

Eco L3 - Globalization, Inequality, and Redistribution

Lecture 3: Inequality between labor and capital

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Roadmap

1. Factor shares in a Cobb-Douglas world
2. Factor shares with CES production
3. The role of institutions and bargaining power

1 Factor shares in a Cobb-Douglas world

1.1 Definition of factor shares

- Capital income = all income flows going to capital owners (independently of any labor input)
- Labor income = all income flows going to labor earners (independently of any K input)
- Caveat: In practice, frontier between capital and labor can be fuzzy

1.2 The Cobb-Douglas production function

- Cobb-Douglas production function: $Y = F(K, L) = K^\alpha L^{1-\alpha}$
- With perfect competition, wage rate v = marginal product of labor, rate of return r = marginal product of capital:

$$r = F_K = \alpha K^{\alpha-1} L^{1-\alpha} \quad \text{and} \quad v = F_L = (1 - \alpha) K^\alpha L^{-\alpha}$$

- So capital income $Y_K = rK = \alpha Y$ and labor income $Y_L = vL = (1 - \alpha)Y$
- Capital and labor shares are entirely set by technology and do not depend on quantities of capital and labor

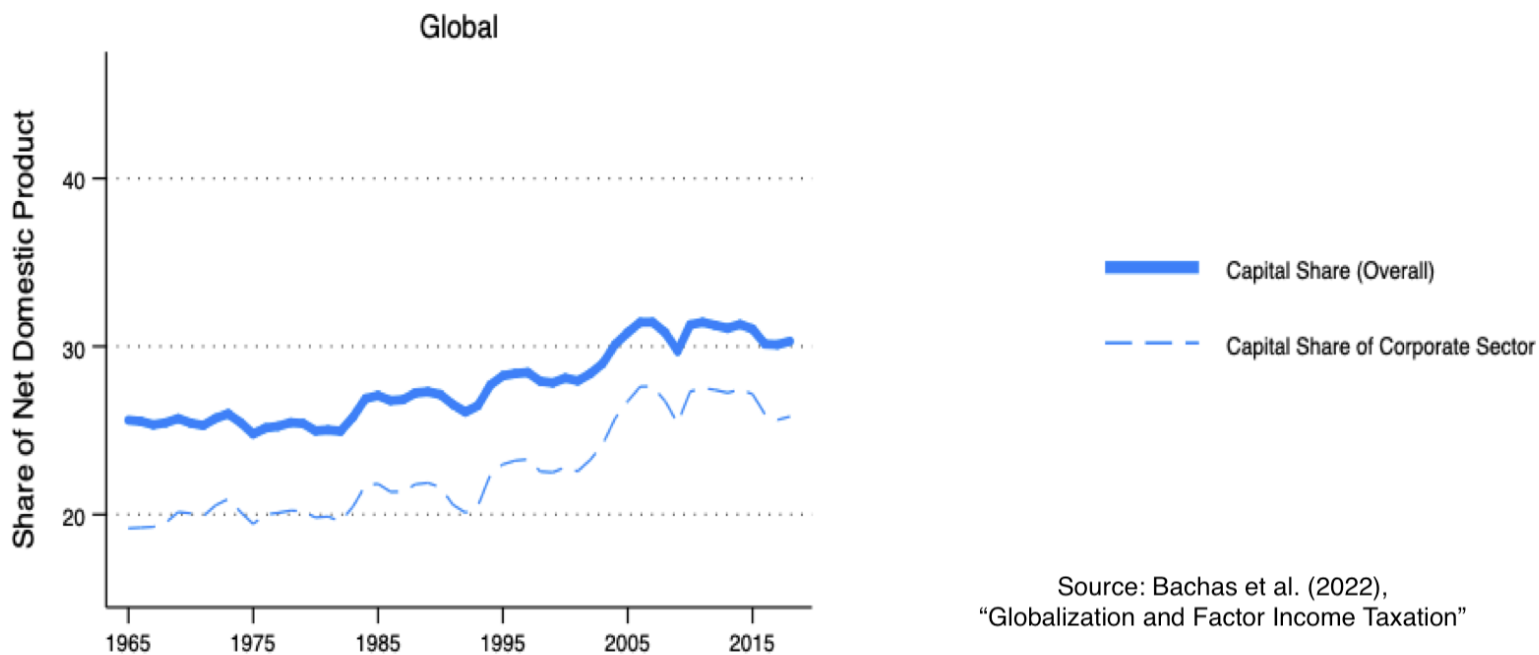
1.3 The limits of Cobb-Douglas

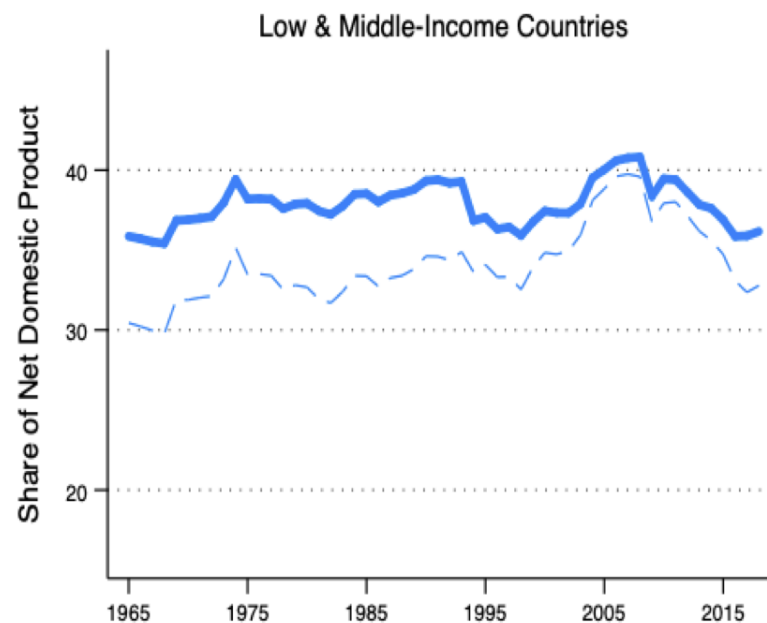
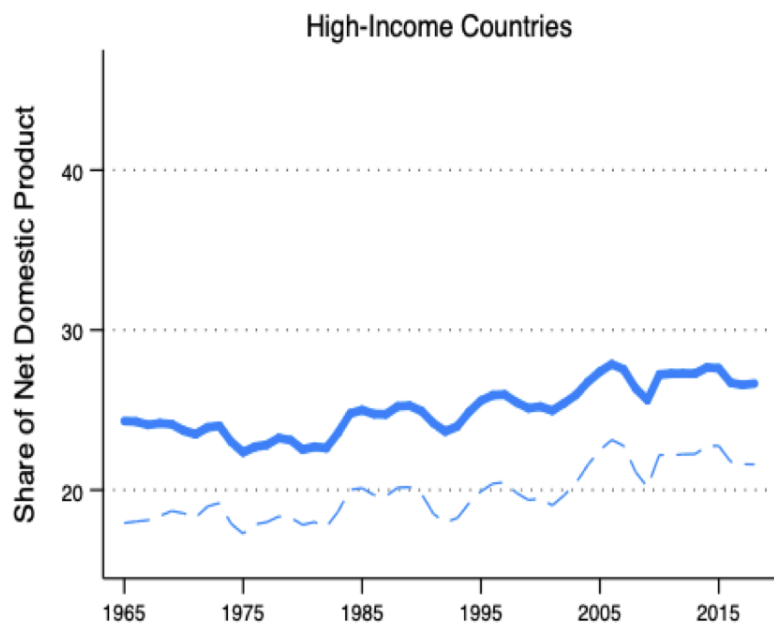
- Cobb-Douglas production very popular for a long time
- Stable factor shares one of Kaldor's (1957) six stylized facts.

Problems:

- Recent increase in capital share at global level.
- Differences across level of development
- Evidence that α was higher in the 19th century than today

