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WAGES, PROFITS, AND INCOME: POLITICS VS. REALITY

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"On Labor Day 1995, the earnings of most American workers are either stuck in the mud or sinking. Profits are up. Paychecks are not."

—*Secretary Robert B. Reich, Labor Day Address, August 31, 1995.*

"The state of the Union is strong. Our economy is the healthiest it has been in three decades."

—*President Clinton, State of the Union Address, January 23, 1996.*

INTRODUCTION

Using distressing stories of laid-off workers, decreasing paychecks, and increasing income inequality, some politicians and journalists have been painting a picture of economic gloom and doom in America. At the same time, the economy exhibits increasing employment, low inflation, and growth. Still, while the economy appears to be doing well, many Americans see themselves as struggling to make ends meet and feel they are worse off than their parents were a generation ago. This raises the obvious question: Are middle-income and low-income workers falling farther behind, or is the standard of living increasing for most Americans?

What has really been happening to wages, profits, and incomes in recent decades?

- ✗ There has been a decline in average real cash wages since 1973, but this does not mean a decrease in the American standard of living. In fact, most workers are better off today because their real compensation and real per capita income continue to increase. Moreover, a broad array of measures indicates that the standard of living for most Americans continues to rise.
- ✗ There is no evidence to support the popular argument that rising corporate profits have come at the expense of workers. Corporate profits and labor compensation generally rise and fall together. Whether corporate profits are falling or rising as a share of national income, the employees' share of a growing economy remains fairly constant.

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- ✗ The slow growth in take-home pay is not the result of "corporate greed." It is the result of a slowdown in the growth of productivity, caused in part by the growth of government taxes and regulations on business and investment. Higher taxes also are taking an ever-larger bite out of personal income, leaving a smaller and smaller share for individuals to spend, save, and invest.
- ✗ Although the income difference between high-wage and low-wage workers has increased, a majority of men and women have seen their real earnings increase. Studies suggest the increasing divergence in the earnings of high-wage and low-wage workers is due primarily to an acceleration in the rate of technological change favoring those with higher skills, changes in the composition of the workforce, and a substantial shift in demand for the products of different industries. Increased trade and the number of low-skilled immigrants, however, have had only a small effect on wage patterns.
- ✗ The dynamic U.S. economy is characterized by an extraordinary degree of income mobility which has been all but ignored in the controversy over wage differences. The notion that low-income or high-income groups are composed of the same people, stuck in the same jobs over time, is an illusion. Data on income mobility reveal that most workers' incomes increase over time. In America, the upward movement of workers in the lowest, second-lowest, and middle-income groups is much larger than the downward movement.

The conventional wisdom is that wages are falling, the middle class is moving down instead of up, and corporate profits are rising at the expense of workers. But like so many other examples of conventional wisdom, it is wrong. The truth is that most workers are better off today because their real earnings are increasing and their standard of living continues to rise. Both corporate profits and labor compensation are growing, and although the difference between high-wage and low-wage workers has increased, the U.S. economy remains dynamic and productive enough to enable most Americans to work their way up the economic ladder.

To the extent that real wages are falling for some workers, the solution is not higher taxes, more mandates and government programs, or job-killing increases in the minimum wage. Instead, what is needed are policies that focus on the primary problems: high taxes and excessive regulation. Removing these obstacles will increase productivity, job opportunities, and real wage growth for all Americans.

HOW COMPENSATION INCREASES WHILE WAGE GROWTH STAGNATES

There has been a decline in average real cash wages since 1973, but this does not mean a decrease in the American standard of living.[1] In fact, most workers are better off today because their real compensation and real per capita income continue to increase.[2] The reason for this is that workers are taking home more of their pay in the form of tax-free benefits than ever before.[3] Hourly wages do not account for the increasing tendency of employees to receive their "pay" in the form of un-

