

EC9AA Term 3: Lectures on Economic Inequality

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- **Slides 3:** Functional Inequality: The Falling Labor Share

The Fourth Fundamental Law of Capitalism

- We now downplay personal endowments and accumulation
 - Though still very much in the background
- Our focus: **the functional distribution across capital and labor**

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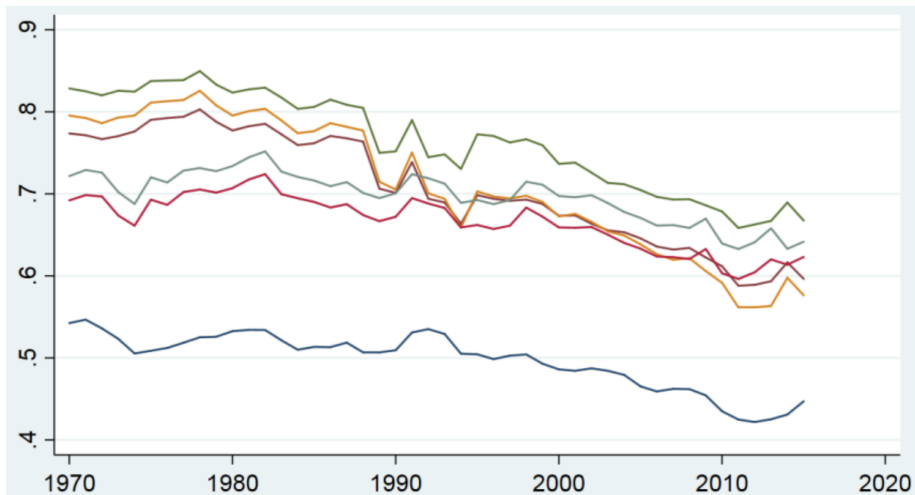
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- A **fundamental law**? You can't be serious.
- It isn't even testable (though stronger versions of it are)
- But it *is* a fundamental device for organizing our thoughts.

Death of a Kaldor Fact

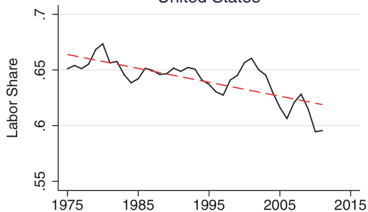
The falling labor share:



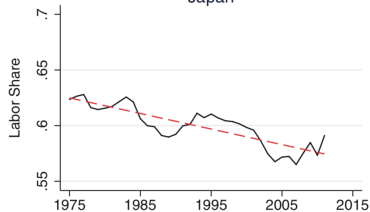
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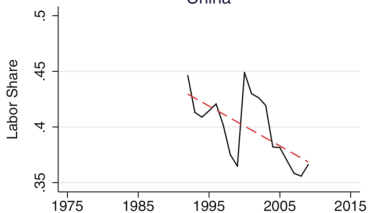
United States



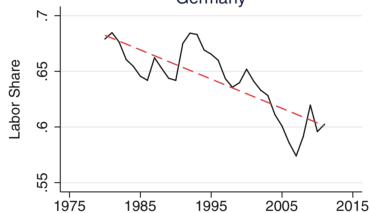
Japan



China



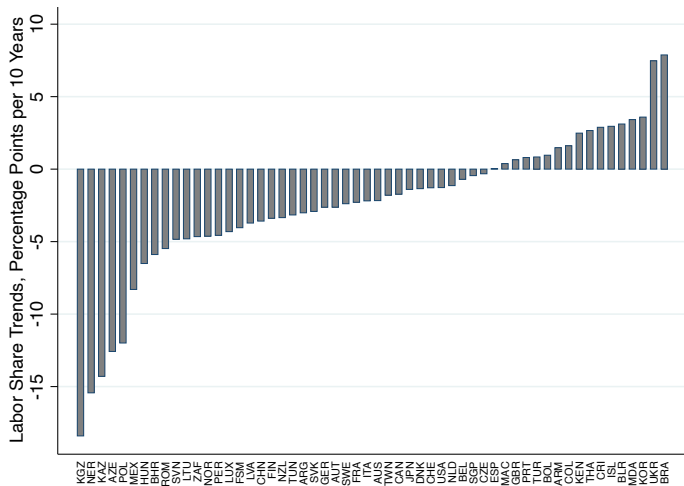
Germany



Karabarbounis and Neiman (2014). Also Harrison (2002) and Rodríguez and Jayadev (2010),