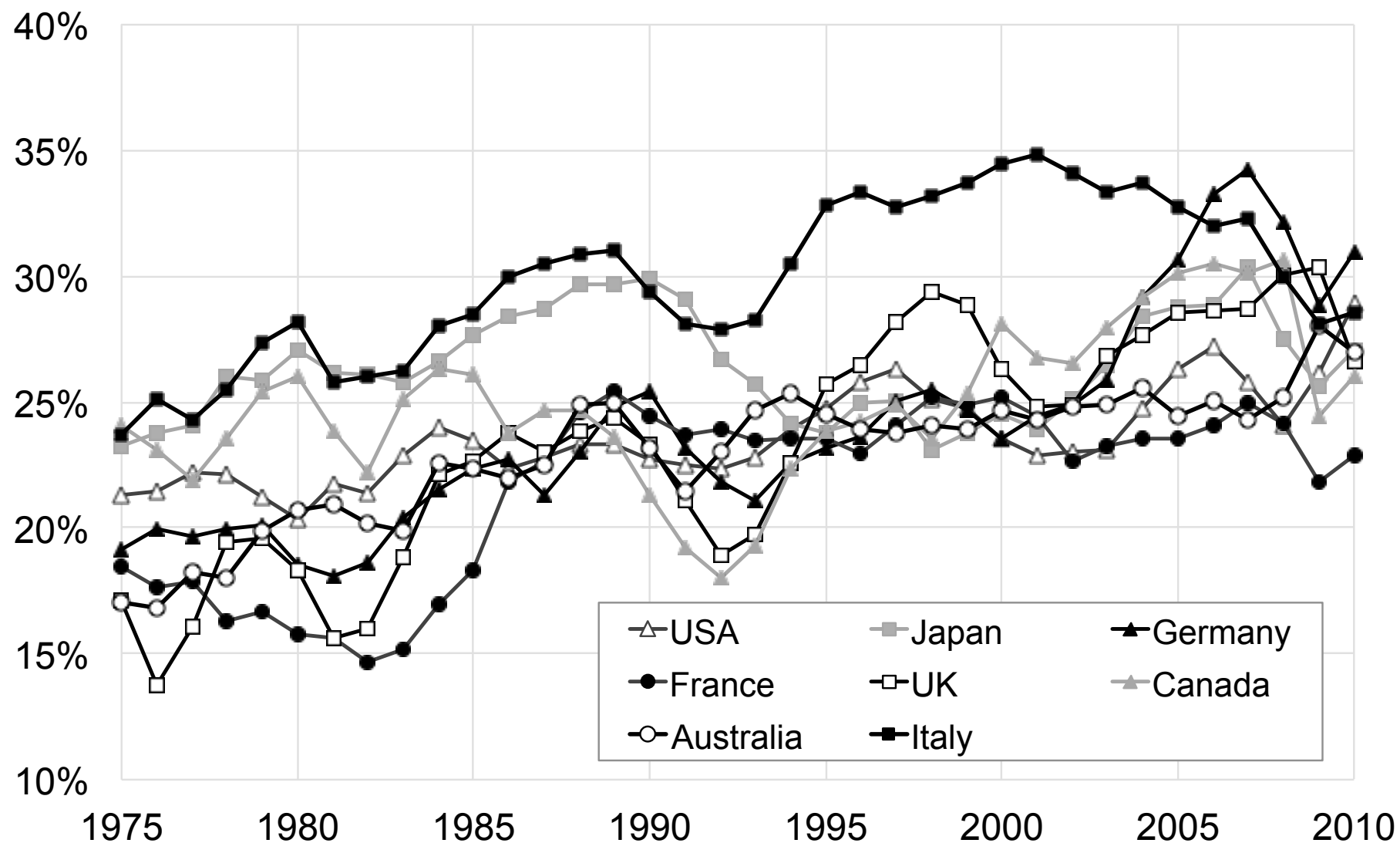
Figure 2: Capital Share of Domestic Product



