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HOW TO RAISE TAKE-HOME PAY WITHOUT DESTROYING JOBS

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Average American workers have become frustrated that their take-home pay seems to buy less and less. Some policymakers say this is because corporations are not passing on to workers the real value of their labor. Focusing on the low-paid, some lawmakers say take-home pay needs to be increased by raising the minimum wage, even though this would destroy thousands of job opportunities.[1]

The problem with this view is that it overlooks the huge gap between what employers pay out to hire and maintain a worker and the amount of money that actually reaches the worker in the form of a paycheck that can be cashed. Most American workers have little understanding of just how much disappears from their earnings before the money reaches their pockets. They usually are aware only of the taxes taken directly from their paychecks. What they do not see is the additional cost of government taxes, mandates, and regulations that employers also must bear and that, in practice, comes out of a worker's compensation.[2] Over the past 20 years, these additional costs have taken an ever-increasing bite out of personal income, creating a larger and larger "wedge" between the cost of hiring a worker and what that worker receives as take-home pay.

How do government taxes, mandates, and regulations increase the cost of hiring employees and reduce the take-home pay of workers?

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1 Increasing the minimum wage will destroy 200,000 job opportunities. See Mark Wilson, "The Folly of Increasing the Minimum Wage," Heritage Foundation *Backgrounder Update* No. 275, April 22, 1996.

2 Mackinac Center for Public Policy, "The Right to Know Payroll Form," April 1996. Workers can determine the amount of Social Security and Medicare taxes they pay, as well as their federal and state income taxes, simply by looking at their pay stubs. Employers, however, usually do not report to workers the cost of government-mandated benefits and taxes paid on behalf of their workers.

- ✗ In 1995, it cost all employers in private industry an average of $17.10 per hour to hire and keep workers on their payrolls.[3] After the cost of government-mandated benefits, taxes, and optional benefits is deducted, workers took home an average of $9.84 per hour, 42 percent less than the total direct expense of employing them. The total tax wedge (government-mandated benefit costs plus taxes) cost workers an average of $4.00 per hour, or 23 percent of their total compensation.[4]
- ✗ In 1995, it cost a typical employer at least $4.76 per hour to hire a minimum wage worker.[5] After the cost of government-mandated benefits and taxes ($1.03) is deducted and the Earned Income Tax Credit is added, however, an average minimum wage worker took home only $3.73 per hour, or 22 percent less than the total expense of employing that worker and 12 percent less than the cash wage of $4.25.
- ✗ These figures do not include the hidden cost of federal regulations. One study estimates the regulatory burden per employee, on average, to be in the range of $3,000 to $4,000. This equals somewhere from $1.40 to $2.00 per hour for a full-time worker.[6]

Government must share the blame for reductions in the take-home pay of American workers. Over the years, it has forced employers to shift more of their employees' "pay" to mandated employee benefits, thereby making the hiring of workers more and more expensive. Employers, as well as employees, operate within a competitive labor market in which wage rates broadly reflect the productivity of workers—*less* the costs of taxes, mandated benefits, and regulations associated with employing a worker. The more productive a worker is, the more that worker will be paid. The smaller the government tax and mandate wedge is, the more cash workers will be able to take home.

The solution to this problem is not more government mandates, such as job-killing increases in the minimum wage. Instead, government should pursue policies that directly reduce the wedge between compensation and take-home pay. Such policies also would promote economic growth and thereby increase productivity, job opportunities, and real earnings. Specifically, Congress should cut payroll and income taxes, reduce the regulatory burden on business, cut the capital gains tax, and improve basic education through school choice.

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3 Bureau of Labor Statistics, Internet site *ftp://stats.bls.gov/pub/news.release/ecec.txt*, or "Employer Costs for Employee Compensation, March 1995," June 22, 1995. The sum of cash wages plus the cost of all employer-paid benefits (government-mandated and optional) and payroll taxes equals total compensation, or the total direct expense to the employer. Employer costs associated with recruitment, screening, and initial training of employees are not included. Also not included are the indirect costs of complying with federal regulations.