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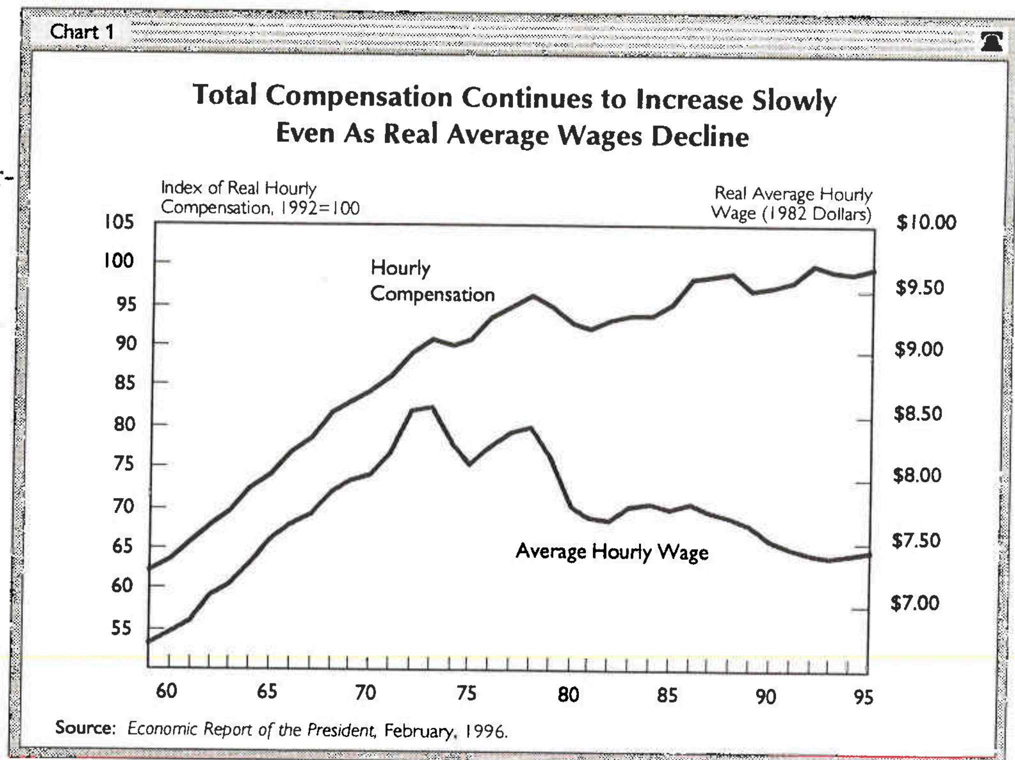
1 W. Michael Cox and Richard Alm, "The Good Old Days Are Now," *Reason,* Vol. 27, No. 7 (December 1995). The authors present a broad array of measures to show how U.S. living standards continue to rise. For example, compared to 1970, real per capita income is 50 percent higher, the environment is cleaner, life expectancy has increased from 70 to 75 years, the average work week is 2.5 hours shorter, and workers have 7 more days of paid vacation.

2 *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1996), pp. 332 and 311.

3 The U.S. tax system encourages workers to take their pay as untaxed fringe benefits instead of taxable cash wages. Employee non-wage benefits accounted for 41.3 percent of payroll costs in 1993, up from almost 18.7 percent in 1951 and 36.6 percent in 1979. See U.S. Chamber of Commerce, "Employee Benefits Survey," various years.

taxed fringe benefits.[4] Moreover, hourly wage data are limited as to the types of employees they cover, further understating actual wage growth.[5] Real compensation thus is a more accurate measure of the "pay" American workers receive because it includes benefits, such as health care and pension payments, as well as cash.



Source: *Economic Report of the President*, February, 1996.

As Chart 1 illustrates, total compensation has increased even when average wages have declined. From 1959 to 1973, real hourly compensation increased by an average of 2.8 percent per year.[6] Between 1973 and 1994, real hourly compensation increased an average of 0.4 percent per year. The problem is not that the average cash wage has declined, but that total "pay" has grown more slowly since 1973. The reason: a slowdown in the growth of productivity caused in part by the proliferation of government regulations, mandates, and higher taxes, all of which reduce the net value of a worker's output, which leads in turn to a slowdown in compensation.[7]

Most of the growth in real compensation since 1986 can be attributed to the fact that benefits have increased faster than cash wages (see Chart 2). Although real wage growth as measured by the Employment Cost Index has stagnated since 1986, sharply rising benefits have increased total compensation by 1.9 percent.[8] Between 1981 and 1995, real employee benefits have increased 26.8 per-

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4 Hourly wage data exclude benefits such as health insurance, workers' compensation, and pensions.

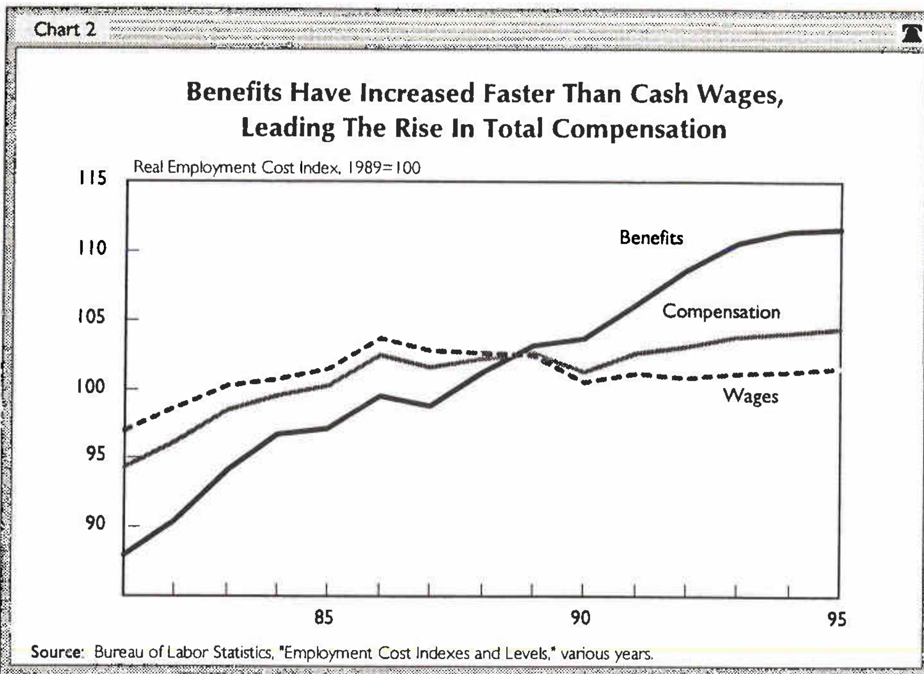
5 Hourly wage data are available only for private nonfarm production and nonsupervisory employees that account for only 68 percent of all payroll jobs. The two largest groups of workers excluded from the measure are supervisors and all government employees.