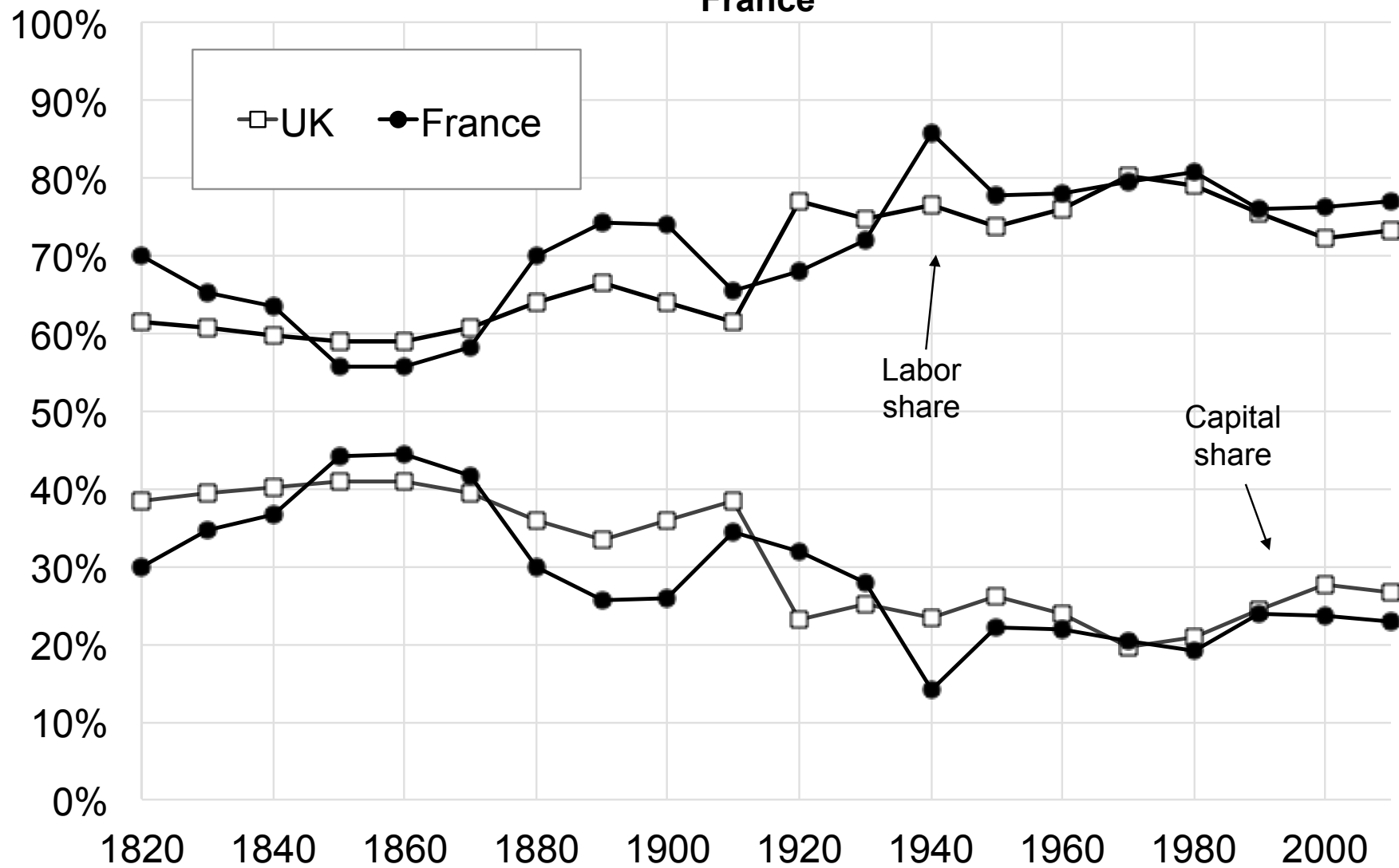


Source: Bachas et al. (2022),
"Globalization and Factor Income Taxation"

Capital shares in factor-price national income 1975-2010



Factor shares in factor-price national income 1820-2010: UK and France



2 Factor shares with CES production

2.1 The elasticity of substitution

- The elasticity of substitution σ captures the response of the capital-labor ratio K/L to a change in relative factor prices v/r :

$$\sigma = -\frac{d\log(K/L)}{d\log(F_K/F_L)} = \frac{d\log(K/L)}{d\log(v/r)}$$

- In the Cobb-Douglas case, σ is exactly equal to 1.

- Ex: if wages rises by 1% relative to r , then firms use 1% less labor relative to K , so that labor share in output remains constant
- However, there is no reason why σ should be equal to 1

2.2 The CES production function

- In the CES production function, the elasticity of substitution can take any value
- With CES production, factor shares are not necessarily constant → useful to think about real world

- A CES production function is given by:

