What is behind the decline in living standards?

The Economist, Mar 24th 2011

ARE you better off than you were two years ago? Although the economic recovery in the developed world is almost two years old, the average Westerner would probably answer “No”. The authorities have applied shock and awe in the form of fiscal and monetary stimulus. They have prevented the complete collapse of the financial sector—bankers’ pay has certainly held up just fine. The corporate sector is also doing well. Even if banks are excluded, the profits of S&P 500 companies were up by 18.7% last year, says Morgan Stanley. But the benefits of recovery seem to have been distributed almost entirely to the owners of capital rather than workers. In America total real wages have risen by $168 billion since the recovery began, but that has been far outstripped by a $528 billion jump in profits. Dhaval Joshi of BCA Research reckons that this is the first time profits have outperformed wages in absolute terms in 50 years.

In Germany profits have increased by €113 billion ($159 billion) since the start of the recovery, and employee pay has risen by just €36 billion. Things look even worse for workers in Britain, where profits have risen by £14 billion ($22.7 billion) but aggregate real wages have fallen by £2 billion. A study by the Institute for Fiscal Studies, a think-tank, found that the median British household had suffered the biggest three-year fall in real living standards since the early 1980s.

Are these trends a belated vindication of Karl Marx? The bearded wonder wrote in “Das Kapital” that: “It follows therefore that in proportion as capital accumulates, the situation of the worker, be his payment high or low, must grow worse.” But Marx also predicted a decline in profit margins in capitalism’s dying throes, suggesting some confusion in his analysis.

A more positive view of this divergence between capital and wages is that developed economies had become too dependent on consumption and had to switch to an export- and investment-led model. That was the view of Mervyn King, the governor of the Bank of England, when he said in January that “the squeeze in living standards is the inevitable price to pay for the financial crisis and subsequent rebalancing of the world and UK economies.”

That reasoning might work for Britain and America. But it is hard to apply to Germany, where unit labour costs have been held down for a decade and where, if the economy does need to be rebalanced, it is arguably in favour of consumption.

There is also a longer-term trend to explain. Wages still account for a much greater slice of income than profits, but labour’s share has been in decline across the OECD since 1980. The gap has been particularly marked in America: productivity rose by 83% between 1973 and 2007, but male median real wages rose by just 5%.

The decline in labour’s share has also been accompanied by an increased inequality of incomes, something that economists have struggled for years to explain. Mean wages, which include the earnings of chief executives and sports stars, have risen much faster than the median. This premium for “talent” may reflect globalisation as the elite are able to move to the countries where their skills are most appreciated. Or it may reflect changes in technology, which have generated outsize rewards for those people most able to take advantage of them.

An alternative explanation has been to blame the decline in trade-union membership. In the 1960s and 1970s powerful unions in manufacturing industries like cars were able to demand higher wages. But high-paying blue-collar jobs have been in decline since then. John Van Reenen, the director of the Centre for Economic Performance at the London School of Economics, reckons that privatisation has also led to a decline in labour’s share of the cake. Managers of newly privatised industries tend to lay off workers as their focus shifts from empire-building to profit maximisation.

One factor that should perhaps get more emphasis is the role of the financial sector. Central banks have repeatedly cut or held down interest rates over the past 25 years in an attempt to boost bank profits and prop up asset prices. With this subsidy in place, is it surprising that earnings in finance have outpaced wages for other technologically skilled jobs?

Attempts to remove that subsidy are met by threats from international banks to move elsewhere. This is a little reminiscent of the protection rackets run by the gangsters in Mario Puzo’s “The Godfather”. It is as if the finance sector is saying: “Nice economy you got there. Shame if anything should happen to it.”