The Economist

Pay and economic growth

A shrinking slice

Labour’s share of national income has fallen. The right remedy is to help workers, not punish firms

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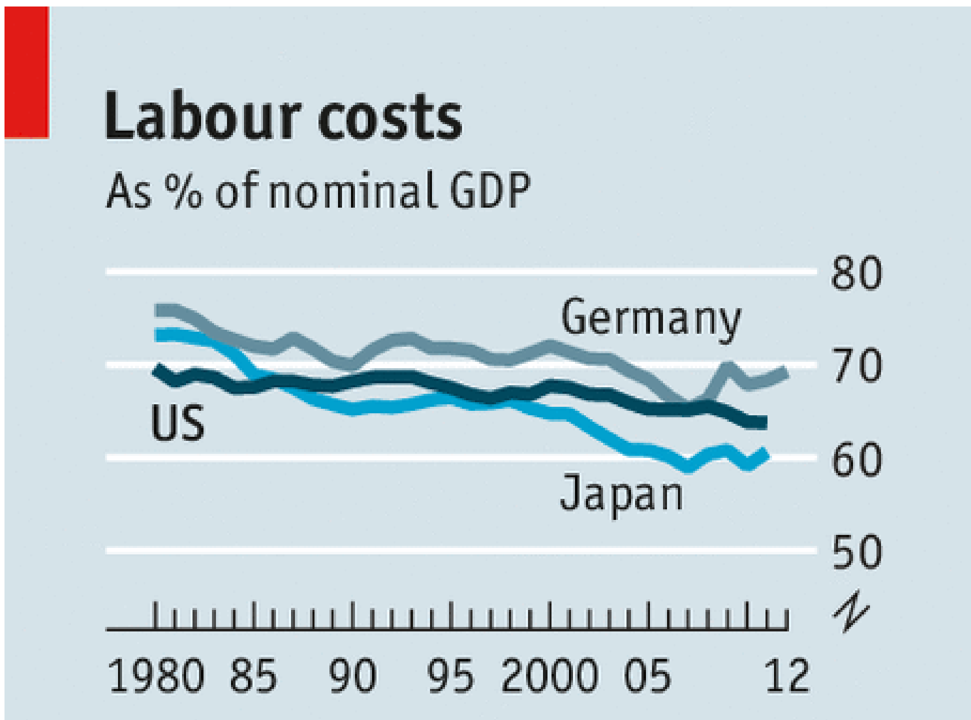

IMAGINE the proceeds of economic output as a pie, crudely divided between the wages earned by workers and the returns accrued to the owners of capital, whether as profits, rents or interest income. Until the early 1980s the relative sizes of those slices were so stable that their constancy became an economic rule of thumb. Much of modern macroeconomics simply assumes the shares remain the same. That stability provides the link between productivity and prosperity. If workers always get the same slice of the economic pie, then an improvement in their average productivity—which boosts growth—should translate into higher average earnings.

More recently, however, economics textbooks have been almost the only places where labour’s share of national income remains constant. Over the past 30 years, the workers’ take from the pie has shrunk across the globe (see article (http://www.economist.com/news/finance-and-economics/21588900-all-around-world-labour-losing-out-capital-labour-pains)). In America, their wages used to make up almost 70% of GDP; now the figure is 64%, according to the OECD. Some of the biggest declines have been egalitarian societies such as Norway (where labour’s share has fallen from 64% in 1980 to 55% now) and Sweden (down from 74% in 1980 to 65% now). A drop has also occurred in many emerging markets, particularly in Asia.

The scale and breadth of this squeeze are striking. And the consequences are ugly. Since capital tends to be owned by richer households, a rising share of national income going to capital worsens inequality. In countries where the gap in wages between high earners and the rest has also increased, the two effects compound each other. In America, the share of national income going to the bottom 99% of workers has fallen from 60% before the 1980s to 50%. When growth is sluggish, as it is now, these shifts mean that most workers are getting a smaller morsel of a smaller slice of a slow-growing pie.

Politically, that is dangerous, and it is producing a lot of predictably polarised debate. The left blames fat-cat firms and the weakness of unions for workers' declining share. Those on the right, if they acknowledge a problem at all, argue that the fault lies with big government and high taxes.

These explanations are hard to square with the fact that the shrinkage in labour's share of the pie has occurred in so many countries, with widely differing levels of unionisation and sizes of government. Indeed, studies comparing the trends in different countries' labour markets suggest that the sorts of things politicians argue about, from corporate-governance rules to trade-union laws, are not what really count here. Bigger global forces seem to be at work. Innovation, especially in information technology, has dramatically increased the wages of workers with the skills to harness it, while hitting others. It has also squeezed labour's overall share of the pie, as firms substitute ever-cheaper machines for less-skilled workers. Some economists also emphasise the role of globalisation, especially trade with China, in adding to the pinch.

All this points to the sorts of things policymakers can do to help. They should focus on improving the prospects of the low-paid and low-skilled. And they should aim to spread capital's gains more widely.

The goal should be to strengthen workers without hamstringing firms. Growth, rather than employment protection, is the priority. More work means a stronger labour market, which would bid up employees' slice, as it did in America in the 1990s when unemployment was at record lows. But even in a growing economy a worker competing with a machine can lose out. So education and training need a reboot too: a greater emphasis on technical subjects, from maths to mechanics, would help ensure that more workers are not replaced by machines but design and operate them.

The charms of popular capitalism

Other sensible reforms may seem counterintuitive. A cut in corporate tax rates is one: combined with a narrowing of the difference between tax rates on individuals' income from capital and from labour (which is often more heavily taxed), the result would be a more efficient system that promoted economic growth, and thus jobs. Policymakers could also think more creatively about broadening capital ownership, whether through pension reform or more privatisation. Paradoxical as it may sound, a good antidote to labour's falling share of national income would be to boost ordinary workers' share of capital.

From the print edition: Leaders