4 The cost of the tax wedge to workers excludes the cost of optional employer-provided benefits (see Chart 1 for a complete description). Further, taking into account that 88 percent of the cost of all legally required benefits typically is shifted to workers in the form of reduced cash pay (see footnote 9), as well as the fact that some workers receive Social Security benefits, the net cost of the tax wedge for workers is between $3.81and $3.69 per hour, or at least 21.6 percent of a worker's total compensation.

5 Heritage Foundation calculation of hourly cash wages plus the cost of government-mandated benefits. Although some employers provide optional benefits to minimum wage workers, accurate cost estimates for minimum wage workers are not available.

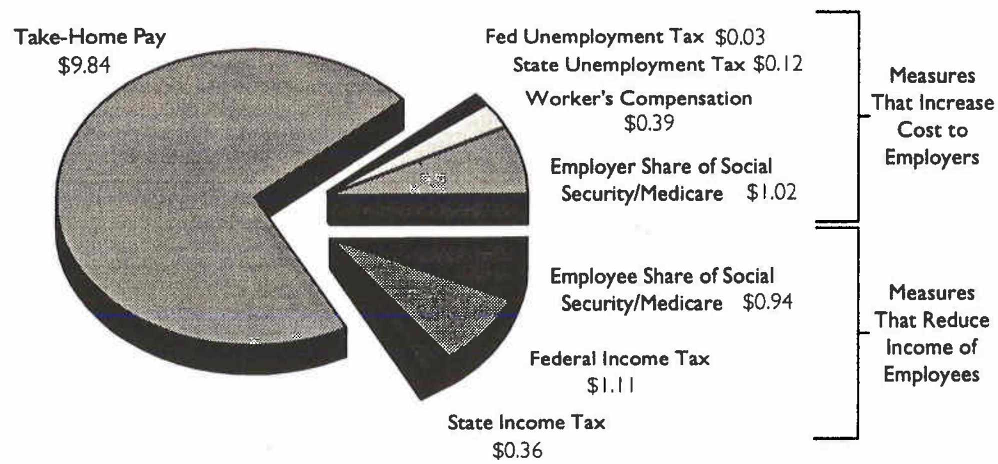
6 This calculation assumes a full-time employee works 2,080 hours per year. See Thomas D. Hopkins, "Profiles of Regulatory Costs," report to the U.S. Small Business Administration, November 1995, Tables A-6 and B-6.

THE DIRECT COST OF GOVERNMENT TAXES AND MANDATED BENEFITS

The hourly wage that employers pay is not what workers take home; nor is it the total cost of labor borne by businesses. When calculating the hourly cash wage rate that a business will pay workers, the employer also must take into account the legal obligation to pay Social Security/Medicare taxes, federal and state unemployment insurance taxes, and workers' compensation taxes.[7] These costs reduce the amount the employer otherwise would be prepared to pay, based on the productivity of the worker. But from the wages and salaries employees receive initially in their paychecks, workers must pay their share of Social Security/Medicare taxes, as well as federal and state income taxes. The difference between this cost of labor to employers (cash wages plus mandated taxes and benefits) and the take-home pay of workers (cash wages minus payroll and income taxes), is the tax wedge (see Chart 1). In 1995, the tax wedge averaged $4.00 per hour, or 23 percent of an average worker's total hourly compensation (see Table 1).[8]

Chart 1

The Government Mandate and "Tax Wedge" Between the Cost of Labor and Take-Home Pay



Cost of Labor: $13.81 per hour

Note: Figures represent hourly averages for all private industries, March 1995. Total does not include optional employer-provided benefits.
Source: Heritage calculations and Bureau of Labor Statistics.

Legally mandated benefits, such as unemployment insurance and workers' compensation, are not "free" to the worker, as many employees assume. A range of studies indicates that, on average, some 88 percent of the cost of all employer-paid government-mandated benefit taxes is shifted to workers in the form of reduced cash compensation.[9]

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7 Total compensation is the sum of an employee's cash pay plus the cost of all employer-paid benefits (government-mandated and optional) and payroll taxes. Total compensation is the same as the total direct cost of labor for the employer.

