Labour's revenge

What happens to US corporate profits if the labour share of income is normalised?

Torgeir Høien, 27 June 2017

According to the Bible, "a workman is worthy of his hire" and according to economists his hire equals his marginal product. Since the end of 2001, US labourers have in all likelihood captured less than their biblical share of income. The increase in labour's marginal productivity, as measured by the growth of labour's average productivity, has been faster than the increase in labour compensation.[1] As a consequence the labour share of income has dropped. Hence the US has been through a period of abnormally high profits per dollar of output. Recently, though, maybe due to divine interference, wage rates have begun to increase faster than productivity. What is the outlook for profits if workmen's hire is equalized to marginal products?

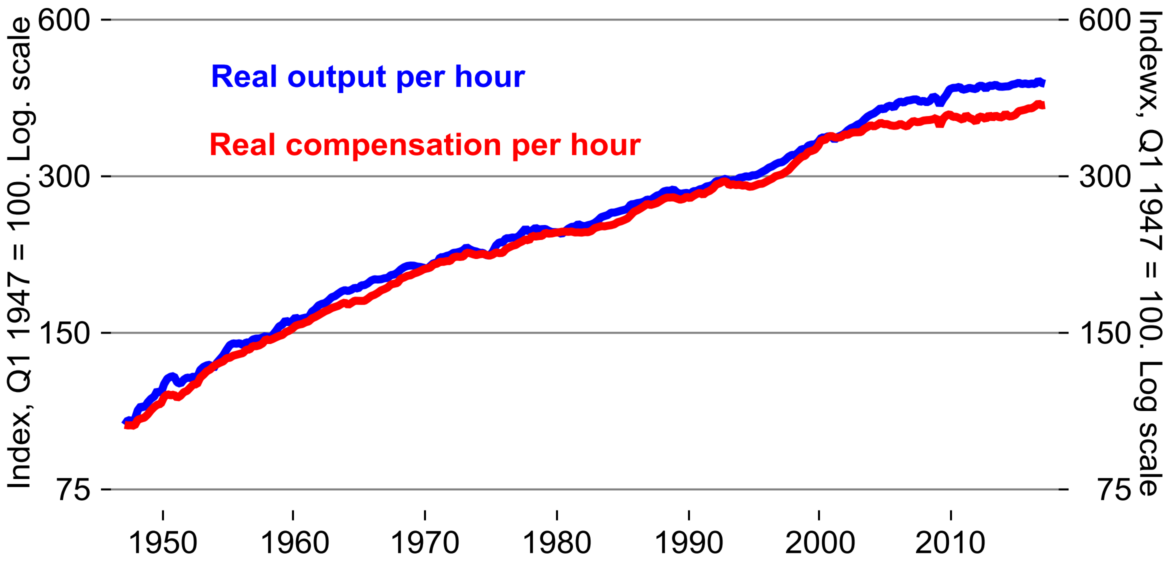
The chart below shows the development in average productivity and real compensation per hour in nonfinancial corporations.[2] This sector accounts for 50 percent of US GDP. The two time series had equal growth rates from Q1 1947 to Q4 2001. But from then on productivity began to grow faster than labour compensation. Productivity increased 24.2 percent from Q4 2001 to Q3 2014, while wages increased 9.3 percent.[3]

[1] Labour compensation includes wages, benefits and employer contributions to social insurance.

[2] Output and labour compensation is deflated by the price index for output from nonfinancial corporations.

[3] The numbers are about the same for the whole business sector, which accounts for 75 percent of GDP. I focus on nonfinancial corporations since US statistical offices provide more comprehensive data for this sector.

