Executive Summary

International Labour Organization

Wage-led Growth

An equitable strategy for economic recovery

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This new volume is the final product of a joint ILO research project that investigates inequality, wage developments and their impact on the economy. It proposes a wage-led growth strategy and will be useful to both future researchers and policy-makers.

The book examines the causes and the consequences of falling wage shares and rising income inequality, notably on aggregate demand and labour productivity. It provides new empirical and econometric evidence regarding the economic causes and potential impact of changing income distribution. It also provides policy strategies and the policy implications of a wage-led recovery that would alleviate the global problems that have been associated with rising household debt needed to sustain consumption expenditures and with the new mercantilist policies based on wage moderation.

Wage-led Growth goes beyond the microeconomic view of wage growth as a cost that has negative consequences on the firm. It considers instead its positive macroeconomic dynamics as wages are a major source of aggregate demand. Wage growth can generate demand growth and productivity growth, and hence create a virtuous circle. Insufficient wage growth, and more broadly the polarization of income distribution, have contributed to the global economic crisis.

This book is particularly timely in view of the existing downward pressures on wage growth, throughout the world and in Europe in particular. The European Commission has included the growth rate of nominal unit labour costs among its 11 scorecard indicators which measure macroeconomic imbalances and which can eventually lead to sanctions against Euro area members. The Commission has imposed upper thresholds on this growth rate, but no lower thresholds, and it has recently criticized a number of countries for having overly high minimum wages. In the eyes of the authors, these types of policies will further dampen wage growth and are thus likely to worsen the outlook for a global economic recovery.

Causes of the declining wage share

Wage growth has lagged behind productivity growth and inflation for several decades now. As a result, wage shares have fallen. The book presents new evidence on the causes for this, which shows that financialization, welfare state retrenchment and globalization have been the main drivers. Contrary to widespread perception, technological changes have not played an important role.

The favourable effects of wage increases on aggregate demand

Perhaps the most striking empirical result of the book is that in all G-20 countries a 1 percentage point increase in the wage share of a country has a positive impact on the domestic demand of that country (meaning here consumption and investment activity). For instance, a 1 percentage point increase in the wage share within the Eurozone area leads to a 0.14 percentage point increase in domestic demand. This positive effect on GDP becomes smaller when the effects on external demand (exports minus imports) are taken into account. The same occurs when an increase in the wage share of individual European countries are being examined, and for other countries such as the United States, Japan, Turkey and the Republic of Korea.

There are some countries where an individual increase in the wage share generates a negative impact on the sum of domestic and external demand, due to its detrimental effect on net exports: Canada, Australia, Argentina, India, South Africa and especially China are in this regime. What the study shows, however, is that this negative effect on GDP gets reversed to a positive effect in Canada, Mexico, Argentina and India when it is instead assumed that the one percentage point increase in the wage share occurs simultaneously in all G-20 countries. The impact of such a coordinated increase in the wage share is a 0.36 percentage point increase in the overall GDP of all G-20 countries, which represent more than 80 per cent of world GDP. A wage-led strategy is a viable economic policy for a world-wide economic recovery.

The favourable impact of wage increases on labour productivity

An increase in the wage share has a favourable impact that goes beyond that of aggregate demand and economic activity. Faster growth in real wages induces positive effects on the growth rate of labour productivity. Real wages have two effects on productivity growth: first, a direct effect, as higher real wages induce firms to introduce more productive methods of production so as to safeguard their profits; secondly, an indirect impact, which arises because higher real wages often induce higher aggregate demand, as pointed out earlier, with the change in the growth rate of aggregate demand feeding a change, of the same sign, in the growth rate of labour productivity. A wage-led strategy thus also has favourable supply-side effects. Slow growth in real wages may give the illusion that the labour market is functioning well, as was the case with the "Dutch employment miracle" of the 1980s and 1990s, and even in the early 2000s, but this is because high employment is caused by low labour productivity, associated with stagnant living standards. A better alternative is a policy of real-wage growth, accompanied by a macroeconomic commitment to full employment.

Income inequality and macroeconomic imbalances

The book also provides a case study of the consequences of rising income inequalities in three countries – the United States, China and Germany – which together represent nearly 40 per cent of global GDP. These three countries have also been associated with large (and different) macroeconomic imbalances. The study shows that the labour supply, saving and financing decisions of private households are to a considerable extent affected by changes in income distribution, although the precise household responses depend on such factors as the deepness and regulation of the credit markets, the quality of the social safety net, the educational system (private versus public financing), the functioning of the labour market (internal versus external flexibility), workers' qualifications (specific/vocational skills versus general skills) and the reactivity of monetary and fiscal policies to cyclical unemployment. The rising income inequality in the United States has led to a change in the consumption and borrowing behaviour of US households. By contrast, in China and Germany, rising income inequality and greater job insecurity have induced households to save more.

A global Keynesian New Deal

While rising income inequality and large global imbalances are important causes of the global financial recession, there is also a third factor: the increased financialization of the economy, associated with the inefficient regulation of financial markets. These three trends have generated unsustainable economic strategies, based on debt-led consumption booms and on export-led mercantilist policies. The book discusses a broad economic policy package, highlighting that a wage-led growth strategy should be part of a Global Keynesian New Deal so as to achieve a long-run stable and equitable recovery. The wage-led growth strategy requires enhanced trade union bargaining power, a reduction of managerial overheads and of profit claims of financial wealth holders, as well as the downsizing of the profit-intensive financial sector. More generally, the New Deal requires first, proper regulation of the financial sector in order to prevent future financial excesses; second, the reorientation of macroeconomic policies towards stimulating and stabilizing domestic demand, in particular in the current account surplus countries; and third, the reconstruction of international macroeconomic policy coordination and a new world financial order along the lines of Keynes's international clearing union, so as to discourage countries from adopting export-led mercantilist policies based on low wages or low wage growth.

Wage-led growth as an alternative to neoliberalism

One may wonder whether it is really possible to reverse the current trend of rising profit shares and rising income inequality, or whether we must sit still and accept the “There is No Alternative” (TINA) slogan? The book shows that changes in income distribution have been driven by globalization, financialization and welfare-state retrenchment rather than by technology. These developments can be influenced by economic policy. Wage growth can stimulate aggregate demand and productivity growth. The Global Keynesian New Deal offers a vision on how to achieve this.