Policies under profit-led and wage-led economies

Orthodox macroeconomic models put more emphasis on the supply side of the economy and presume that demand follows supply. In this regard, it is customary in orthodox analysis to treat wages as just a cost of production and neglect that wages are also a source of demand.

Definition 1. An aggregate demand regime is wage-led when a rise in the wage share (or a fall in the profit share) increases aggregate demand.

Demand is wage-led if the increase in consumption resulting from a rise in the real wage (or a rise in the wage share or a fall in the profit share) more than compensates the reduction in private investment and exports caused by a higher real wage. Conversely, the decrease in consumption resulting from a fall in the real wage exceeds the increase in private investment and exports that may follow a lower real wage.

Definition 2. An aggregate demand regime is profit-led when a rise in the profit share (or a reduction in the wage share) increases aggregate demand.

Demand is profit-led if the reduction in consumption resulting from a fall in the real wage (or a fall in the wage share or a rise in the profit share) is more than compensated by an increase in private investment and exports derived from a lower real wage. Conversely, the increase in consumption resulting from a rise in the real wage does not compensate the presumed contraction in private investment and exports derived from a higher real wage. It follows from Definitions 1 and 2 that:

- an increase in the wage share expands aggregate demand if the demand regime is wage-led;
- an increase in the wage share contracts aggregate demand if the demand regime is profit-led;
- an increase in the profit share expands aggregate demand if the demand regime is profit-led;
- an increase in the profit share contracts aggregate demand if the demand regime is wage-led.

The four components of aggregate demand are private consumption expenditure C, private investment expenditure I, government expenditure G, and net exports (NX, exports minus imports). The domestic components of aggregate demand are C, I, and G. Since G can be considered essentially as exogenous, to determine the domestic demand regime it is enough to assess how a change in income distribution affects C and I. The orthodox presumption is that income distribution plays no role in establishing aggregate demand, since the proportion of income that is consumed (the propensity to consume) out of wages is supposed to be the same as the proportion consumed out of profits.

Empirical evidence suggests that the propensity to consume (save) out of profits is smaller (higher) than the propensity to consume (save) out of wages. In this case, a shift in income distribution towards wages will increases consumption. But is this favourable effect on aggregate demand overturned by the negative impact of a higher wage rate on on private investment?

• **View 1** (Michaeł Kalecki). An increase in the wage share is not detrimental to investment because investment depends on expected profitability, which to a great extent depends on realized profitability (sales). Investment is seen as the result of an accelerator effect: the multiplier effect ($\uparrow$I $\Rightarrow$ $\uparrow$AD $\Rightarrow$ $\uparrow$Y) is reinforced by the accelerator effect $\uparrow$Y $\Rightarrow$ $\uparrow$I arising from the fact that an expanding economy stimulates further investment (as previous investment proved to be profitable).

• **View 2** (Marxists). Expected profitability is a function of the profit share in aggregate income or, more precisely, of the profit rate firms expect to obtain from its productive capacity under normal circumstances. With everyting else given, higher real wages are paid off the profit margin. As a result, a higher real wage lowers profitability and this reduces investment.

Under View 1, the domestic demand regime is wage-led: an increase in the wage share also increases aggregate consumption and investment. Under View 2, the domestic demand regime could be profit-led: an increase in the wage share would reduce the sum of aggregate consumption and investment whenever the change in consumption is smaller than the change in investment.

	Effects of national increase in profit share on:					Effect of worldwide increase in profit share on aggregate demand
	C/Y	I/Y	NX/Y	private excess demand/Y	aggregate demand	
	A	B	C	D (A+B+C)	E	G
Euro area-12	−0.439	0.299	0.057	−0.084	−0.133	−0.245
Germany	−0.501	0.376	0.096	−0.029	−0.031	-
France	−0.305	0.088	0.198	−0.020	−0.027	-
Italy	−0.356	0.130	0.126	−0.100	−0.173	-
United Kingdom	−0.303	0.120	0.158	−0.025	−0.030	−0.214
United States	−0.426	0.000	0.037	−0.388	−0.808	−0.921
Japan	−0.353	0.284	0.055	−0.014	−0.034	−0.179
Canada	−0.326	0.182	0.266	0.122	0.148	−0.269
Australia	−0.256	0.174	0.272	0.190	0.268	0.172
Turkey	−0.491	0.000	0.283	−0.208	−0.459	−0.717
Mexico	−0.438	0.153	0.381	0.096	0.106	−0.111
Korea, Rep. of	−0.422	0.000	0.359	−0.063	−0.115	−0.864
Argentina	−0.153	0.015	0.192	0.054	0.075	−0.103
China	−0.412	0.000	1.986	1.574	1.932	1.115
India	−0.291	0.000	0.310	0.018	0.040	−0.027
South Africa	−0.145	0.129	0.506	0.490	0.729	0.390

To establish the total demand regime the effect on net exports of a change in the wage share should be determined. With constant export prices, a wage raise may render some exports unprofitable; and if a raise in export prices accompany the wage raise, some exports may turn uncompetitive. In sum, an increase in the wage share is detrimental to exports and net exports (as a wage share raise promotes imports). The table on the left (M. Lavoie and E. Stockhammer (2013): *Wage-led growth*, p. 31) provides evidence of demand regimes.