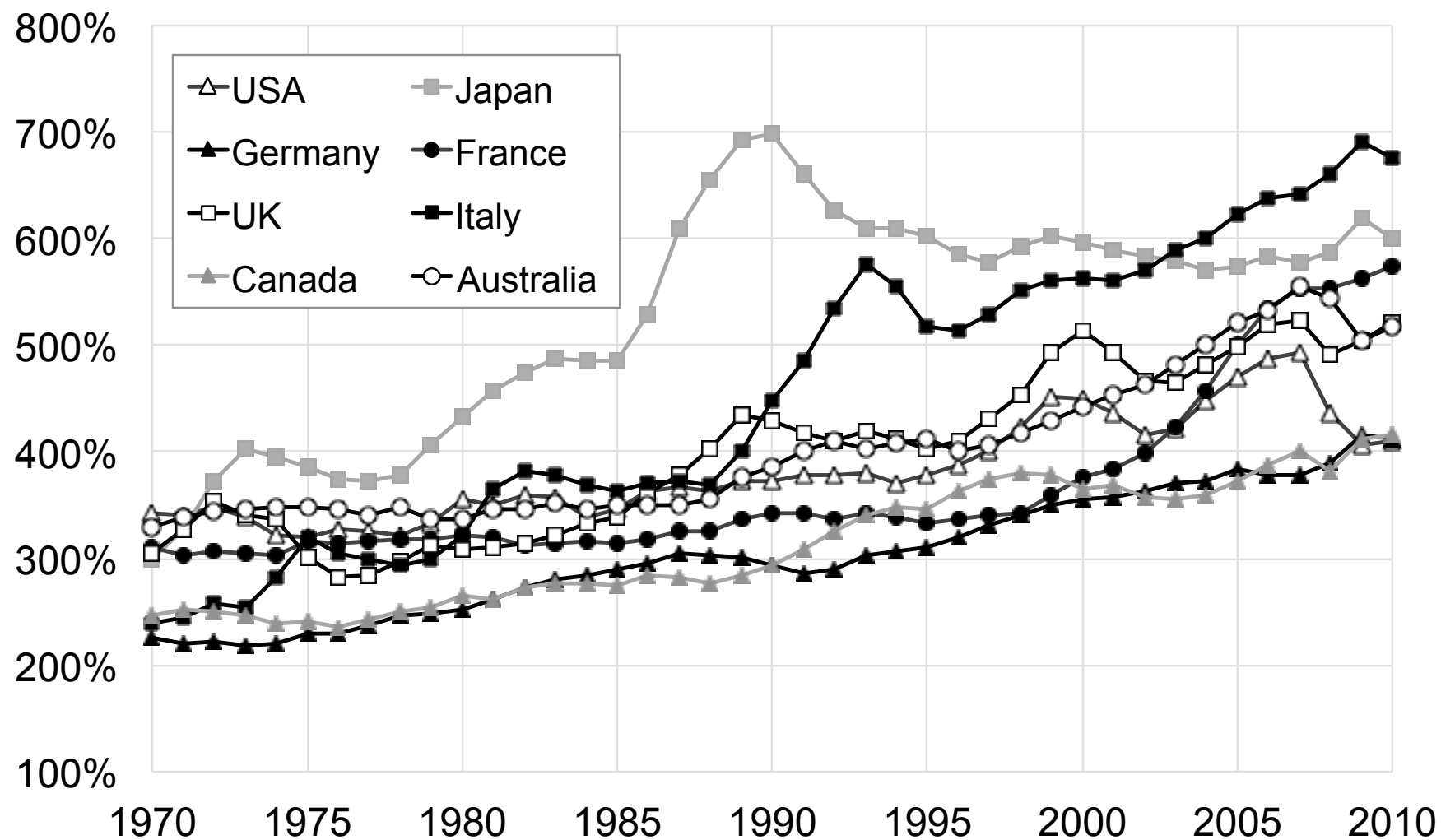
$$F(K, L) = (a \cdot K^{\frac{\sigma-1}{\sigma}} + (1 - a) \cdot L^{\frac{\sigma-1}{\sigma}})^{\frac{\sigma}{\sigma-1}}$$

- $\sigma =$ constant elasticity of substitution
- As $\sigma \rightarrow \infty$, the production function becomes linear:
 $Y = rK + vL$. Robot economy
- As $\sigma \rightarrow 0$, the production function becomes putty-clay, i.e.
 $F(K, L) = \min(rK, vL)$: no substitution possibility

