A smaller share of a smaller pie

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Stagnant wages are at the heart of political developments in many western countries. That is obvious in an immediate sense, for example, in the US, where the "left-behind" have brought Donald Trump to power, and in the UK, where renewed wage squeezes have put additional pressure on an already fractured politics. But it is also a long-term political challenge. The extent to which the incomes of typical workers have decoupled from the overall growth of the economy during the past few decades matters enormously for what sort of political programmes are either possible or desirable.

In the US, the divergence between labour productivity and typical worker pay has been particularly salient. As we have discussed earlier, the divergence is milder in some other places, which do not see (or at least not to the same degree) the US double evolution toward a lower labour share of aggregate income and much greater inequality of labour income itself.

But clearly wherever this pattern holds, a question for policymakers is how to interpret it and what to do about it. In the US until now, the loudest narrative has been that workers are no longer reaping the fruits of growth as they used to, and so the focus should shift to distribution and inequality rather than overall productivity growth.

Now Anna Stansbury and Lawrence Summers argue that this is the wrong way of looking at things. In a new paper, they examine the relationship between changes in productivity and changes in typical workers' pay over one- to five-year time spans in the post-1948 US economy, and find that the relationship holds up well. As Summers puts it in an interview, it would be wrong to shift policy attention from growth to inequality. This is because in their research, whenever productivity does tick up, so do wages (and vice versa). The longer-term failure of wages to keep up, they argue, should be attributed not to a "delinkage" of productivity from pay, but to other forces that have held wage growth back. Given those forces, it remains the case that if productivity could be made to grow faster, wages would too.

While an extremely useful contribution, there are several odd things about the research. One is that it finds that the "linkage" between productivity and pay has been much *stronger* since 1973 than it was before (and indeed that it was vanishingly weak before 1973). This flies so much in the face of the overwhelming impression of the immediate postwar decades that until it receives a satisfactory explanation we should suspend belief in the other results.

Another oddity lies in the authors' suggested interpretation. Even at face value, their results show that at least for non-managers, only one-half to two-thirds of a productivity increase feeds through to wage increases. That already sounds like quite a bit of "delinkage" to be explained. The political importance of this is that it erodes the postwar social contract exemplified in, for example, the Treaty of Detroit, according to which the full rate of productivity growth should be reaped by workers in their pay packages.

And the question for economists is whether there is a particular economic mechanism through which the nature of the productivity growth has changed so as to withhold more of its rewards from workers. That would certainly merit the label "delinkage". And there are several likely candidates.

Gene Grossman, Elhanan Helpman, Ezra Oberfield and Thomas Sampson have just published theoretical research showing how slowing productivity growth (which can have many reasons) could directly lead to a lower labour share of national income. The idea is that slower productivity growth leads to lower interest rates (because there is less demand for savings), which allows workers to invest more and more patiently in their schooling and skills. Put together this means that as workers dutifully boost their human capital, physical capital becomes relatively scarce, which pushes down the price of labour relative to capital.

An alternative explanation is that reduced competition (and its flip side, increased monopoly profits) at the same time harms productivity and the labour share of income. We have formerly discussed how in theory, fatter price margins by companies can hurt workers and productivity. Jason Furman, who led Barack Obama's Council of Economic Advisers, has long looked at evidence that this is taking place. He and Peter Orszag (in research presented at the same conference as that of Stansbury and Summers) now argue that this common-cause argument is the right way to look at things: "Reduced [business] dynamism and reduced competition can cause [both] lower productivity and inequality" — with the root causes including higher barriers to competition due to changes in economic structure (such as network effects in the digital economy), market institutions (the same investors owning competing businesses) and policies (more professional licensing requirements).

These are not either/or matters. Boosting productivity can be seen as good for its own sake even if workers' rewards are less than they used to be; and one can care about restoring the link between productivity and wages regardless of the rate of growth. But the main insight is surely the both/and aspect: it may well be the same policy measures that will both bring back long-term growth and its linkage to workers' pay.