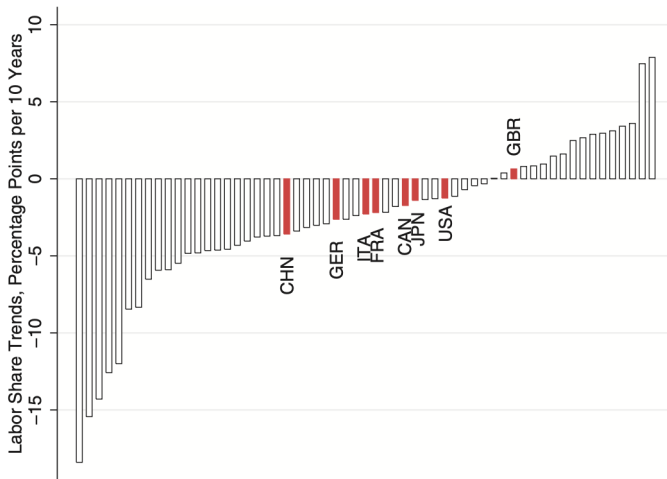
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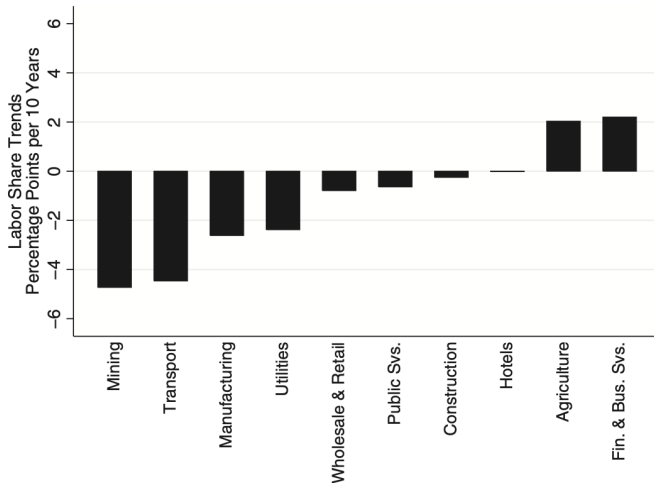
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 - globalization + cheap labor
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 - explanation, or outcome of declining labor power?

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■ **Covid-19**

Explanations

- **Capital-Labor Substitution**

Explanations

■ Capital-Labor Substitution

- Employment elasticities by sector, various regions. Kapsos (2005).

Region	Agriculture	Industry	Services
World	0.24	0.21	0.61
W. Europe	-1.08	-0.50	0.74
N. America	-0.02	0.26	0.60
Central/Eastern Europe	-0.51	0.11	0.51
East Asia (excl. Japan)	0.10	0.07	0.47
Japan	-2.04	-0.83	0.76
Australia/NZ	0.18	0.26	0.61
South-East Asia	0.01	0.82	1.08
South Asia	0.38	0.41	0.46
Latin America	-0.16	0.63	1.09
Sub-Saharan Africa	0.69	0.88	0.89

Explanations

■ Capital-Labor Substitution

- GDP and employment growth, some developing countries. An et al. (2017).

	Yearly, 1991–2000		Yearly, 2001–2015	
Country	GDP	EMP	GDP	EMP
Egypt	4.27	1.47	4.33	2.31
India	5.73	0.60	7.09	0.61
Indonesia	4.84	1.96	5.41	1.73
Kenya	2.09	2.20	4.38	2.00
Morocco	4.78	5.11	4.46	1.04
Nicaragua	3.17	5.61	3.66	3.19
Pakistan	4.48	1.99	4.29	2.84
Philippines	2.75	2.51	5.11	2.46
Tanzania	4.15	2.55	6.41	3.34
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■ But ...

- Net effect on labor share depends on the **elasticity of substitution**.
- E.g., dividing line: Cobb-Douglas production function.
- This is what I want to try and explore further.

Our Theory: Accumulation and Automation

■ Two pillars:

- I. Human-physical asymmetry
- II. Machine capital and robot capital

I. The Human-Physical Asymmetry

Mankiw-Romer-Weil 1992:

$$\dot{k}(t) = s_k y(t) - (n + \delta)k(t)$$

$$\dot{h}(t) = s_h y(t) - (n + \delta)h(t)$$

What does the second equation mean?