2.3 Factor shares in a CES world

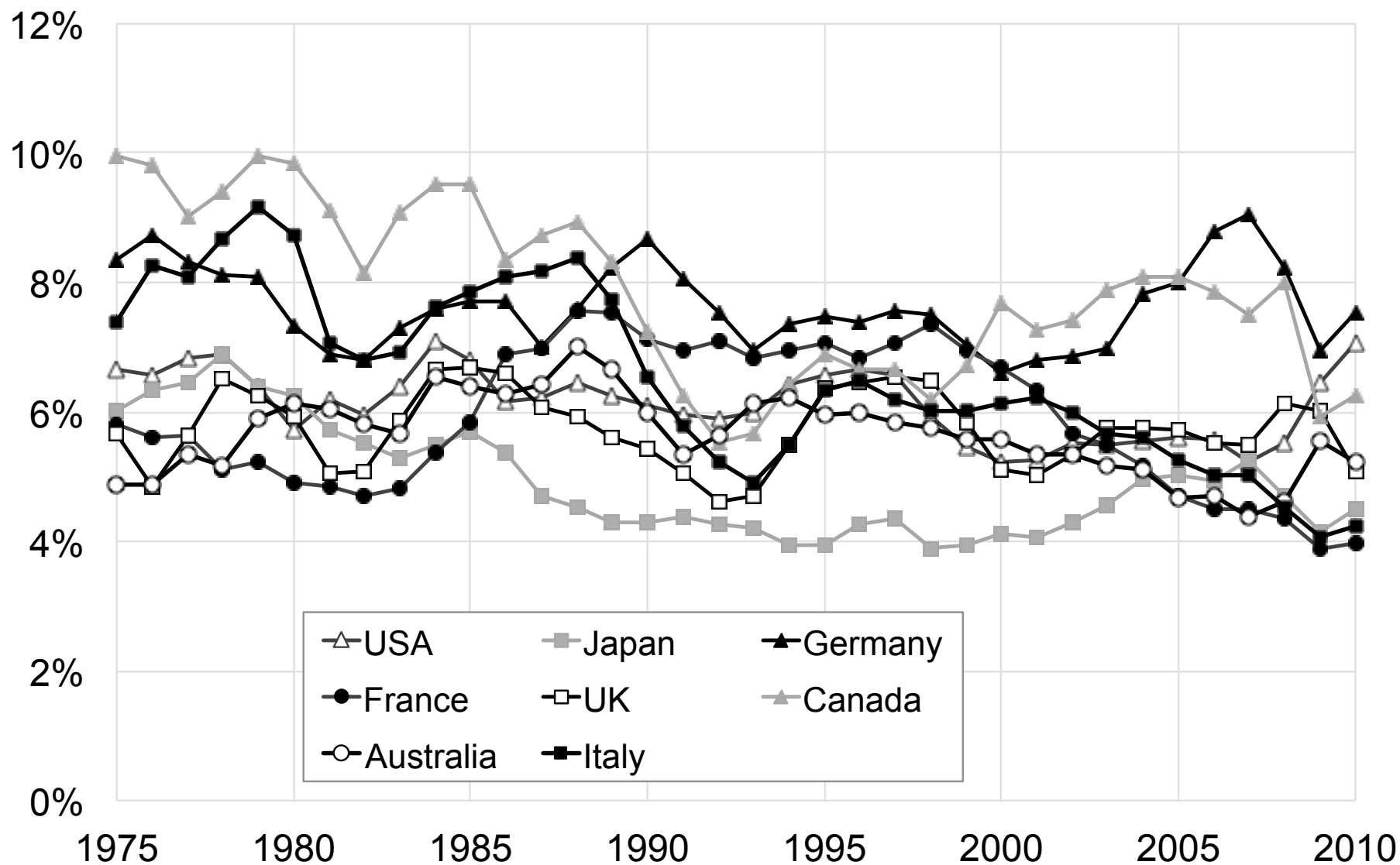
- The CES function helps think about the rise of the capital share
- Theorem: α is a rising function of β iff $\sigma > 1$
- Remember the accounting identity: $\alpha = r \cdot \beta$
- σ links the capital/income ratio β and the capital share α : it determines how much the rate of return r falls when β rises