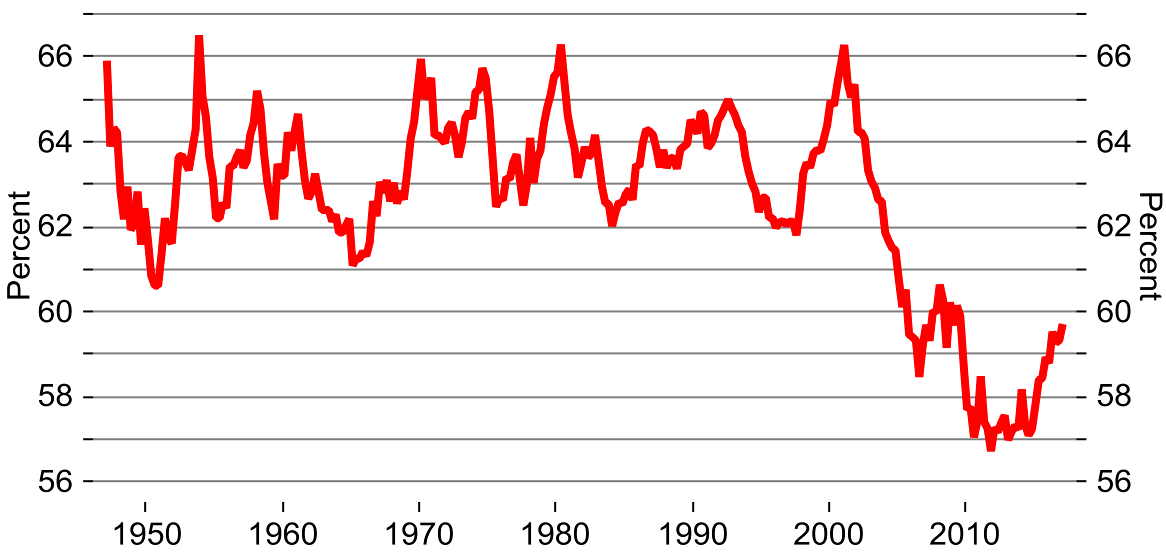
Productivity and labor compensation in nonfinancial corporations



Sources: BLS and Skagen

When labour compensation growth lags productivity growth, the labour share of income falls. From Q1 1947 to Q4 2001 the labour share of income from nonfinancial corporations was on average 63.5 percent. The share has sometimes deviated from its average, but the sharp drop after 2001 is unprecedented. At its lowest level, in Q3 2014, the labour share was 57.1 percent, 10 percent lower than its 1947 to 2001 average.[4]

Labor's share of income from nonfinancial corporations



Sources: BEA and Skagen

[4] The development in productivity, labour compensation and the labour share of value added was almost identical in the broader business sector.

Several hypotheses have been put forward regarding the divergent development of compensation and productivity. The culprit may have been a lack of competition for labour. If an increasing number of industries consist of fewer firms, competitive pressure might be insufficient to ensure that the earnings are equalized to marginal products. With monopsony a part of profits may be monopoly rent, not a reward for savings and risk-taking. Note that technological innovations can create greater product heterogeneity and effectively increase the amount of industries. Also, new regulations may have created higher barriers to entry. Another possibility is that labour's *marginal* productivity may have increased less rapidly than labour's *average* productivity. Globalization, i.e. the tighter integration of product markets across countries, which accelerated when China became a member of the WTO in December 2001, may *de facto* have integrated the markets for some kinds of labour. But other large and small open economies – I have checked the Eurozone and Norway using numbers that are comparable to the US statistics, suggest that this effect is small. In these two other economies real hourly labour compensation in the private financial sector has grown at about the same rate as average labour productivity since 2001.

Since Q3 2014, due to more intense competition (or an exhaustion of the globalization effect), labour compensation has begun to grow more rapidly than productivity. From Q3 2014 to Q1 2017, real labour compensation per hour in nonfinancial corporations was up 5.1 percent while average productivity increased 0.3 percent. This lifted the labour share of income to 59.1 percent in Q1 2017.[5]

Suppose that the post-millennial episode was an anomaly and the labour share will revert back to its pre-2002 average. Assume also that the speed of adjustment matches what has been observed since Q3 2014. This means that it will take close to 4 years to bring that share of income back to its pre-2002 average. Note that the rate of productivity growth is irrelevant for this adjustment process. What is important is the growth of labour compensation *relative* to productivity growth. If productivity growth speeds up, labour compensation growth has to be correspondingly higher in order to generate a labour ratio that is in line with its long-term average.