6 *Economic Report of the President*, 1996, p. 332.

7 Olivia S. Mitchell, "The Effects of Mandating Benefits Packages," National Bureau of Economic Research Working Paper No. 3260, February 1990; Wayne B. Gray, "The Cost of Regulation: OSHA, EPA and the Productivity Slowdown," *American Economic Review*, Vol. 77, No. 5 (December 1, 1987); Thomas D. Hopkins, "The Cost of Federal Regulation," *Journal of Regulation and Social Costs*, Vol. 2, No. 1 (March 1992).

8 The Employment Cost Index (ECI) is a measure of the change in the cost of labor, free from the influence of employment shifts among occupations and industries, that is estimated by the Bureau of Labor Statistics. The compensation series includes changes in wages and salaries and employer costs for employee benefits. The wage and salary series and the benefit cost series provide the change for the two components of compensation. Wages and salaries are defined as the hourly straight-time wage rate (reported or computed), and benefits include paid leave; premium pay for overtime, shift differentials, and lump-sum bonuses; insurance benefits; retirement and savings benefits; and legally required benefits such as Social Security, federal and state unemployment insurance, and workers' compensation.

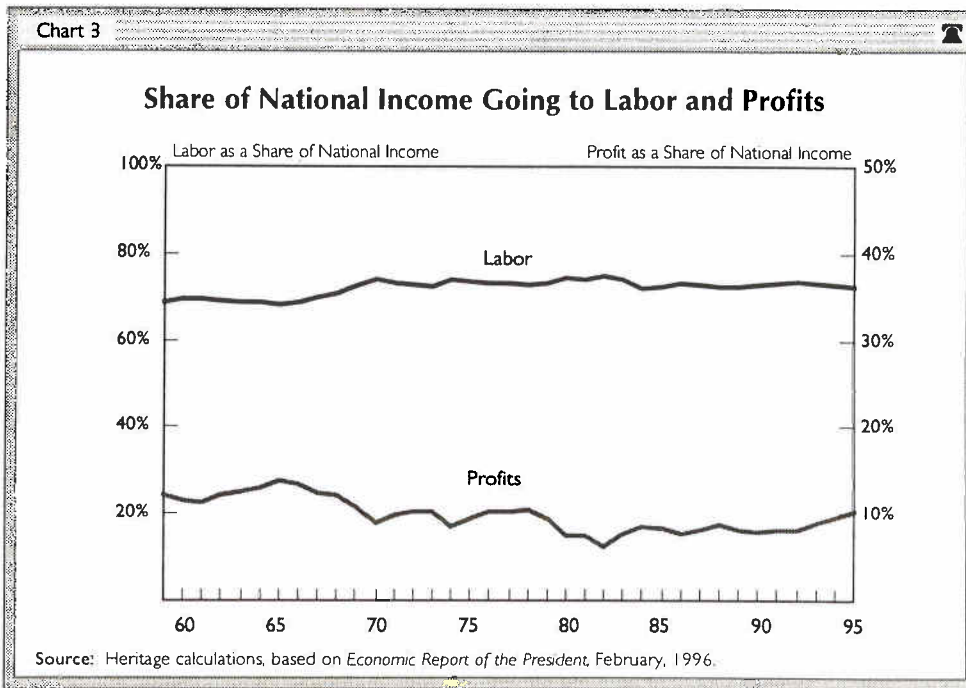
cent as workers have continued to demand more of their total pay in the form of tax-free benefits, and the cost of providing those benefits has increased.



While real compensation for most Americans has increased, workers correctly believe that they should be better off today than they are. Tax increases in the 1990s deprived them of a higher standard of living by undercutting the economy's rate of growth, undercutting productivity gains, and holding back pay increases.[9] If workers and businesses were not burdened with large tax and regulatory increases, total compensation and real take-home pay would be higher.