Private wealth / national income ratios 1970-2010

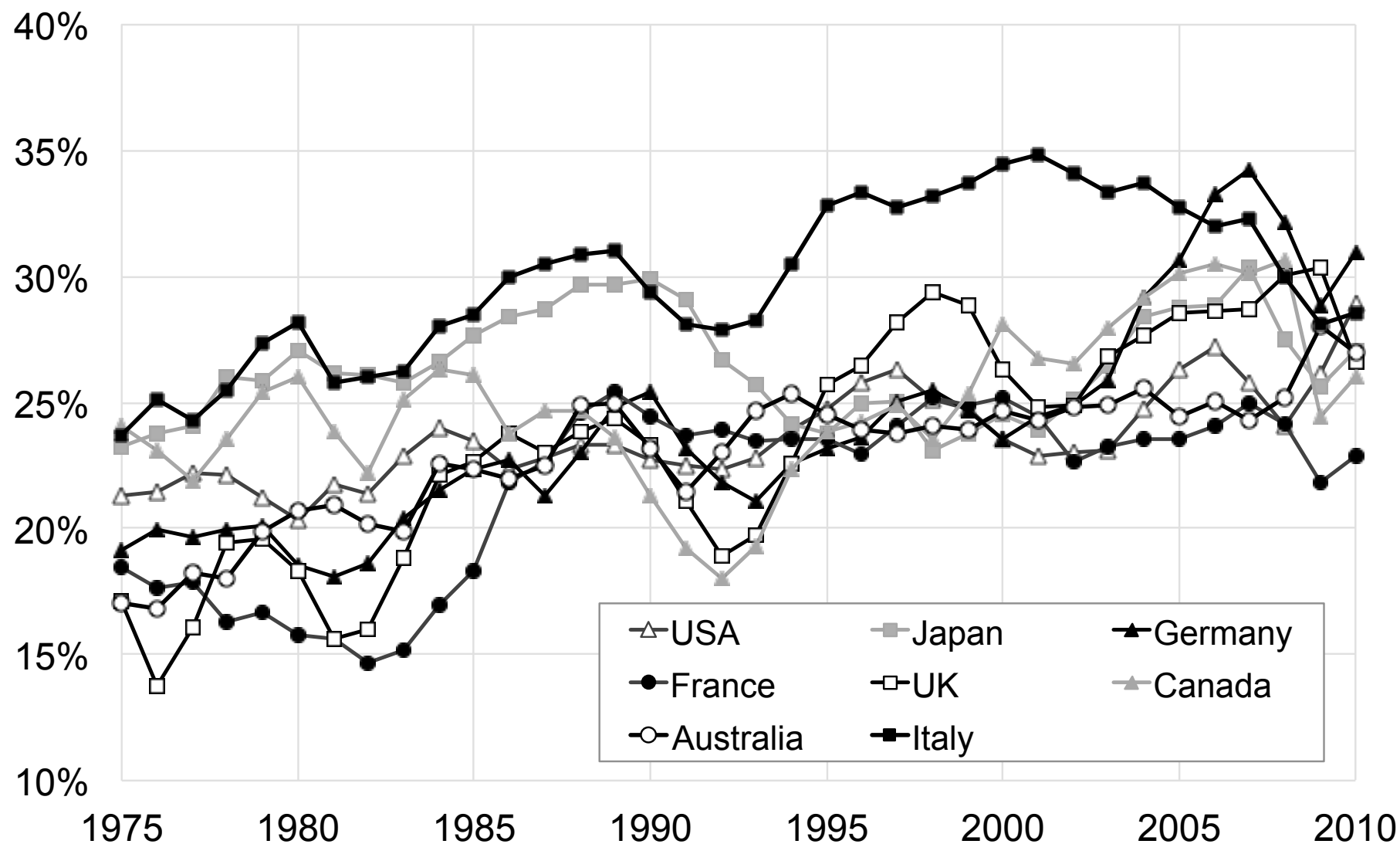


Source: Piketty and Zucman (2014). Authors' computations using country national accounts. Private wealth = non-financial assets + financial assets - financial liabilities (household & non-profit sectors)

Average return on private wealth 1975-2010



Capital shares in factor-price national income 1975-2010



- σ doesn't have to be much > 1 to account for observed trends
- If $\sigma = 1.5$, capital share rises from $\alpha = 28\%$ to $\alpha = 36\%$ when β rises from 250% to 500%
- In case β reaches 800%, α would reach 42%
- In case $\sigma = 1.8$, α would be as large as 53%