8 Heritage Foundation calculation based in part on Bureau of Labor Statistics, "Employer Costs for Employee Compensation" data. Optional employer-provided benefits that account for another $3.26 per hour, or 19 percent of total compensation, are not included in the tax wedge but also increase the cost of labor.

9 The 88 percent figure is based on such analyses as Jonathan Gruber and Alan B. Krueger, "The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers Compensation Insurance," *Tax Policy and Economy* (1991); Jonathan Gruber, "The Incidence of Mandated Maternity Benefits," *American Economic Review*, Vol. 84 (June 1994), pp. 622-641; and Lawrence H. Summers, "Some Simple Economics of Mandated Benefits," *American Economic Review*, Vol. 79, No. 2 (May 1989).

Table 1

Taxes and Government Mandates Drive A Wedge Between The Total Cost Of Labor To Employers And Workers' Take-Home Pay

	All Private Industry	Manufacturing Industries	Service Producing Industries	Minimum Wage Workers
Total Direct Cost of Employing a Worker	$17.10	$20.47	$15.88	$4.76
Legally Mandated Employer Costs	+$1.59	+$1.86	+$1.43	+$0.51
Social Security/Medicare	+1.02	+1.21	+0.96	+0.33
Federal Unemployment	+0.03	+0.03	+0.03	+0.03
State Unemployment	+0.12	+0.14	+0.11	+0.04
Workers' Compensation	+0.39	+0.48	+0.30	+0.11
Optional Employer Costs	+$3.26	+$4.90	+$2.76	NA
Paid Leave	+1.09	+1.54	+1.00	NA
Supplemental Pay	+0.47	+0.80	+0.37	NA
Insurance	+1.15	+1.72	+0.98	NA
Retirement & Savings	+0.52	+0.75	+0.41	NA
Other	+0.03	+0.09	+0.00	NA
Cash Wages Paid to Worker	$12.25	$13.72	$11.67	$4.25
Percent of Total Costs	71.6%	67.0%	73.5%	89.3%
Less Government Taxes	-$2.41	-$2.79	-$2.21	-$0.52
Social Security/Medicare	-0.94	-1.05	-0.89	-0.33
Federal Income Tax	-1.11	-1.34	-0.98	-0.16
State Income Tax	-0.36	-0.40	-0.34	-0.04
Take-Home Pay For Worker	$9.84	$10.93	$9.46	$3.73
Percent of Total Compensation	57.6%	53.4%	59.6%	78.3%
Mandated Benefit and Tax Wedge	+$4.00	+$4.65	+$3.64	+$1.03
Percent of Total Compensation	23.4%	22.7%	22.9%	21.7%

Notes: These figures represent averages for all workers. Optional employer benefits for minimum wage workers are not available. Estimated federal income taxes include the Earned Income Tax Credit. State income taxes are estimated to average 2.9% (0.9% for minimum wage workers). The tax wedge has not been adjusted. See footnotes 11, 13, and 15.

Sources: Heritage Foundation calculations and Bureau of Labor Statistics.

- **In 1995, it cost all private industry employers an average of $17.10 per employee per hour to hire and keep workers on their payrolls.**[10] After the cost of government-mandated benefits, taxes, and optional benefits is deducted, workers took home an average of $9.84 per hour, or 42 percent less than the total expense of employing them. The total tax wedge cost workers an average of $4.00 per hour, or 23 percent of their total compensation.[11]

- **In 1995, it cost manufacturing industry employers an average of $20.47 per employee per hour to hire and keep workers on their payrolls.**[12] After the cost of government-mandated benefits, taxes, and optional benefits is deducted, workers took home an average of $10.93 per hour, or 47 percent less than the total expense of employing them.