HIGHER PROFITS BENEFIT WORKERS, FALLING PROFITS LIMIT COMPENSATION GROWTH

There is no evidence to support the popular assumption that rising corporate profits and the record high stock market have come at the expense of workers.[10] *The Washington Post* was correct when it editorialized: "[Secretary of Labor Robert Reich] charges that the productivity improvements are going disproportionately to corporations. That's not the real explanation. While corporate profits, as a share of total economic output, are slightly higher than in the late 1980s, they remain lower than in the 1970s. The causes of the country's poor wage per-



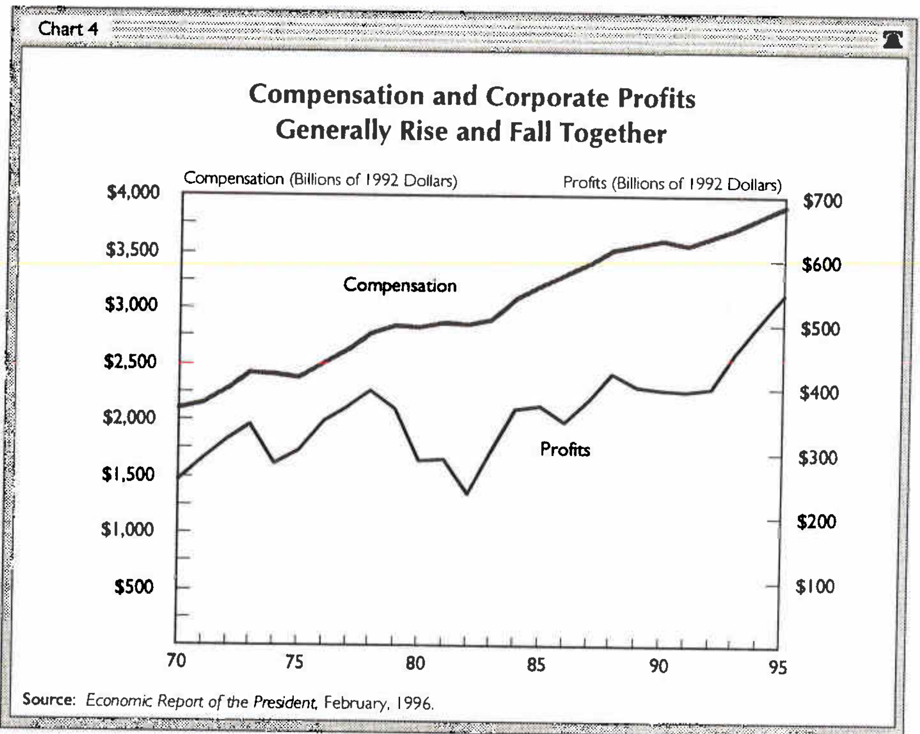
9 This point will be addressed in a forthcoming paper.

10 Ken Deavers, "Soaring Profits, Stagnating Real Wages: Not the Real Story," Employment Policy Foundation *Fact & Fallacy*, December 1995.

formance lie elsewhere."[11] Those causes also do not include the trade deficit or immigration, both of which increased during the 1980s at the same time labor compensation increased significantly.

✓ **Whether corporate profits are falling or rising as a share of national income, labor's share of a growing economy remains fairly constant** (see Chart 3). The share of national income going to corporate profits declined in a seesaw fashion from 14.1 percent in 1965 to a post-World War II low of 6.0 percent in 1982. Workers' share of national income, however, rose from 68.1 percent in 1965 to 74.2 percent in 1970 and has remained relatively stable ever since.

✓ **Corporate profits and labor compensation generally rise and fall together** (see Chart 4). When corporate profits declined in 1974, labor compensation declined too. When corporate profits declined from 1979 to 1982, compensation failed to increase. Corporate profits resumed their increase in 1983, and labor compensation followed suit, increasing by 23.3 percent from 1982 to 1988. From 1988 to 1991, the growth of corporate profits declined and labor compensation stagnated; when corporate profits began to increase again in 1992, however, so did labor compensation.



Source: *Economic Report of the President*, February, 1996.

✓ **Higher profits also benefit workers because they are shareholders.** Sixty-four percent of all workers are employed by companies with pension plans, and 50 percent of all workers participate in those plans.[12] Nineteen percent of all workers also have their own individual retirement accounts (IRAs).

There is no evidence to support the popular argument that rising corporate profits have come at the expense of workers. Corporate profits and labor compensation generally rise and fall together. Real labor compensation has risen $340 billion (in 1992 dollars) between 1991 and 1995, and corporate profits have increased $152 billion over the same period. Moreover, the fixed-pie assertion that a higher level of after-tax profits means less income available for labor compensation or tax revenue for the government is simply wrong. The problem is that the share of national income taken by all levels of government has increased from 32 percent in 1965 to 39 percent in 1994.[13] This leaves a steadily smaller share for private citizens to spend, save, and invest.