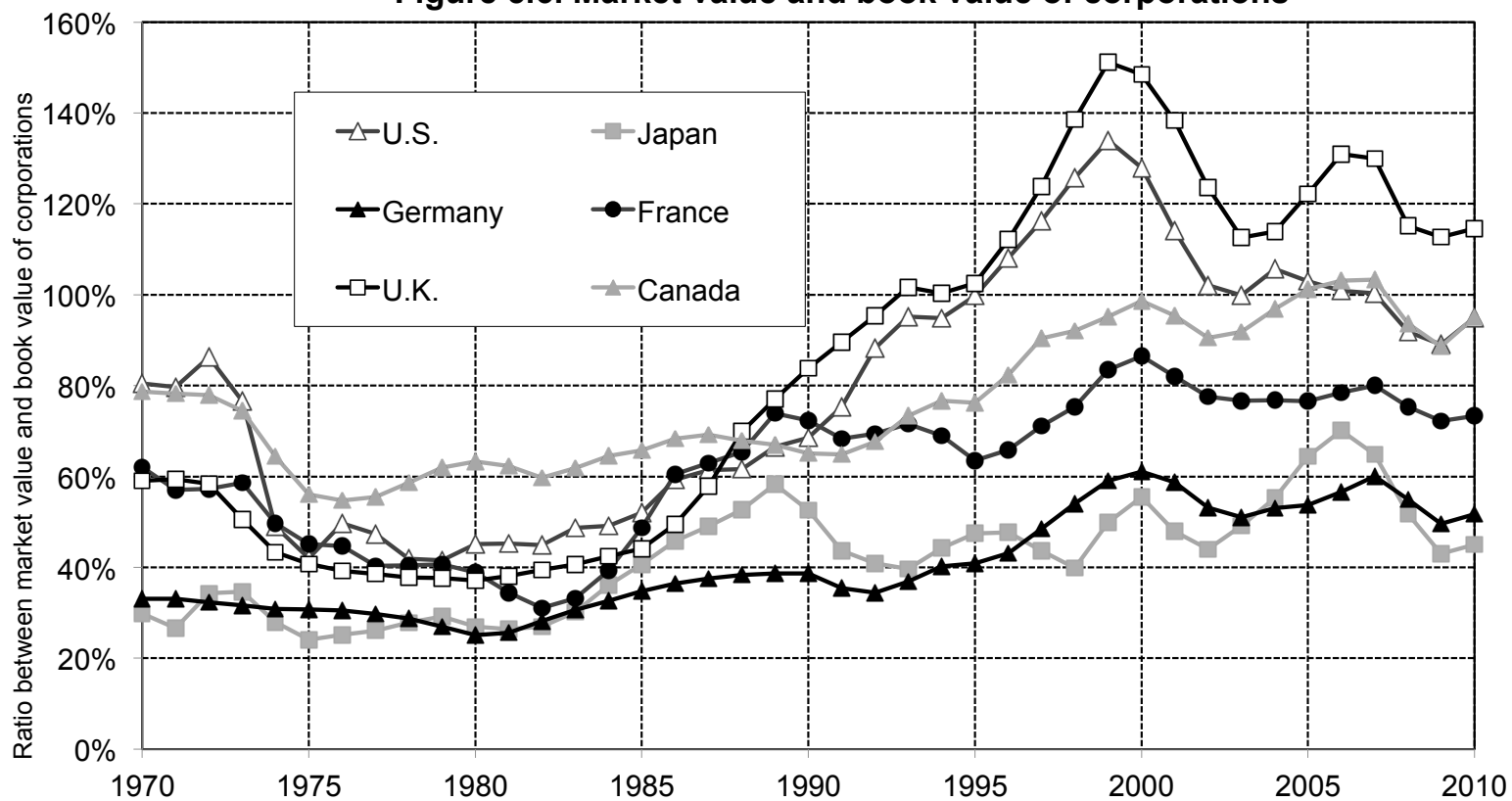
2.4 What do we know about σ ?

- Micro literature usually finds $\sigma < 1$
- A recent macro literature finds $\sigma > 1$. Example: Karabarbounis and Neiman (2014)
- Possible that σ has increased over time: change in the nature of wealth, globalization

3 Change in the market power of capital

- So far we assumed perfect competition: capital and labor are paid their marginal product
- What if capital is paid more (or used to be paid less) than its marginal product?
- Possible channels: decline of unions, globalization, rise of network industries (Facebook, Twitter), change of social norms
- Evidence of change in market power for capital: rise of Tobin's Q

Figure 5.6. Market value and book value of corporations



Tobin's Q (i.e. the ratio between market value and book value of corporations) has risen in rich countries since the 1970s-1980s. Sources and series: see piketty.pse.ens.fr/capital21c.

Summary

- Factor shares are not constant: the capital share α is rising, the labor share $1 - \alpha$ falling
- One explanation is that the rise of the capital share of income may be the consequence of the rise of the stock of capital (rising β).
- If capital and labor are relatively substitutable ($\sigma > 1$), a rise in the wealth-income ratio β will trigger a rise in the capital share α
- Another explanation is that market power for capital may be rising
- Because K income is unequally distributed (more than L income), $\uparrow \alpha$ can have big consequences for interpersonal inequality

References

Karabarbounis, Lukas and Brent Neiman, “The Global Decline of the Labor Share”, *Quarterly Journal of Economics*, 2014 (web)

Piketty, Thomas, *Capital in the 21st Century*, Cambridge: Harvard University Press, 2014, Chapter 1

Piketty, Thomas, and Gabriel Zucman, “Capital is back: wealth-income ratios in rich countries 1700-2010”, *Quarterly Journal of Economics*, 2014 (web)