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10 Bureau of Labor Statistics, Internet site *ftp://stats.bls.gov/pub/news.release/ecec.txt.*

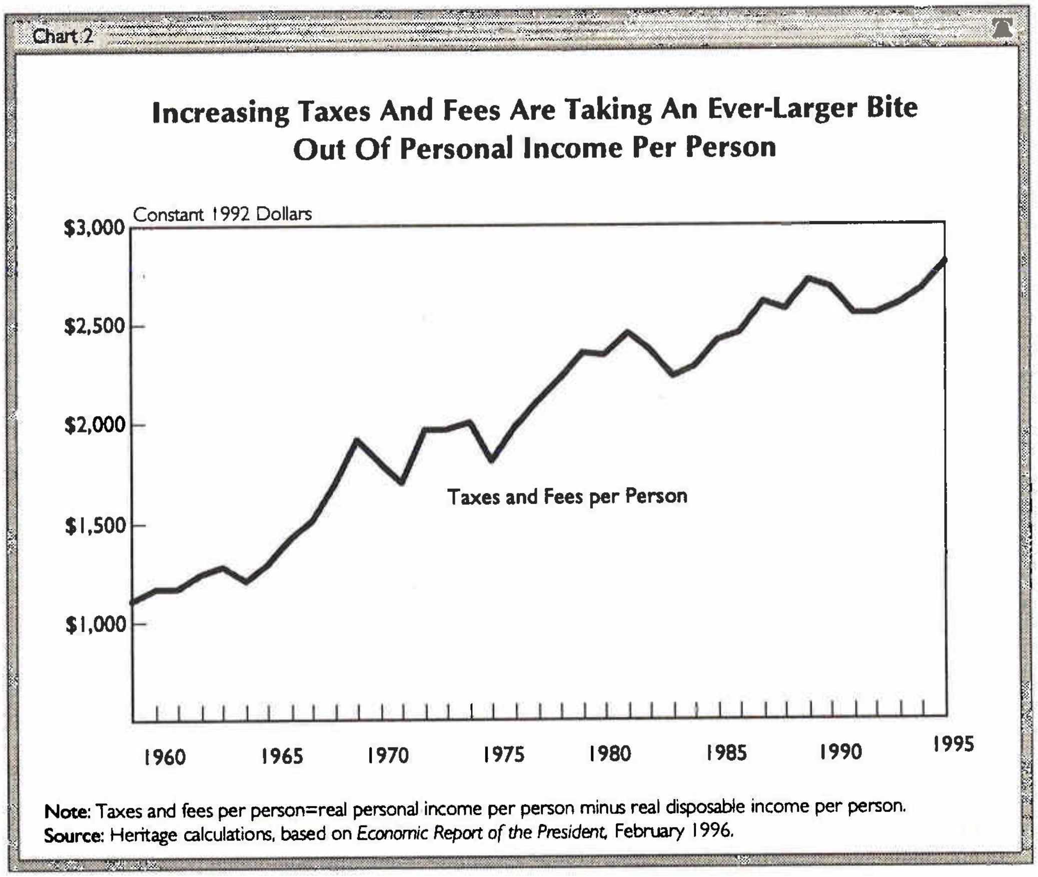
11 Taking into account that 88 percent of the cost of all legally required benefits is shifted to workers in the form of reduced cash pay and that some workers receive Social Security benefits, the net cost of the tax wedge for workers is between $3.81and $3.69 per hour, or at least 21.6 percent of a worker's total compensation.

12 Bureau of Labor Statistics, Internet site *ftp://stats.bls.gov/pub/news.release/ecec.txt.*

The total tax wedge cost workers an average of $4.65 per hour, or 23 percent of their total compensation.[13]

✗ **In 1995, it cost service industry employers an average of $15.88 per employee per hour to hire and keep workers on their payrolls.**[14] After the cost of government-mandated benefits, taxes, and optional benefits is deducted, workers took home an average of $9.46 per hour, or 40 percent less than the total expense of employing them. The total tax wedge cost workers an average of $3.64 per hour, or 23 percent of their total compensation.[15]

✗ **In 1995, it cost a typical employer at least $4.76 per hour to hire a minimum wage worker.**[16] After the cost of government-mandated benefits and taxes ($1.03) is deducted, however, an average minimum wage worker took home only $3.73 per hour, or 22 percent less than the total expense of employing that worker and 12 percent less than the cash wage of $4.25.