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- Physical capital can be indefinitely replicated:
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- But human capital *cannot* be replicated in the same way.
 - always in *one* physical self [inalienable].
 - To some extent, scalable within occupation or sector
 - But more fundamentally, scales *across* sectors.

II. Machines and Robots

- **Many sectors** indexed by j :

$$y_j = f_j(k_j, \tau_j), \text{ [sector-specific, CRS]}$$

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- **So capital comes in two flavors:**
 - k : machines, complementary to labor.
 - r : robots, substitutes for labor.

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- Or that it will ever fully happen; e.g.:
- $\tau_j(h, r) = \nu_j r + \mu_j h + r^{\alpha_j} h^{1-\alpha_j}$ for $\nu_j > 0$, $\mu_j > 0$, and $\alpha_j \in (0, 1)$.

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- But certainly a threat if the price is right:

“nothing humans do as a job is uniquely safe anymore. From hamburgers to healthcare, machines can be created to successfully perform such tasks with no need or less need for humans, and at lower costs than humans...” Scott Santens,

The Boston Globe, 2016

Three Special Sectors

- **Machine capital:** $y_k = f_k(k_k, \tau_k)$, with $\tau_k = \tau_k(h_k, r_k)$.
- **Robot capital:** $y_r = f_r(k_r, \tau_r)$, with $\tau_r = \tau_r(h_r, r_r)$.
- **Education:** $y_e = f_e(k_e, \tau_e)$, with $\tau_e = \tau_e(h_e, r_e)$.
- All assumptions made earlier **apply to these sectors** as well.

A Bit More on Education

- Raw labor is given (or normalized), but **human capital grows endogenously**.
- Initial allocation of humans across occupations.
- Individuals can move from sector to sector (or task to task).
- Educational cost = $e(i, j)p_e$, the endogenous price of education.

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■ Asymptotic Homotheticity of Preferences:

- If $\mathbf{x}_m(\mathbf{p}, z)$ is demand for goods by type m as function of current z , then

$$\lim_{z \rightarrow \infty} \frac{\mathbf{x}_m(\mathbf{p}, z)}{z} = \mathbf{d}_m(\mathbf{p}) \text{ for some unit-expenditure demand function } \mathbf{d}_m(\mathbf{p}).$$

Price System

Competitive Pricing

- **numeraire**: rental rate on machine capital
- **p**: prices, includes (p_r, p_k, p_e)
- **w**: wages, includes (w_r, w_k, w_e)

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$$q_j = q_j(w_j, p_r) = \min \{w_j h_j + p_r r_j \mid \tau_j(h_j, r_j) = 1\}.$$

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- **Unit cost function for output** determines output price p_j by CRS:

$$p_j = c_j(1, q_j) = \min \{k_j + q_j \tau_j \mid f_j(k_j, \tau_j) = 1\}$$

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Some Properties and Implications of Prices

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- profit-maximization:

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■ automation index for each sector j and relative price $\zeta_j \equiv w_j/p_r$:

$$a_j(\zeta_j) \equiv \min_{(r_j, h_j)} \left\{ \frac{r_j}{h_j \zeta_j + r_j} \mid (r_j, h_j) \text{ minimizes unit cost under } \zeta_j \right\} \in [0, 1].$$

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- consumption-savings choices pinned down by:

$$\text{Interest rate } (t) = \frac{1 + (1 - \delta)p_k(t + 1)}{p_k(t)} - 1.$$

where $\delta \in (0, 1)$ is the rate of depreciation.

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- The two faces of capital
 - machines and robots **Pillar II**
- Otherwise pretty standard:
 - (Asymptotically) homothetic preferences
 - Competitive price system;
 - Condition for growth (patience relative to technology).

The Critical Role Played by Robot Production

- **Robot production function** like any other:

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- **Combining:**

$$p_r \leq c_r(1, \nu_r^{-1} p_r).$$

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- **Big question:** given this inequality, how high can robot prices go?
(relative to the normalized cost of machine rentals, set to 1)

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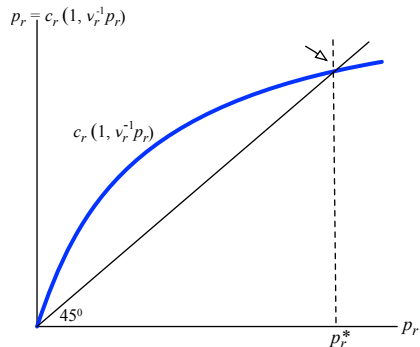
- Depends on whether $c_r(1, \nu_r^{-1} p_r)$ goes below 45° line as $p^r \uparrow$.
- I.e., whether $c_r(1, \nu_r^{-1} p_r) < p_r$ for all large p_r .