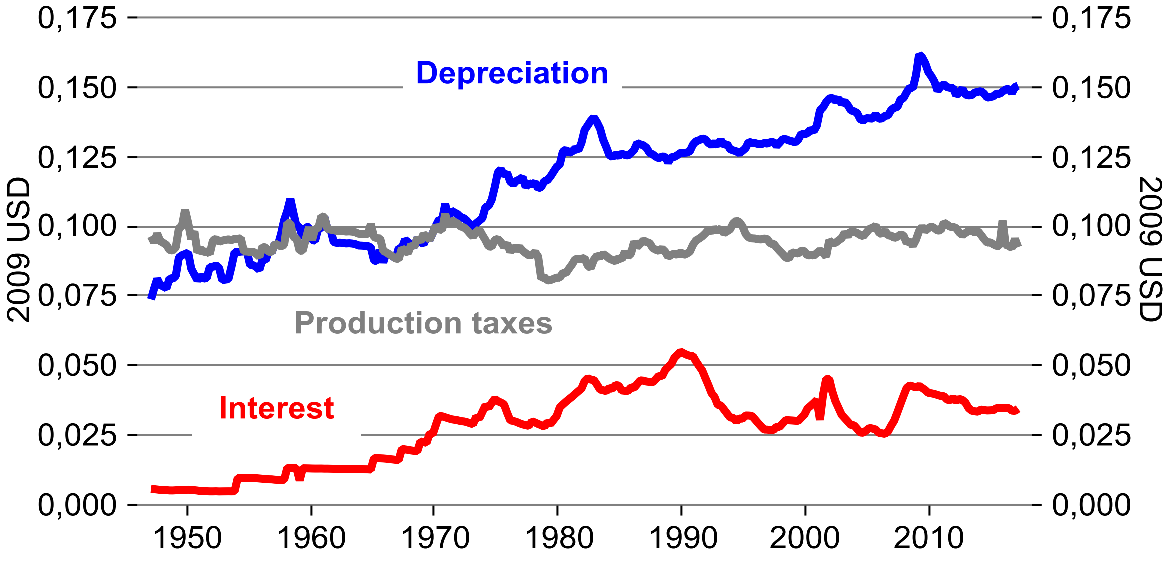
With low inflation, signs of an uptick in wage growth have recently attracted a great deal of attention. What is often overlooked, however, is that wage growth might be totally unrelated to movements in the general price level. If real wages have become too low relative to labour productivity, then a spike in nominal wages might not signal increased consumer goods inflation. If the labour share is about to be normalized, an increase in nominal labour unit costs cannot be matched by a corresponding increase in consumer prices. For what is needed is a rise in real unit labour costs. Thus high wage inflation might not herald an end of "lowflation".

What happens to real unit profits if the labour share is normalized? Real unit profits are the amount of cents earned by equity owners per constant dollar of output. In addition to wages, real unit profits depend upon depreciation, interest, and production taxes. The

[5] The wider business sector saw the same reversal of the labour share. In Q1 2017, the labour share in the business sector was 58.4 percent, up from 56 percent in Q3 2014.

chart below shows that increased depreciation and interest costs caused real unit profits to trend downwards from 1947 to 2001. Depreciation and interest costs have been somewhat volatile. However, from Q4 2001 to Q3 2014, real non-labour unit costs just fell 1 cent, and since Q3 2014 they were up less than 1 cent. Thus, the major impact on real unit profits since 2001 has been movements in real unit labour costs.