Over the years, proliferating mandates and rising taxes have increased the cost of hiring workers. By 1994, the cost of government-mandated benefits accounted for 8.9 percent of total employer payrolls, up from 6.3 percent in 1971 and just 3.5 percent in 1951.[17]

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13 Taking into account that 88 percent of the cost of all legally required benefits is shifted to workers in the form of reduced cash pay and that some workers receive Social Security benefits, the net cost of the tax wedge for manufacturing workers is between $4.43 and $4.32 per hour, or at least 21.1 percent of a worker's total compensation.

14 Bureau of Labor Statistics, Internet site *ftp://stats.bls.gov/pub/news.release/ecec.txt.*

15 Taking into account that 88 percent of the cost of all legally required benefits is shifted to workers in the form of reduced cash pay and that some workers receive Social Security benefits, the net cost of the tax wedge for service-producing workers is between $3.47 and $3.36 per hour, or at least 21.2 percent of a worker's total compensation.

16 Heritage Foundation estimate of hourly cash wages plus employer-paid taxes for legally mandated benefits. Although some employers provide optional benefits to minimum wage workers, accurate estimates of the cost are not available.

17 U.S. Chamber of Commerce, "Employee Benefits Historical Data," 1982, and "Employee Benefits Survey," 1994.

Government taxes and fees have been taking an ever-increasing bite out of personal income (Chart 2). Although real personal income per person increased 121 percent from 1959 to 1995, government taxes and fees paid per person increased 155 percent in real terms over the same period.[18] In 1994, federal, state, and local governments took an average of $2,800 (in 1992 dollars) from every person.

In addition, in recent years there has been a significant increase in mandated benefits (Table 2), and these costs are likely to become larger in the future. For example:

- ☞ If Congress proceeds with a proposed 90 cent increase in the minimum wage, it will cost consumers and workers about $2.2 billion per year as the cost of entry-level jobs is passed on through higher prices and lower real wages. It also will cause employers to create over 200,000 fewer entry-level jobs each year until 1999.[19]
- ☞ The Medicare program is on the brink of insolvency. To put it on a sound financial basis without reforming and improving the way the program operates could mean as much as a 3.52 percentage point increase on top of the current 2.9 percent Medicare payroll tax. This means workers earning $45,000 per year would have to pay an additional payroll tax of $1,584 per year.

If Americans had to write a monthly check for each tax and government-mandated benefit, they would quickly understand how government excess, rather than corporate greed, consumes their take-home pay.

THE HIDDEN COSTS OF GOVERNMENT REGULATION

Taxes and mandated benefits are not the only government policies that drive a wedge between the cost of hiring an employee and that employee's take-home pay. Regulations also increase the cost of employing workers. For example, environmental and workplace safety regulations impose costs that take the form of such things as compliance expenditures (e.g., equipment purchases, worker training); time lost due to paperwork requirements; delays in the processing and issuance of permits required by the government; and attorneys fees incurred in regulation-related litigation. For the smallest businesses, the costs of tax compliance (paying professionals to decipher the tax code, filling out forms, maintaining the appropriate records) and payroll recordkeeping are the largest components of the regulatory burden.[20]

Regulation imposes the heaviest burden on small and medium-sized businesses because they find it harder to spread the high overhead costs of paperwork, attorney and accountant fees, and staff time needed to negotiate the federal regulatory maze. According to recent studies by Professor Thomas Hopkins of the Rochester Institute of Technology:

- ☞ For the average firm with fewer than 20 employees, the regulatory cost per employee is estimated to be about $5,500. For the largest firms (those with more than 500 employees), the cost is about $3,000 per employee.[21] Unfortunately, Congress has responded to the dispropor-

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18 Mark Wilson, "Wages, Profits, and Income: Politics vs. Reality," Heritage Foundation *F.Y.I.* No. 97, April 19, 1996.