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11 "Why Wages Are Stuck," *The Washington Post*, July 29, 1995, p. A12.

12 U.S. Department of Labor, *Pension and Health Benefits of American Workers*, 1994.

13 *Economic Report of the President*, 1996, pp. 305 and 371.

WAGE AND INCOME DIFFERENCES HAVE INCREASED

Wage growth and wage differences are two distinct concepts,[14] but they interact to shape a worker's sense of well-being. If all real wages increase, everyone is better off, even if there is a widening difference in earnings. On the other hand, if average real wages stagnate while wage differences are growing, low-wage workers as a group may become poorer as the rich grow richer.[15] In the case of the United States, the former pattern holds true: The standard of living for most Americans actually continues to rise, even though both wage and income differences have widened.[16]

Studies suggest that there are several reasons for widening wage differences. The accelerated rate of technological change, for example, favors those with higher skills. Also, changes in the composition of the workforce—including a slowdown in the relative growth rate of college graduates and the increasing labor force attachment of women—lead to a divergence of incomes. And there has been a substantial shift in demand for the products of different industries (such as lower paying services replacing higher paying manufacturing).[17] The increase in low-skilled immigrants (both legal and otherwise) and trade, however, had only a small effect on wage patterns in the 1980s.[18]

Since 1973, income differences among families also have grown because of the sharp rise in the proportion of Americans who live in families with no male workers, growing differences in earnings among men, and the increasing likelihood that in a traditional family both husband and wife will be working.[19]

The size of a family makes a difference. Census Bureau income data collected according to the presence of children show that while families with no children experienced a 36 percent increase in real median income over the past 25 years, families with one or two children did considerably less than half that well. The real median income of families with more than three children declined over the same period.[20]

Although the difference between high-wage and low-wage workers has increased, a majority of men saw their real earnings rise 5 percent or more from 1979 to 1989, and a large majority of women (76 percent) saw their earnings increase.[21] Moreover, a broad array of measures indicates that the standard of living for most Americans continues to rise. To the extent that real wages are falling for some workers, the solution is not higher taxes, more mandates, or job-killing increases in the minimum wage. Instead, what is needed are lower taxes for families and reforms that will increase worker productivity and job opportunities for Americans by, for example, improving basic education and encouraging more investment.

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14 The term "wage differences" refers to the statistical distribution of workers' wages.

15 It is important to note that this possibility ignores income mobility and data that reveal most individuals' incomes increase over time.

16 Cox and Alm, "The Good Old Days Are Now."

17 John Bound and George Johnson, "What Are the Causes of Rising Wage Inequality in the United States?" Federal Reserve Bank of New York *Economic Policy Review*, January 1995.

18 Jagdish Bhageati, "Trade and Wages: Choosing Among Alternative Explanations," Federal Reserve Bank of New York *Economic Policy Review*, January 1995.

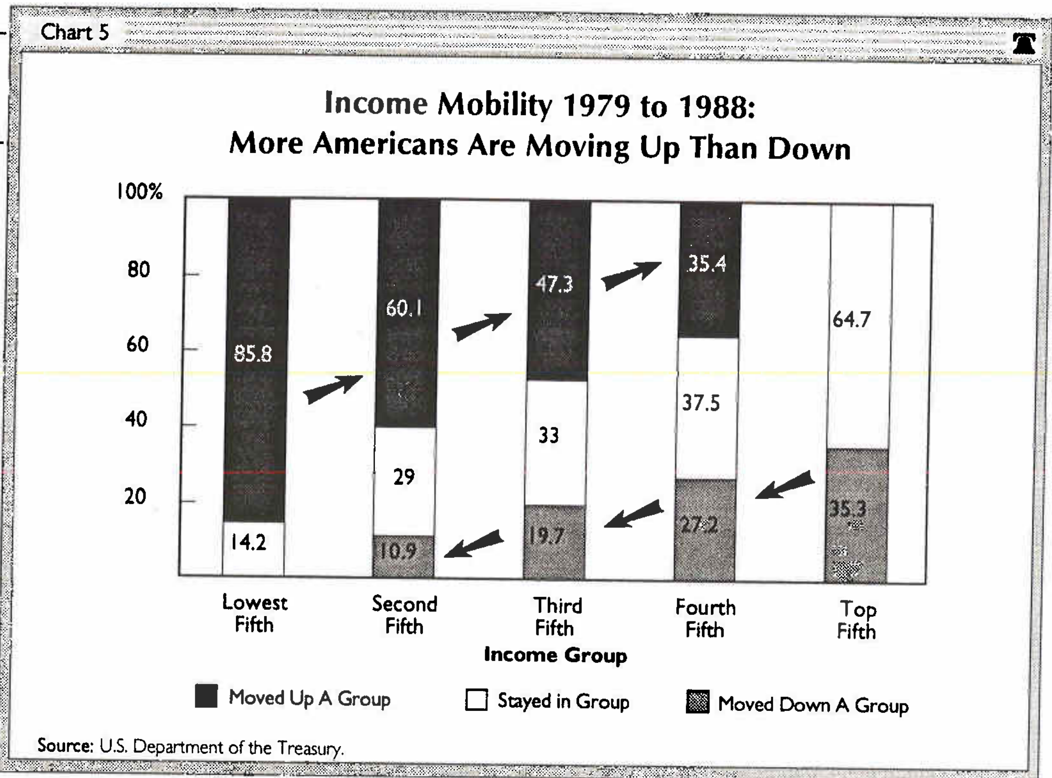
19 Gary Burtless, "Trends in the Level and Distribution of U.S. Living Standards, 1973-1993," draft paper, Brookings Institution, January 3, 1996.

