2. Literature review

The issue of increasing personal income inequality, in particular earnings inequality, has attracted a significant amount of research. In contrast, changes in functional income distribution, i.e. the fall in the share of wages in GDP have only recently been the subject of research with an aim to pin down the effects of technology, globalization, and changes in the bargaining power of labour. Different economic schools of thought developed distinct starting points for their analysis of functional income distribution.

The neoclassical approach, which also forms the basis for the New Keynesian analysis, starts with a production function with two factors: capital and labour. The relative income shares of labour and capital are determined by technology. If a firm produces in a fully competitive market with full-capacity utilisation and the production function is characterised by constant elasticities of substitution between capital and labour the relative income shares of the productive factors are determined by their marginal productivity which is technologically given by the employment elasticity of output. Hence, the focus on technological change which characterises many studies in the mainstream economic tradition derives directly from their theoretical approach. There are two critical assumptions in this framework: fully competitive markets and full-capacity utilisation. As soon as the assumption of perfect competition is dropped, i.e. if firms and workers act in oligopolistic markets as is mostly the case, relative bargaining power is influenced by the price setting power (mark-up power) of firms (Stockhammer, 2009). There is a substantial literature in the New Keynesian tradition that derives from this (EC, 2009). Empirically, this approach is most prominently represented by the IMF (2007), EC (2007), Bassanini and Manfredi (2012), and Karabarbounis and Neiman (2012). Indeed their findings indicate that technological change is the primary determinant of falling wage shares followed by globalisation. However, Stockhammer (2015) argues that a close examination of the reported findings reveals serious robustness issues regarding the effects of technology. Indeed both the IMF (2007) and the EC (2007) report that the technology variables are not robust to the inclusion of time effects. However, they do not interpret the non-robust effects of technology with caution, but rather make a strong case that the fall in the wage share is an unavoidable outcome of technological progress.

Consistent with the nature of modern capitalist economies, the relaxation of the assumption of full-capacity utilisation gave birth to Keynesian macroeconomics which