19 Mark Wilson, "The Folly of Increasing the Minimum Wage," Heritage Foundation *Backgrounder Update* No. 275, April 22, 1996.

20 Thomas D. Hopkins, "The Changing Burden of Regulatory Paperwork and Tax Compliance on Small Business: A Report to Congress," October 1995, p. 20.

21 Hopkins, "Profiles of Regulatory Costs," p. 1. Cost estimates include process, social, and economic regulation.

tionate burden on small business by exempting different sizes of companies from different regulatory statutes. The effect of this approach has been to discourage companies near an established threshold from hiring new employees.[22]

☞ The business regulatory burden also varies considerably by industry. For example, the average cost of regulation per employee in the manufacturing industry, where regulatory costs are the highest, is in the range of $5,000 to $7,000. For the service industry, where regulatory costs are the lowest, it is in the range of $2,000 to $3,000. As Table 3 shows, these average costs are equal to a range of approximately $1.00 to $3.00 per hour per worker.[23]

As Professor Hopkins notes, estimating the precise cost of federal regulations to business and workers is extremely difficult. These cost estimates are intended to offer only an illustrative profile of the cost of the regulatory system. While these estimates do not factor in the benefits of particular regulations, understanding the cost impact is important for policymakers, particularly in light of the already significant costs to employers of taxes and mandated benefits.

Although regulation imposes costs on businesses, ultimately they are passed on to individual Americans, often through lower wages (see Chart 3).[24] Moreover, mandated requirements, such as family and medical leave, directly affect an employer's decisions about whether and when to hire a worker, which worker to hire, how much cash to pay the worker, and how long to keep that worker. The rise in mandated labor costs paid by employers is one of the most important forces leading companies to lay off workers, as well as to utilize part-time, temporary, and contract labor.[25]

Table 2

Some Federally Required Burdens on Employers

Payroll Taxes	
Social Security	
Medicare	
Federal Unemployment Insurance	
State Unemployment Insurance	
Mandated Benefits	
Davis-Bacon Act of 1931	(prevailing wage requirements)
Fair Labor Standards Act of 1938	(minimum wage & overtime)
Workers' Compensation	
Equal Pay Act of 1963	
Service Contract Act of 1965	(prevailing wage requirements)
Americans with Disabilities Act of 1990	
Family and Medical Leave Act of 1993	
Various Regulations	
Title VII of Civil Rights of 1964	
Age Discrimination in Employment Act of 1967	
Executive Order 11246	(non-discrimination in employment by federal contractors)
Occupational Health and Safety Act of 1970	
Rehabilitation Act of 1973	
Federal Mine Safety and Health Act of 1977	
Worker Adjustment and Retraining Notification Act of 1988	
Migrant and Seasonal Agricultural Worker Protection Act of 1983	
Immigration Control Act of 1986	
Employee Polygraph Protection Act of 1988	
Drug-Free Workplace Act of 1988	
Various environmental regulations	(e.g. Clean Air Act)

Source: *Federal Labor Laws*, West Publishing Company, 1993.

A recent study by Richard Vedder for the Center for the Study of American Business shows that in addition to the costs of complying with regulation, there are longer-run costs in the form of reduced productivity. Vedder explains that when a business must de-

Estimates are for 1992 (in 1995 dollars).

22 Murray Weidenbaum, "Government Regulation and Medium-Sized Businesses," Center for the Study of American Business *Issue Series* No. 77, March 1996, p. 8.

23 Hopkins, "Profiles of Regulatory Costs," Tables A-6, B-6.

24 For a more detailed discussion, see William G. Laffer III, "How Regulation Is Destroying American Jobs," Heritage Foundation *Backgrounder* No. 926, February 16, 1993.