20 Karl Zinsmeister, "Payday Mayday," *The American Enterprise*, September/October 1995, p. 44.

21 Stephen J. Rose, "On Shaky Ground: Rising Fears About Incomes and Earnings," National Commission for Employment Policy Research Report No. 94-02, October 1994.

MORE AMERICANS ARE MOVING UP THE ECONOMIC LADDER

The dynamic U.S. economy is characterized by an extraordinary degree of income mobility which has been all but ignored in the controversy over wage differences. The notion that low-income or high-income groups are composed of the same people over time is an illusion. Data on income mobility reveal that most workers' incomes increase over time. The comparison of average incomes by group would be meaningful only if America were a caste society in which the people comprising one group remained constant. This is one reason why Americans with modest incomes tend to resist "soak the rich" class warfare arguments: They hope to be rich one day themselves. Further, average wage statistics are affected by economic changes that do not adversely affect most American workers.[22]



During the 1980s, there was considerable upward mobility for those in the lower-income and middle-income groups.[23] For example, from 1979 to 1988, the income of 85.8 percent of workers in the lowest income group had increased enough to move them up into a higher-income group.[24]

Income mobility is important, but the direction of that mobility is more important. Needless to say, some people move up while others are moving down (see Chart 5). But in America, the upward movement of workers in the lowest, second-lowest, and middle-income groups is much larger than the downward movement. From 1979 to 1988, the income of 60.1 percent of workers in the second-lowest income group had increased enough to move them up into a higher income group, and 47.3 percent of workers in the middle group had moved up.[25] Over the same period, much smaller percentages of workers were moving down: only 10.9 percent of the second-lowest group and 19.7 percent of the middle group.

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22 For example, if all else remains the same, employment growth in smaller firms that generally pay less than larger firms will cause average wages to fall. Likewise, employment growth in service industries that generally pay less than manufacturing also will cause average wages to fall, even if the number of jobs and average pay in manufacturing remain the same.

23 "Income groups" refers to income quintiles. That is, all families or households are ranked top to bottom by income and divided into fifths, creating five income groups (bottom, lower, middle, upper, and top).

24 Joint Economic Committee, *Income Mobility and Economic Opportunity*, August 1995.

25 *Ibid.*

The possibility of moving down increases as incomes rise, while the probability that low-wage workers will move up is much greater for those in the lowest quintile. Moreover, a worker in the lowest income group was more likely to have moved into the top income group by 1988 than to have remained in the bottom group.

More than 60 percent of all workers can point to a minimum wage job as their first job experience.[26] Some 40 percent of workers starting a minimum wage job receive their first raise within 4 months, and 63 percent of those workers earn 20 percent more than the minimum wage within 12 months.[27]

The U.S. economy, while not without problems, thus remains dynamic, open, and productive enough to enable most Americans in the bottom income groups to work their way up the economic ladder. What is needed is policies to ensure that the opportunity for advancement is extended as widely as possible.

INTERNATIONAL COMPARISONS: MORE EQUALITY AND LESS GROWTH

Concern about stagnating wages and increasing income inequality has some politicians looking to Europe for solutions. But proponents of government actions to "alleviate inequality" would do well to ponder the anemic job growth in Europe. European firms are encumbered with costly mandates and taxes that have discouraged hiring and held back employment growth,[28] so while incomes are more equal in Europe, this equality comes with a very high price in terms of economic growth, new jobs, and inflation.

- From 1983 to 1993, the U.S. economy has grown an average of 2.9 percent per year, compared with 2.3 percent in the European Union.[29]
- Between 1970 and 1992, employment increased in the United States by 49 percent, compared with only 9 percent in the European Community.[30]
- Europe's employment rate (the proportion of its population of working age that is working) is the lowest of any industrialized part of the world. Moreover, it has fallen over the past two decades. The employment rate in the United States, which started in 1970 at a level similar to the European Community's, has grown in two decades to its current level of around 70 percent.[31]
- From 1983 to 1993, the U.S. unemployment rate averaged 6.9 percent per year, compared with 9.9 percent in the European Union.[32]
- From 1983 to 1993, consumer prices in the U.S. rose an average of 3.7 percent per year, compared with 5.1 percent in the European Union.[33]

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26 David Card and Alan Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton, N.J.: Princeton University Press, 1995).