The world economy is a closed economy. Thus, while an economy can expand demand by exporting more, it is not possible that all economies expand their demands by exporting more. If an economy enjoys a profit-led demand regime, a wage cut will have an expansive effect on aggregate demand. But if all economies restrain wages, the total effect on demand could be regressive, leading to a world-wide recession. Conversely, if wages are increased (or taxes on wages are reduced) in all economies, even if some of them have profit-led demand regimes, the world effect on demand could be positive if the domestic demand of the profit-led ones is wage-led. Recent empirical studies indicate that the world economy appears to be wage-led.

Remark 3. Empirical evidence suggests that the demand regime of most European countries (Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Spain, Sweden, United Kindgom) is wage-led. The demand regime of Japan and the United States appears to be profit-led.

Definition 4 (informal). An economy is profit-led (or the economy is in a profit-led economic regime) if a shift towards profits has a favourable effect on the economy. An economy is wage-led (the economy is in a wage-led economic regime) if a shift towards wages has a favourable effect on the economy.

A wage-led economy poses a serious challenge to orthodox economics. This "wisdom" recommends austerity policies (which, in requiring a reduction of public expenditure, adversely affect the recipients of the lowest wages) and "structural reforms" (euphemism for "wage cuts"). The application of those measures in a wage-led economy has a negative impact on economic activity. This negative impact worsens the budget deficit (so governments are told to deepen and pursue further austerity policies) and renews the call for more structural reforms (inasmuch as wage reduction are deemed insufficient). The result is a devilish spiral of austerity policies, structural reforms, and contraction of economic activity, as seen in recent years in Spain. The obvious alternative to the orthodox medicine in a wage-led economy is to implement a wage-led growth strategy. This strategy will be even more successful if coordinated internationally, given that the world economy is most likely to be wage-led.

Definition 5. A pro-capital distributional policy is a policy that reduces the wage share in aggregate income. A pro-labour distributional policy is one that result in an increase in the wage share.

> "Pro-capital distributional policies (…) include measures that weaken collective bargaining institutions (by granting exceptions to bargaining coverage), labour unions (for example, by changing strike laws) and employment protection legislation, as well as measures (or lack of measures) that lead to lower minimum wages. There are also measures that alter the secondary income distribution in favour of profits and the rich (…) Ultimately, pro-capital policies impose wage moderation. Pro-labour policies, in contrast, are often referred to as policies that strengthen the welfare state, labour market institutions, labour unions, and the ability to engage in collective bargaining (…). All else being equal, with a pro-labour distributional policy, the wage share will remain constant or will increase over the long run, as real wages grow in line with labour productivity or exceed productivity. By contrast, in the case of a pro-capital distributional policy, real wages will not grow as fast as labour productivity."
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> Marc Lavoie; Engelbert Stockhammer (2013): *Wage-led Growth: Concept, Theories and Policies*, chapter 1.

		Distributional policies and strategies	
		Pro-capital	**Pro-labour**
Economic regime	**Profit-led**	'Neoliberalism in theory' Trickle-down capitalism	'Doomed social reforms' (TINA)
	Wage-led	'Neoliberalism in practice' – Unstable, has to rely on exogenous growth drivers (debt-led growth or export-led growth)	Social Keynesianism Post-war Golden Age

Fig. 1. Economic regime, pro-capital policies, and pro-labour policies, *Wage-led Growth*, p. 20

Fig. 1 identifies the four scenarios that arise from the combination of economic regimes (profit-led or wage-led) with redistribution policies (pro-capital or pro-labour).

• <u>Pro-capital policies in a profit-led economy lead to a profit-led growth process</u>. This scenario is associated with trickle-down economics, as policies that favour entrepreneurs are presumed to lead to an expansion, with workers eventually benefiting from wage cuts as higher profit margins induce entrepreneurs to increase productive capacity and more employment.

• <u>Pro-labour policies in a wage-led economy lead to a wage-led growth process</u>. This scenario seems to characterize the interval 1945-1970s: the expansion of the welfare state in advanced economies led to an age of growth with rising real wages and labour productivity that benefited workers and entrepreneurs.

• <u>Pro-labour policies in a profit-led economy generate stagnation or unstable growth</u>. In this context, social reforms are doomed to fail. This is the situation that neoliberals presume that occurs when progressive social reforms are implemented and would correspond to the 'there is no alternative' (TINA) scenario: it is futile to try to conduct policies favouring workers because they are inconsistent with the nature of the economic regime and will eventually have to be abandoned.

• <u>Pro-capital policies in a wage-led economy generate stagnation or unstable growth</u>. This is described as 'neoliberalism in practice' insofar as a couple of decades of pro-capital policies (1980s-2000s) has resulted in more inequality and disapointing economic growth in comparison with the 1945-1970s period. Pro-capital policies have been complemented by an excessive reliance on the financial sector (debt-led growth) and/or on foreign demand (export-led growth). Such a reliance has produced economic and financial instability.