25 Jack A. Meyer, "The Impact of Employee Benefit Costs on Future Job Growth," Manufacturers Alliance *Policy Review* No. PR-133, March 1995.

vote resources to implementing regulatory mandates, those resources are used in a less efficient manner because firms are forced to use more costly and less productive methods of production.[26]

Table 3

Direct and Indirect Costs Can Consume Half the Cost of Employing a Worker

Hourly Wage/ Hourly Costs	All Private Industry	Manufacturing Industries	Service Producing Industries	Minimum Wage Workers
Take-Home Pay For Worker	$9.84	$10.93	$9.46	$3.73
Total Direct Cost of Employing a Worker	$17.10	$20.47	$15.88	$4.76
Regulatory Costs Per Employee	$1.38-$2.05	$2.48-$3.33	$.94-$1.47	$.94-$1.47
Total Direct and Indirect Costs	$18.48-$19.15	$22.95-$23.80	$16.82-$17.35	$5.70-$6.23

Notes: All figures are in 1995 dollars.
Sources: Thomas D. Hopkins, *Profiles of Regulatory Costs*, A Report to the U.S. Small Business Administration; Heritage calculations.

This significant "drag" on productivity denies workers higher wages and a higher standard of living.

Other studies support similar conclusions. One 1987 study by economist Wayne Gray examined the effects of Environmental Protection Agency (EPA) and Occupational Safety and Health Administration (OSHA) regulations on 450 manufacturing industries and concluded that these regulations explained more than 30 percent of the slowdown in productivity from the 1960s to the 1973-1978 period.[27] A 1995 study by the Employment Policy Foundation found that 19 percent of the productivity slowdown during the 1970s is directly attributable to regulations published by OSHA[28] and that nearly half of the slowdown in long-run productivity growth can be explained by rising government regulatory activity.[29] Further, since productivity and workers' pay and benefits rise together, government regulations are directly responsible for some part of the slowdown in wage growth and take-home pay (Chart 3).

RAISING TAKE-HOME PAY

Congress and the Administration should focus on policies that will increase wages and job opportunities for Americans by improving labor productivity and reducing the cost of employing workers. Specifically, Congress and the Administration should:

Cut payroll taxes. Taxes and government-mandated benefits cost the average worker over 21 percent of total compensation—13.8 percent for minimum wage workers. The solution is not more mandates—for example, a higher minimum wage. Cutting payroll taxes, however, would directly increase take-home pay.

26 Richard K. Vedder, "Regulation's Trillion-Dollar Drag on Productivity," Center for the Study of American Business *Policy Brief* No. 165, March 1996. Although this study suggests that nearly half of the slowdown in long-run productivity growth, and therefore wage growth, from 1963 to 1993 can be explained by rising government regulatory activity, this should be considered a somewhat high estimate because the study did not account explicitly for regulatory benefits.

