POLICY BRIEF

GREENWICH POLITICAL ECONOMY RESEARCH CENTRE

The empirical case for a wage-led recovery policy for Europe

Özlem Onaran
University of Greenwich

Thomas Obst
University of Greenwich

No. PB05-2015

UNIVERSITY of GREENWICH

The empirical case for a wage-led recovery policy for Europe[1]

The Europe 2020 strategy of the European Commission (EC) as well as the national reform and stability programmes attribute a central role to wage moderation policies. Real wage growth below productivity growth and policies to deregulate the labour market in order to achieve this are recommended to increase the international competitiveness of the EU. However, the track record of these policies in the last three decades has been poor growth performance along with a declining share of wages in national income and rising inequality. Our results of a new project for the Foundation for European Progressive Studies (FEPS) show that the EC policy of wage moderation is counter-productive, and leads to a stagnation in growth, risk of deflation, and destabilizing growth models driven by debt or export surpluses in the absence of a healthy growth in wages.

Our approach highlights the role of wages as a source of demand, and not only a cost item. ***Overall, a simultaneous decline in the wage share by 1 percentage point in all countries leads to a decline in the EU15 GDP by 0.30%. The negative effect of the simultaneous race to the bottom on growth ranges between 0.07% in Ireland and 1.03% in Greece.***

We estimate the effects of a decline in the wage share on domestic consumption, private investment, domestic prices, export prices, exports, and imports in the EU15 countries. In all countries, consumption decreases, since workers consume more as a proportion of their income compared to those who earn profit income. Second, private investment is not very responsive to the increase in profits, but responds strongly to demand; when the wage share is decreased in all the EU15 countries, investment decreases in the majority of the countries (the UK, Germany, Spain, Greece, Austria, Portugal, Finland, Luxembourg). In countries such as Ireland, France, Italy, the Netherlands, and Sweden the increase in investment due to higher profits remains insufficient to offset the negative effects on domestic consumption. Third, net exports (exports minus imports) increase due to a fall in unit labour costs, but again in the vast majority of countries, this increase is not enough to offset the negative effect on domestic demand.

Our findings show that the EU15 as a whole is a wage-led economy; i.e. a fall in the wage share leads to lower growth. Large economies such as the UK, Germany, France, Italy, and Spain as well

[1] Acknowledgements: This paper has received funding from the Foundation of European Progressive Studies, TASC, and Irish Congress of Trade Unions for the project titled "Wage-Led Growth in Europe? Demand Effects of Changes in Functional Income Distribution in Financialised Open Economies."

as some small economies such as Greece, Portugal, Sweden, Finland, the Netherlands, and Luxemburg are wage-led. Four small economies, Ireland, Austria, Belgium and Denmark, are profit-led in isolation, i.e. they could grow along with a rise in the profit share, if they are the only countries doing this. However, it is misleading to analyse the EU Member States (MS) in isolation, since the same wage moderation policies have been implemented in all countries simultaneously. The EU is a rather closed economy with low extra-EU trade and high intra-EU trade; hence a fall in the wage share in Europe as a whole has only moderate positive effects on trade balances, but it has substantial negative effects on domestic demand. When wages change simultaneously in all the EU15 countries, the export prices of each country relative to the other countries change little. "Beggar thy neighbour" policies through wage suppression in the EU15 lead to strong negative effects on domestic demand, which cannot be offset by the international competitiveness effects. Hence not only the wage-led countries but also the profit-led countries such as Ireland and Austria contract as an outcome of wage restraint policies. Greece, albeit a small open economy, is affected most strongly as a combination of four factors: domestic consumption falls strongly; private investment does not respond to higher profits; exports are not very sensitive to labour costs; and imports do not react to the fall in labour costs at all.

These results are in striking contrast to the expectations of neoclassical economics, which forms the theoretical basis of the wage restraint policies of the EC, which assumes that all our economies and Europe as a whole is profit-led. This is empirically not true.

In a wage-led economy like the EU as a whole, more egalitarian policies are consistent with growth. In Table 1, we suggest a wage-led recovery scenario, where all EU15 countries increase their wage share during 2016-2020, albeit at differentiated rates, with a 5%-point cumulative increase in the wage-led countries in the next five years, a 3%-point increase in the intermediate group of Ireland and Austria, which become wage-led when there is a simultaneous change in wages, and a 1%-point increase in Belgium and Denmark, which remain profit-led also in the race to the bottom scenario. In this scenario, all individual EU15 countries can grow along with an improvement in equality, and the overall EU15 GDP would be 1.51% higher in 2020.

Table 1: ***The effects of a wage-led recovery scenario on growth***

	Increase in the wage share	% change in GDP
A	3	1.15
B	1	0.27
DK	1	0.44
FIN	5	1.49
F	5	1.12
D	5	2.2
GR	5	5.12
IRL	3	0.33
I	5	1.18
L	5	0.64
NL	5	0.95
P	5	2.38
E	5	2.71
S	5	1.28
UK	5	0.96
EU 15 GDP*		1.51

Notes: A = Austria, B = Belgium, DK = Denmark, FIN = Finland, F = France, D = Germany, GR = Greece, IRL = Ireland, I = Italy, L = Luxembourg, NL = Netherlands, P = Portugal, E = Spain, S = Sweden, UK = United Kingdom
* EU15 GDP is calculated by multiplying country specific growth rates with the weighted share of each country in EU15 GDP.

- A COORDINATED WAGE-LED RECOVERY POLICY CAN LEAD TO 1.51% HIGHER GDP IN THE EU15 IN 2020

- TO DEFEAT DEFLATION EUROPE NEEDS A PAY RISE: THE WAGE-LED RECOVERY LEADS TO 1.2 PERCENTAGE POINT INCREASE IN INFLATION

This wage-led recovery scenario will lead to only a modest 1.2 percentage point increase in inflation in the EU15. In light of a risk of deflation in the Eurozone our findings indicate that a wage stimulus in the EU15 would help the ECB approach its inflation target. This alternative scenario would be consistent with an annual nominal wage increase of 3.1% in the EU15 on average (assuming a 0.7% annual increase in labour productivity).

Wage policy coordination among the EU Member States (MS) can improve macroeconomic performance as well as avoid reliance on unsustainable growth models driven by debt or export surpluses to substitute deficient domestic demand. While pro-labour policies can also be implemented in a single country in particular in the wage-led economies, the impact of these policies is stronger when they are coordinated, and provide opportunities to avoid reliance on wage competition in even small economies such as Ireland or Austria. Indeed, Ireland and Austria cannot grow along with a decline in the wage share, when wage moderation policies are implemented in all the EU MS.

However, the effects that can come from a wage-led recovery on growth and hence employment are modest, albeit positive, in magnitude; hence it is crucial that policies for wage-led development are complemented by a broad mix of economic policies, in particular public investment in social and physical infrastructure. The impact of wage increases on trade imbalances across countries require further targeted investment and industrial policy at the European level.

About the authors:

Ozlem Onaran is Professor of Workforce and Economic Development Policy and Director of the Greenwich Political Economy Research Centre at the University of Greenwich.
Thomas Obst is a PhD Candidate at the University of Greenwich.