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- $c_r(1, \nu_r^{-1} p_r) < p_r$ for all large p_r .

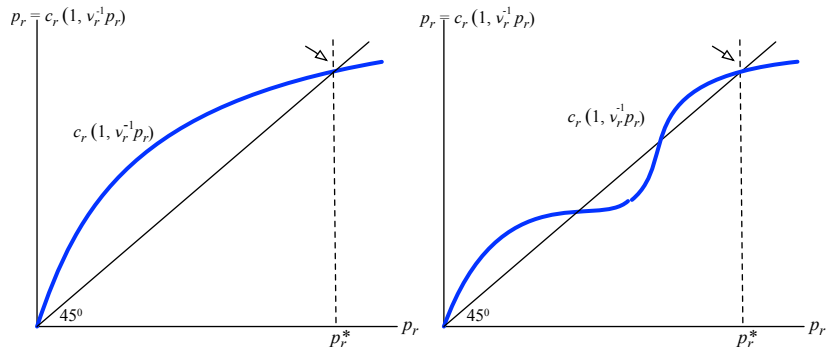
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- Equivalent to $\nu_r > \lim_{\rho \rightarrow 0} c_r(\rho, 1)$.
- If this condition holds, then p_r must be bounded.

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- **If $\nu_r > \lim_{\rho \rightarrow 0} c_r(\rho, 1)$, then p_r must be bounded.**
- Condition automatically holds for Cobb-Douglas production
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- Or for all CES production with elasticity of substitution no less than 1.
- Could fail if elasticity of substitution is below 1.
- **Example:** $y_r = \left[\frac{1}{2}k_r^{-1} + \frac{1}{2}\tau_r^{-1} \right]^{-1}$
- Condition holds when $\nu_r > 1/2$, fails when $\nu_r \leq 1/2$.

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- Connection to self-replication in the robot sector (von Neumann).

The Critical Role Played by Robot Production

- **This boundedness of robot prices is key.**
- It bounds machine capital prices $p_k(t)$, and therefore the average interest rate

$$\text{Interest rate } (t) = \frac{1 + (1 - \delta)p_k(t + 1)}{p_k(t)} - 1.$$

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- So under sufficient patience, the economy must grow.

- Human wages rise, robot prices bounded
- $\Rightarrow$ **automation index $\rightarrow 1$ in every growing sector.**

Automation and the Declining Labor Share

Theorem 1

- Assume (a) high patience among some subset of population, (b) asymptotically homothetic preferences, and (c) self replication. Then:
- (i) Per-capita national income grows without bound: $Y(t) \rightarrow \infty$;
 - (ii) Each sector that grows without bound is asymptotically fully automated in the long run;
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[Link to Piketty](#)

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- Technical progress.

Directed Technical Progress

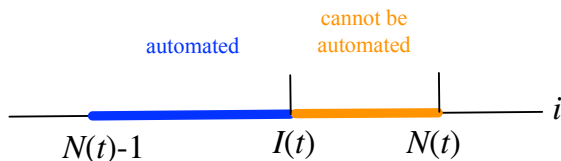
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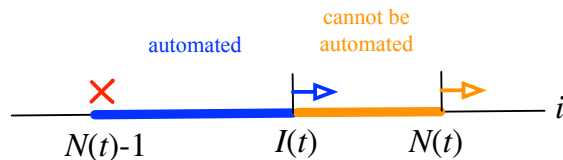
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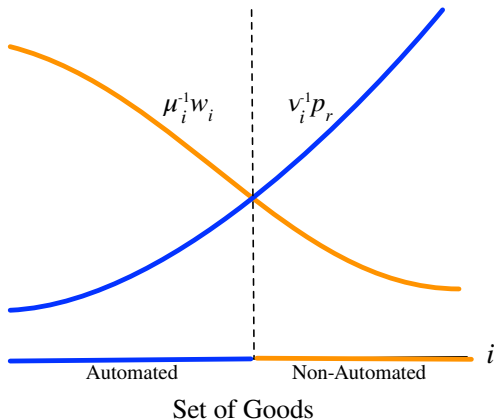
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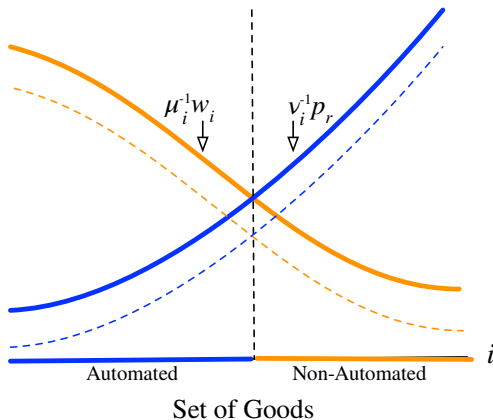
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Directed Technical Progress

