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Income distribution and aggregate demand
A global Post-Keynesian model

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The dramatic decline in the share of wages in GDP in both the developed and developing world during the neoliberal era of the post-1980s has accompanied lower growth rates at the global level as well as in many countries. Mainstream economics continue to guide policy towards further wage moderation along with austerity as one of the major responses to the Great Recession. This decades' long race to the bottom creates a vicious cycle. The main caveat of this common wisdom is to treat wages merely as a cost item. However, in reality wages have a dual role affecting not just costs but also demand.

In our recent paper, we work with a post-Keynesian/post-Kaleckian model, which allows this dual role, and estimate the effect of a change in income distribution on aggregate demand (i.e. on consumption, investment, and net exports) in the G20 countries. If the total effect is negative, the demand regime is called wage-led; otherwise the regime is profit-led.

Three important findings emerge: First, domestic private demand (i.e. the sum of consumption and investment) is wage-led in all countries, because consumption is much more sensitive to an increase in the profit share than is investment. Second, foreign trade forms only a small part of aggregate demand in large countries, and therefore the positive effects of a decline in the wage share on net exports do not suffice to offset the negative effects on domestic demand. Similarly, in the Euro area as a whole, consisting of countries with strong trade relations with each other and a low trade volume with countries outside Europe, the private demand regime is wage-led. Finally, even if there are some countries, which are profit-led, *the planet earth as a whole is wage-led*. This makes intuitively sense; because what we find is that planet earth is a closed economy as long as we are not trading with Mars, not just yet! A simultaneous wage cut in a highly integrated global economy leaves most countries with only the negative domestic demand effects, and the global economy contracts. Furthermore some profit-led countries contract when they decrease their wage-share, if a similar strategy is implemented also by their trading partners. Beggar thy neighbor policies cancel out the competitiveness advantages in each country and are counter-productive.

At the national level, the US, Japan, the UK, the Euro area, Germany, France, Italy, Turkey and Korea are wage-led. Canada, Australia, Argentina, Mexico, China, India, and South Africa are profit-led. However, Canada, India, Argentina, and Mexico also contract as an outcome of a race to the bottom. The expansionary effects of a pro-capital redistribution of income in these countries are reversed when relative competitiveness effects are reduced as all countries implement a similar low wage competition strategy; this consequently leads to a fall in the GDP of the rest of the world as well as import prices.

The microeconomic rationale of pro-capital redistribution conflicts with the macroeconomic outcomes.

At the national level, if a country is wage-led, pro-capital redistribution of income is detrimental to growth. There is room for policies to decrease income inequality without hurting the growth potential of the economies.

For the large wage-led economic areas with a high intra-regional trade and low extra-regional trade, like the Euro area, macroeconomic and wage policy coordination can improve growth and employment. The wage moderation policy of the Euro area is not conducive to growth.

A global wage-led recovery, to put an end to both the unsustainable debt-led consumption and export-led beggar thy neighbor models, as a way out of the global recession is economically feasible. Growth and an improvement in equality are consistent. We present a scenario, where all countries can grow along with an improvement in the wage share, and the global GDP would increase by 3.05%.

The austerity policies with further detrimental effects on the wage shares since 2010 will only bring further stagnation.

Strengthening the bargaining power of labor unions via an improvement in union legislation, increasing the coverage of collective bargaining, increasing the social wage via public goods and social security, establishing sufficiently high minimum wages, and leveling the global playground through international labor standards are the key elements in creating the balance of power relations in favor of a wage-led global recovery.

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