The global upward trend in the profit share

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"The global upward trend in the profit share" by Luci Ellis and Kathryn Smith, Monetary and Economic Department, Bank for International Settlements, July 2007

One of the puzzles challenging economists, investors and policymakers is the persistent increase in company profits as a share of gross domestic product (GDP) in recent decades. The central issue is whether or not it's an enduring phenomenon driven by an underlying secular trend.

Many economists have analysed the rise in profit share. One of the more illuminating explanations comes from Luci Ellis and Kathryn Smith in this paper published by the Bank of International Settlements. Written in 2007, it is even more relevant today. The pair were able to attain cross-country data sets generally not available to most other researchers that allowed them to test various hypotheses across nations and over time.

Their research showed that, rather than being a recent phenomenon, profit shares to GDP have risen since about the mid-1980s in most developed economies for which comparable data is available, to levels that are usually high. (Conversely, that means wages levels to GDP are unusually low.)

The authors found that the trend was apparent even after controlling for factors that might previously have been thought to have been its cause, including the business cycle, deregulation of the labour market, and the entry of China and other emerging-market economies into the global trading system. Another cause might have been a change in fundamentals in the goods market or a sign of some underlying inefficiency, with firms being able to extract increasing economic rents. Such shifts in factor shares could have important macroeconomic implications. For example, future investment might be stronger if firms seek to take advantage of high returns on capital. A reversal of the factor share trends through higher wage growth could be interpreted as adding to inflation pressures, rightly or wrongly. On the other hand, if the rising profit share was the result of widening margins, this could also add to inflation pressures.

The paper concludes that the combination of this trend's timing and its cross-country pattern is consistent with a technological cause - faster innovation increasing the rate of obsolescence in capital goods and the ex ante rate of churn in the labour market. This greater churn strengthens firms' bargaining positions and allows them to capture a larger share of factor income. The increase is therefore, in essence, a reallocation of economic rents - a new equilibrium, but not necessarily an optimum. The authors found that the effect is stronger where labour market institutions are more rigid, consistent with the cross-country pattern in the trends in the profit share. They judged that there is a positive relationship between the size of the trend in the profit share and the extent of product market regulation. This suggests a role for competition and innovation in driving down high profit margins. These explanations appear to fit the data better than alternatives raised in other literature.

The paper's technological explanation implies that the recent upswing in profit share is not part of a cycle. It is not inherently likely to reverse, nor was itself the necessary reversal of an earlier – perhaps unsustainable – shift up in the labour share brought about by a change in workers' bargaining power. Indeed, the paper's preferred explanation is correct, then the observed shifts in factor shares were simply a redistribution of existing economic rents, which could continue for some time before stabilising, only reversing if the underlying drivers do. These conclusions have profound long-term implications for equity investors.

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