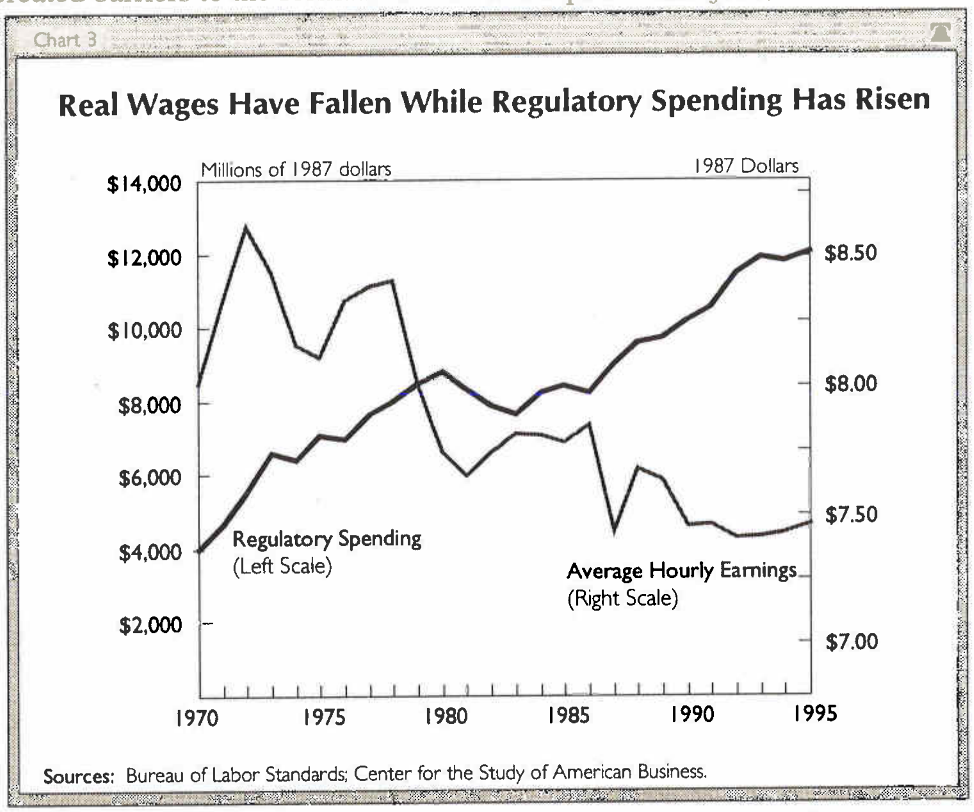
27 See Wayne Gray, "The Cost of Regulation: OSHA, EPA, and the Productivity Slowdown," *American Economic Review*, December 1987.

28 Max Lyons, "OSHA: The Case for Reform," Employment Policy Foundation, October 9, 1995.

29 See note 26, *supra*.

Cut the capital gains tax. The U.S. tax code punishes capital investment by taxing investment income more than once.[30] It taxes corporate and individual income from investment, and then taxes capital a third time by taxing capital gains. Lowering the captial gains tax would increase investment in the U.S. and provide an incentive for both American and foreign firms to put their capital to work here with American workers. A capital gains tax cut also would make more venture capital available for emerging technologies and for research and development that would improve future productivity.

Enact significant regulatory reform. The explosion of new regulations since 1988 has raised the cost of labor and capital, created barriers to the formation of new companies and jobs, and raised the cost of employing Americans. This higher cost of employment in turn means that in a competitive economy, the return to labor in the form of wages is reduced. The regulatory burden needs to be rolled back, not only to allow wages to rise, but also to decrease the cost of hiring workers. To do this, Congress should strengthen White House oversight of executive branch agencies; establish in statute a set of principles, including cost-benefit analysis, to guide regulatory decisionmaking; establish a regulatory budget; and require federal agencies to review existing regulations to ensure that they meet sound regulatory principles.[31]



Increase the skills of the workforce. What is needed is fundamental change aimed at improving basic education through school choice, strengthening core curricula, and enabling local educators to improve discipline and set high expectations. Congress also should consider tax-deferred or tax-free education savings accounts similar to individual retirement accounts, or enabling states and individuals to use lump-sum unemployment insurance benefits for education and training.

30 Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995.

31 See Angela Antonelli, "Regulation," in Stuart M. Butler and Kim R. Holmes, eds., *Issues '96: The Candidate's Briefing Book* (Washington, D.C. The Heritage Foundation, 1996).

Conclusion

Politicians who blame "corporate greed" for what is happening to the take-home pay of American workers are diverting attention from the real problem: an overly intrusive and expensive federal government. Over the years, more and more mandates, higher and higher taxes, and excessive regulation have slowed the growth of the economy and created a larger and larger wedge between the cost of hiring employees and workers' take-home pay. If Americans had to write a monthly check for each tax and government-mandated benefit, they would quickly realize the significant costs government imposes and the effects on their take-home pay.

The solution to these problems is not more government mandates and programs, such as job-killing increases in the minimum wage. Instead, what is needed are policies that focus on the primary problems—high payroll and income taxes, and excessive regulation. Removing these obstacles will increase productivity, job opportunities, and real wage growth for all Americans.