



# Capitalism and labor shares: A cross-country panel study



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## ABSTRACT

We examine the empirical relationship between the institutions of economic freedom and labor shares in a panel of up to 93 countries covering 1970 through 2009. We find that a standard deviation increase in the Fraser Institute's Economic Freedom of the World (EFW) score is associated with about a 1/3 standard deviation increase in a country's labor share. Starting from the sample mean labor share in our panel, this amounts to about 4.26 percentage points. This relationship is robust to considering OECD and non-OECD samples separately. It is also (both qualitatively and quantitatively) robust to controlling for differences in human capital levels, labor productivity, trade union density, and international economic flows. Breaking the EFW into its individual component areas, the regulation of credit, business and labor appears to be the most important source of the positive EFW–labor share relationship.

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*The directing motive, the end and aim of capitalist production, is to extract the greatest possible amount of surplus value, and consequently to exploit labor-power to the greatest possible extent.*

[Karl Marx, *Capital* (V. I, Ch. 13)]

*Capitalist production, therefore, develops technology, and the combining together of various processes into a social whole, only by sapping the original sources of all wealth — the soil and the labourer.*

[Karl Marx, *Capital* (V. I, Ch. 15)]

*The produce of the earth—all that is derived from its surface by the united application of labour, machinery and capital, is divided among three classes of the community; namely, the proprietor of land, the owner of stock or capital necessary for its cultivation, and labourers by whose industry it is cultivated. [...] To determine the laws which regulate this distribution, is the principal problem in Political Economy[.]*

[David Ricardo, *On the Principles of Political Economy, and Taxation* (preface)]

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## 1. Introduction

Most economists would use the term *capitalism* in reference to an economic system where resources are allocated through free exchange against a backdrop of well-defined and enforced private property rights. The term is somewhat unfortunate in that it connotes favoritism towards a specific “class”—namely, the *capitalists*; presumably at the expense of their workers. But this is not surprising. The use of the word in reference to an economic system originated with socialist historians.<sup>3</sup> It is perhaps more felicitous to refer to a system of *economic freedom*.

For many, however, capitalism by any other name would smell as foul, and the whiff of favoritism towards capital has by no means passed away with Marx. Take for example the political scientist Ollman (2007, p. 28) who claims that “capitalists [...] do not make a necessary ‘material’ contribution to the production of wealth[;] there is no good reason that they should take [...] any of the wealth, power and status that goes with owning capital.”<sup>4</sup> Similarly, the political philosophers Hardt and Negri (2009, p. 383) espouse “struggles against capitalist exploitation, the rule of property, and the destroyers of the common[.]” Outside of ivory towers, labor leader James P. Hoffa (2011) proclaims that “[s]ome of the most trusted institutions in the world are finally awakening to the dangers of unrestrained global capitalism. [...] The reason for integrating regional economies into global networks has always been to shift power away from workers.”

While such views may be far removed from those of mainstream economists, an empirical question still remains: does capitalism favor capital over labor? One straightforward way to address this question is to ask whether or not more economic freedom leads to a smaller share of production being paid out as wages, salaries, and benefits. *Does more capitalism lead to a smaller labor share of income?* We find it surprising that, to our knowledge, there are no empirical studies that address this question.

We fill this void using an unbalanced panel of data on 93 countries covering up to 39 years (1970 through 2009). Fig. 1 provides an informal look at the relationship between countries’ Economic Freedom of the World (EFW) index values Gwartney, Hall, and Lawson (2012) and their labor shares using this data. The first panel (left) is a scatter plot where all 93 countries are represented. The second panel (center) and third panels (right) are based on OECD countries and non-OECD countries respectively.<sup>5</sup> All of these plots include best-fit OLS lines, but even without them positive relationships between the two variables are apparent in each of the three cases.

Of course, there are several reasons why an interpretation of the relationships in Fig. 1 as causal is suspect. There are undoubtedly other variables that are correlated with both labor shares and economic freedom, such that economic freedom is an endogenous regressor in a simple bivariate regression. We deal with this endogeneity in several ways. First, we derive an empirical framework from production theory. Although neoclassical production theory does not explicitly model the role of institutions, it compactly summarizes the role of technology and factors of production in a relationship between labor share and the capital-to-output ratio. The capital-output ratio is included in all of our specifications (along with the per capita GDP level and an index of democracy). Second, in most specifications we include period fixed effects to control for variation over time in omitted variables. Third, we check the robustness of the labor share/economic freedom to various control variables, including proxies for human capital levels, labor productivity, trade union density, agriculture and manufacturing shares, and international trade and investment flows. Finally, we introduce a plausible identification strategy that employs lagged values of institutional quality measures as instruments in two-stage least squares (2SLS) estimation.

We report that a standard deviation increase in the economic freedom of the world (EFW) index is associated with about 1/3 of a standard deviation increase in a country’s labor share. If our identification strategy is valid, the 2SLS estimated effect is over 1/3 of a standard deviation increase in labor share. Starting from the mean labor share in our sample, this is an increase of over 4.3 percentage points.

The positive correlation between economic freedom and labor shares is robust to all of the additional controls that we list above. The correlation is also larger for non-OECD countries. Breaking down the EFW into its five constituent area indices, those relating to *freedom to trade internationally* and the *regulations of credit, business, and labor* appear to drive the results. Alternatively, by itself the *size of government* index is negatively related to labor shares. A smaller value of this index implies, among other things, a larger share of government enterprises in the economy. One possible interpretation of the estimated relationship between this index and labor shares is that it is indicative of redistributive policies under the guise of compensation to government employees. The estimated effect of the size of government index becomes small and statistically insignificant when we employ 2SLS.

Why is a cross-country study of capitalism and labor shares interesting? Even if one disagrees with David Ricardo’s characterization of the “principal problem in Political Economy”, our research complements numerous previous studies reporting that economic freedom correlates with higher rates of economic growth. Examples include papers by Ayal and Karras (1998), Dawson

<sup>3</sup> The term first appeared in this context in writings of Pierre-Joseph Proudhon and Lousi Blanc (Braudel, 1979, p. 237).

<sup>4</sup> Ollman refers to Marx’s demonstration of the above as one of his “greatest achievements”.

<sup>5</sup> In this paper we define our OECD sample as member countries as of 1973. With New Zealand’s addition in 1973 there the OECD numbered 24 countries. There were no additions for over 20 years (until Mexico in 1994). Since our panel is divided into 5-year intervals, this choice of OECD sample ensures that all included countries were OECD members during all of the panel observations.

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