Non-labor real unit costs in nonfinancial corporations

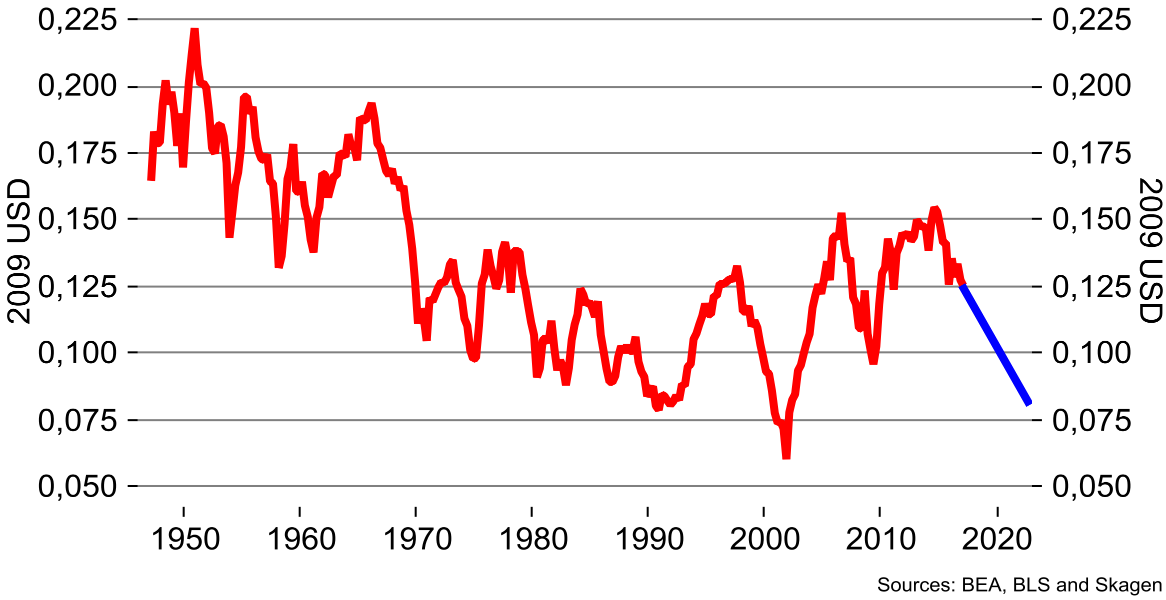


Sources: BEA, BLS and Skagen

From Q4 2001 to Q3 2014, real unit profits rose from 6 cents to 15.5 cents. Since Q3 2014 real unit profits have declined to 12.5 cents. A further decline is in the pipeline if the labour share of income is about to be normalized. Suppose that real labour unit costs rise from 59.1 cents to 63.5 cents by Q1 2021, as assumed above. If non-labour real unit costs do not change, real unit profits would then drop to 8.1 cents. That is 35.2 percent lower than its current level.[6]

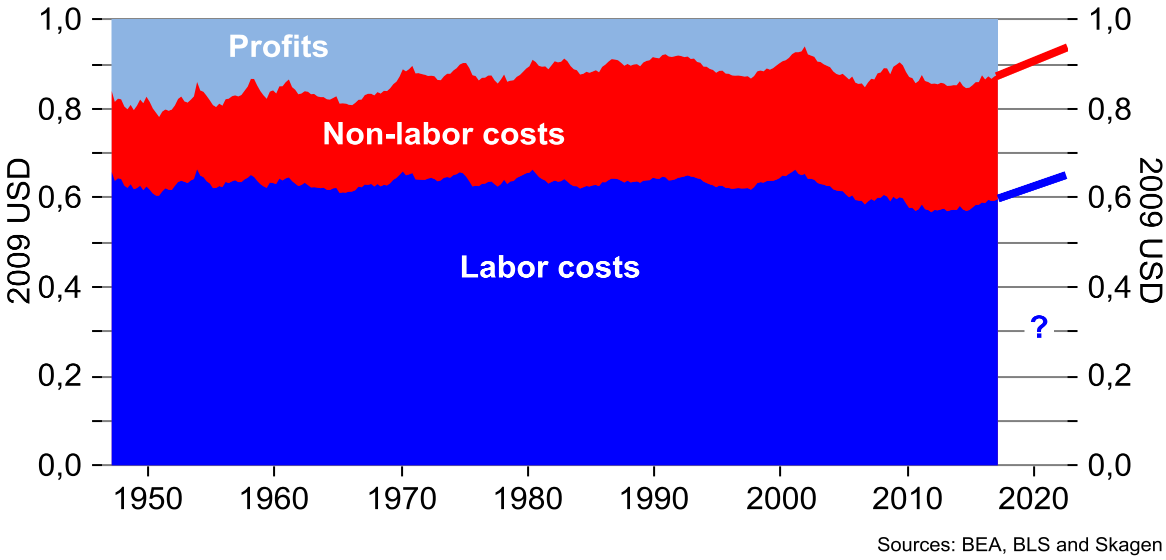
[6] Aggregate real profits of course also depend upon the amount of output produced.

Real unit profits in nonfinancial corporations



The next chart does not add new information, but might show more intuitively where each dollar of real value added went – and where it may go.

Costs and profits per dollar of value-added in nonfinancial corporations



Since it is not obvious what caused the labour share of income to begin to drop in 2001, it is difficult to predict its future level. It is by no means certain that the labour share will revert to its 1947-2001 average. And if it does, the speed of adjustment might differ to what has been observed over the last two years. What I have done is to illustrate a potential, but plausible, scenario for unit profits in the US in the years ahead.