27 Ralph E. Smith and Bruce Vavrichek, "The Wage Mobility of Minimum Wage Workers," *Industrial Relations and Labor Review*, Vol. XLVI, No. 1 (October 1992), pp. 82-88.

28 Adam Thierer, "Preparing for the 'Jobs Summit': The Five Principles of Job Creation," Heritage Foundation *Backgrounder* No. 982, March 11, 1994.

29 U.S. Department of Commerce, *U.S. Global Trade Outlook: 1995-2000*, 1995.

30 European Commission, internet site *http://www.cec.lu/en/record/white/c93700/ch8_1.html*, or as published in "White Paper on Growth, Competitiveness, and Employment: The Challenges and Ways Forward into the 21st Century," December 1993.

31 *Ibid.*

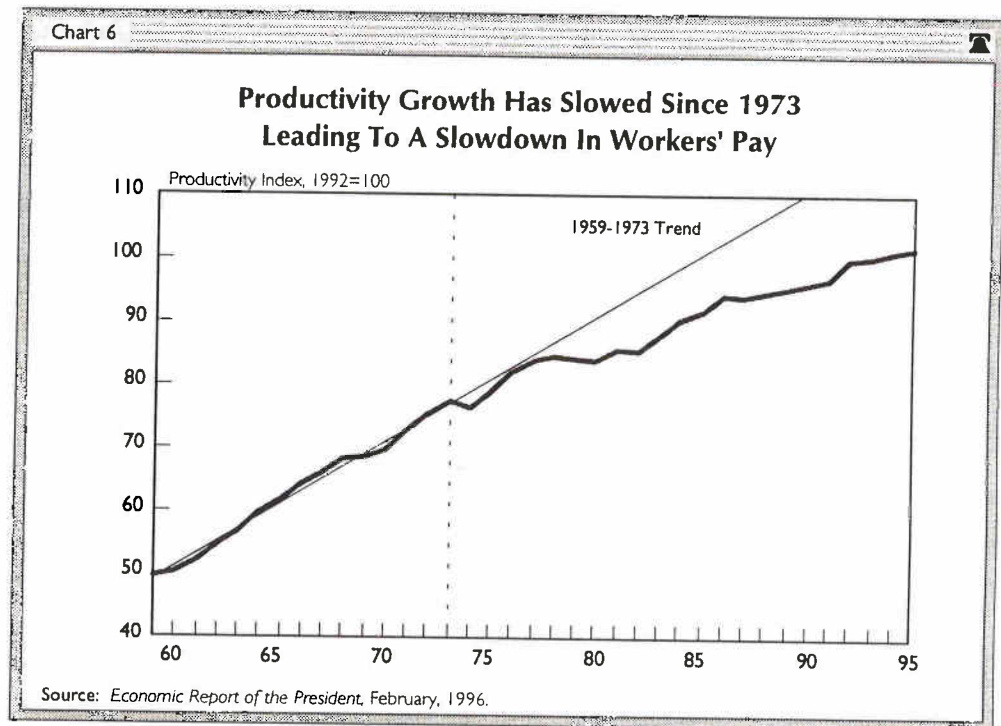
32 Department of Commerce, *U.S. Global Trade Outlook: 1995-2000*.

☞ Although wage differences between low-income and middle-income workers are much higher in the United States than in Europe, the relative differences between middle-income and high-income workers are the same.[34]

Europe is now realizing that its existing collective bargaining, tax, and labor cost arrangements do not create more jobs; instead, they cause gains from economic growth to be absorbed mainly by those already employed. European Community member states are seeking to remove obstacles to employment growth by adjusting employer taxes, the idea being to make more jobs available to the relatively less-skilled by reducing the cost to employers. They also are lowering the relative cost of labor with respect to other factors of production—for example, by reducing the employers' social security contributions. These are precisely the types of policies that should be adopted in the United States instead of more mandates and labor market restrictions.

TAXES AND MANDATES LIMIT TAKE-HOME PAY AND EMPLOYMENT GROWTH

Real compensation and benefits are important, but take-home pay is what matters most to workers.[35] The slow growth in take-home pay is not the result of corporate greed or trade deficits.[36] It is the result of a slowdown in the growth of productivity caused in part by the expansion of government regulation, which in turn reduces the net value of workers' output and contributes to slower wage growth.[37] Further, an ever-larger share of workers' total pay (wages and benefits) is beyond their control, consumed by mandated benefits and taxes.