Directed technical progress to the rescue?

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- Cost $\kappa(\rho)$ increasing, convex, prohibitive at $\bar{\rho}$, same for every factor and sector.
- Gets temporary patent protection, which she licenses to an active firm.
- After one period the advance goes public.
- Spillover fraction $\gamma > 0$ (public) for this factor in other sectors.

Directed Technical Progress

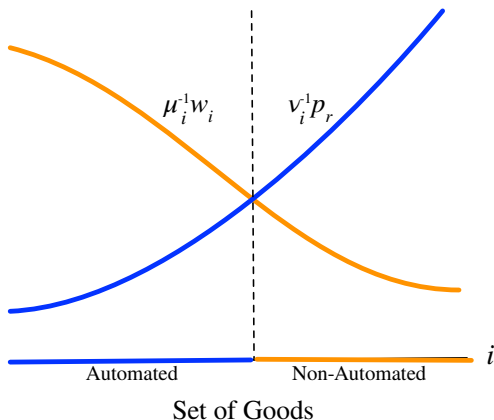
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- *Make the same assumptions as in Theorem 1.*
- *Then in any equilibrium with ongoing wage growth, the income share of human labor must converge to zero as $t \rightarrow \infty$.*

Directed Technical Progress

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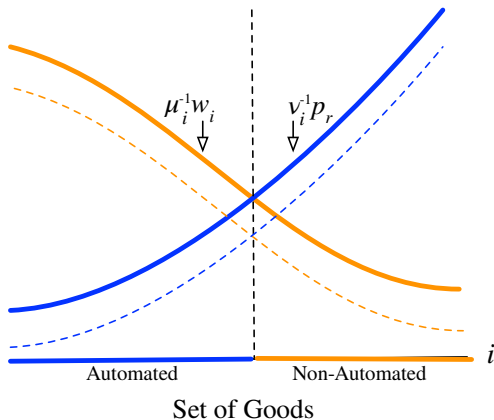
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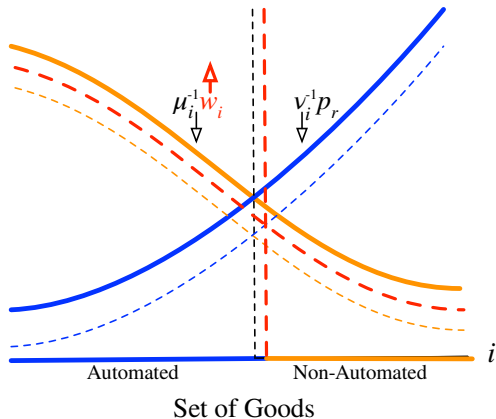
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- A natural consequence of any theory that rests on **two pillars**:
 - An **asymmetry** in physical and human capital accumulation
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- **Other important features:**
 - **Preference neutrality** with respect to human-friendly or robot-friendly goods.
 - **Enough patience** for ongoing growth and capital accumulation.
 - **Self-replication**: production of automata by means of automata.
- **Under these conditions, labor income share $\rightarrow 0$:**
 - full automation in the long run ...
 - ...despite wages rising over time (slow automation).

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- But the underlying worry is about the **personal distribution of income**.
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Social Alternatives:

- universal basic income (e.g. *Ideas for India* special issue, *Economic Survey*)
- social stock portfolios (e.g., Ghosh and Ray 2020 on the **India Fund**)
- See **Supplement to Slides 3**.