factors such as migration of production, reduced unionisation and reduced labour demand across sectors, which can depress wages and adversely affect labour shares. With its focus on the former aspect, the burden of the IMF's argument is clear. It is not globalisation so much but the disruption caused by technological advance that explains the decline in labour shares. And policy should facilitate adjusting to that disruption through measures such as skill enhancement and education so that lower- and middle-skilled workers can look to the higher-skill occupations available in advanced countries in the new environment.

Finally, the IMF briefly notes that policy and institutional changes—fall in unionisation that affects the bargaining power of labour, corporate tax reductions that favour capital, and technological changes and deregulation that increase concentration and boost profits—can also have an impact on wage shares and distribution.

Flawed reasoning

Among the many difficulties one can have with the IMF's reasoning, some are worth underlining. One is the emphasis on substitution of capital for labour driven by changes in the relative prices of these "factors', or a cheapening of capital relative to labour. This assumes that there are enough products with alternative technologies that favour significant shifts in capital or labour intensity in their production. It also assumes that there is an exogenously given relative price of capital with respect to labour in response to which firms make decisions on choice of technology. There are significant conceptual and empirical issues with these presumptions that make them unwarranted, as noted extensively in the literature.

In any case, in most areas for products of similar technical and quality characteristics, the extent to which technology of any generation offers substantial options to adjust the mix of capital and labour that can be used for production is extremely limited. So reducing labour displacement and increasing labour absorption requires adjusting the product mix, which implies a shift in the pattern of demand. In general, within manufacturing per se, among countries with similar per capita incomes, those with less inequality are likely to be characterised by demand patterns that favour industrialisation that is less top heavy and more labour absorbing. To suggest that irrespective of product mix, mere changes in the relative prices of capital and labour can deliver significantly different capital intensities and employment outcomes flies in the face of empirical evidence to the contrary.

If product mix does matter, then the statement that within-industry changes are responsible for as much as 90 per cent of the reduction in labour share as a result of lower labour use is problematic. What is more, if the argument is that global integration results in the offshoring of labour-intensive processes that are not amenable to shifts in capital intensity, then there will be certain industries that will be offshored and others that will not, resulting in a strong association between domestic production patterns and labour share trends.

The really serious omission in the analysis is the complete disregard of the rise in the share of the financial sector in GDP in advanced countries. The period covered by the IMF study was one in which the share of the financial sector in income and wealth and the ratio of financial profits to non-financial corporate profits were on the rise. A substantial part of the increase in income and wealth was because of asset price inflation and the resulting capital gains. This led to a significant increase in the share of profits in national income and, therefore a decline in the share of wages in income. This, interestingly, hardly receives any attention in the discussion in World Economic Outlook. Here again the intention seems to be to avoid discussion of trends resulting from deregulation and liberalisation for an understanding of the huge increase in inequality during the years of globalisation.

All of these problems with the IMF's analysis obviously affect its assessment of why developing countries as a group are also characterised by a decline in labour shares despite the migration of production to them. The IMF advances three central arguments as part of this assessment. First, since the processes relocated from developed to developing countries are those in which capital is not easily substituted for labour, the large reserve army of labour in these countries and their much lower wage rate cannot make much of a difference to capital or labour intensity in the industries concerned. That is, while advanced countries benefit from the substitution of capital for labour, developing countries cannot since in their case possible combinations of capital and labour in relocated industries are more or less fixed. So labour absorption into these activities is limited and, therefore, their contribution to improving labour shares in income is restricted. Since tasks offshored as a result of global integration will also reflect this limited possibility of substitution of capital for labour, increased participation in global value chains under globalisation will only increase capital intensity and lower labour income shares.

Financial liberalisation

Finally, financial integration is also seen as raising capital intensity and reducing labour shares. This is because "by increasing access to capital, financial integration lowers the cost of capital in capital-scarce countries, facilitating capital deepening and potentially inducing greater substitution of capital for labour". So it is not just inflexible technology but flexible ones that permit substitution of capital for labour that hurts workers in poor countries. All postulates favour the IMF's argument that technological factors account for the plight of labour. But not the evidence. Note, there is no reference here to the displacement of domestic production after trade and investment liberalisation as a result of the import competition and entry of foreign firms with capital-intensive technologies. No attention is paid to the effect that financial liberalisation in developing countries has on fiscal policy, with the emphasis on curtailing expenditure in order to reduce the fiscal deficit, which slows growth in income and employment. And, last but not least, the feedback effects of the rising share of surplus in national income on employment and labour share, because of the depressing effects it has on demand and growth, are completely ignored.

Overall, the IMF's aim is to delink the disturbing long-term decline in the share of labour in national income from the rise of finance, the turn to neoliberalism and the kind of globalisation that results. Any reaction against these has to be reversed, as Christine Lagarde insists, resulting in a set of banal prescriptions on how to deal with a problem that is at the centre of the crisis of capitalism today.

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