As Chart 6 illustrates, productivity growth has slowed since 1973, leading to reductions in the growth of workers' pay. From 1959 to 1973, productivity increased an average of 3.2 percent per year, and real hourly compensation increased by an average of

33 *Ibid.*

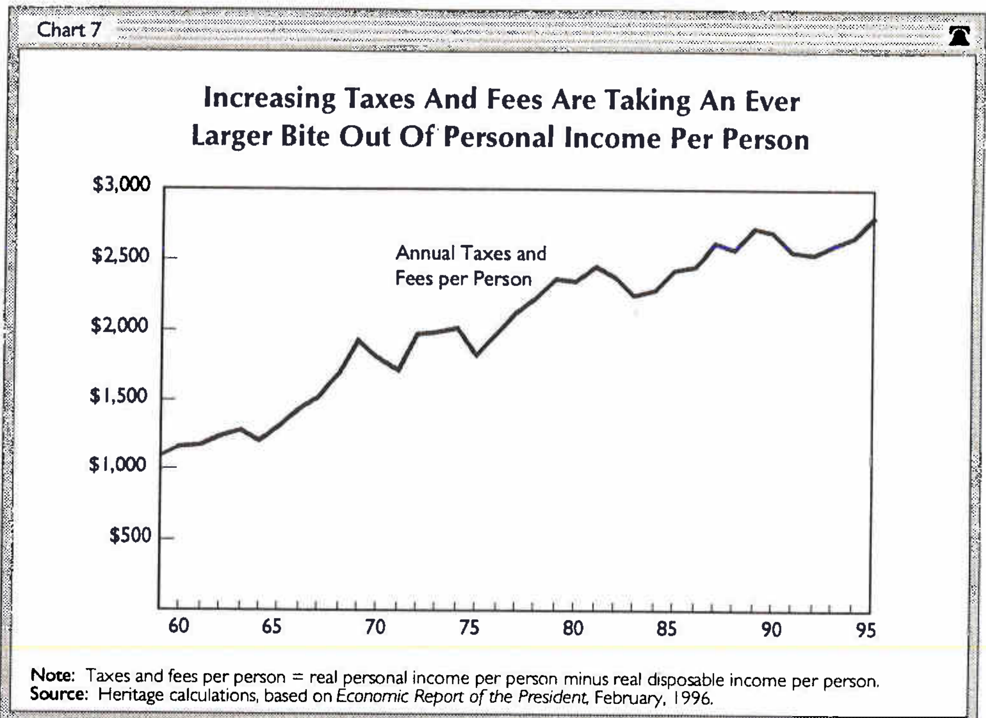
34 Francine D. Blau and Lawrence M. Kahn, "Wage Inequality: International Comparisons of Its Sources," American Enterprise Institute seminar presentation, March 18, 1996.

35 Take-home pay is defined here as total employee compensation less employer-paid benefits and taxes paid by both employer and worker.

36 Real wages began falling in 1973 about the time corporate profits also began to fall. The U.S. balance of trade also was substantially better, and NAFTA had not been signed.

37 Gray, "The Cost of Regulation: OSHA, EPA and the Productivity Slowdown," and Hopkins, "The Cost of Federal Regulation."

2.8 percent per year.[38] Between 1973 and 1994, however, productivity growth slowed to an average of 1.3 percent per year, and real hourly compensation growth increased an average of 0.4 percent per year.



Note: Taxes and fees per person = real personal income per person minus real disposable income per person.
Source: Heritage calculations, based on *Economic Report of the President*, February, 1996.

Government taxes and fees at all levels are taking an ever-increasing bite out of personal income (see Chart 7). Although personal income per person increased 121 percent from 1959 to 1995, government taxes and fees paid per person at all levels increased 155 percent over the same period. In 1994, federal, state, and local governments took an average of $2,800 (in 1992 dollars) from every man, woman, and child.

Several studies also point to the job-destroying effect of the regulatory and mandate explosion in recent years.[39] For example:

- There are at least 3 million fewer jobs in the American economy today because of the growth of regulation over the last 20 years.[40]
- A 1990 study estimated that environmental regulations alone had caused national employment to be 1.2 percent less in 1990 than it otherwise would have been.[41]
- In 1994, legally required benefits[42] accounted for 8.9 percent of total employer payrolls, up from 6.3 percent in 1971 and 3.5 percent in 1951.[43] These mandated benefits are not "free" to the worker, as many employees assume. A range of studies indicates that, on average, 88 percent of the cost of all legally required benefits or payroll taxes is shifted to workers in the form of reduced cash compensation.[44]

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38 *Economic Report of the President*, 1996), p. 332.

39 Lowell Gallaway and Richard Vedder, "Out of Work: Unemployment and Government in Twentieth-Century America," Holmes and Meier, 1994; Mitchell, "The Effects of Mandating Benefits Packages"; Gray, "The Cost of Regulation: OSHA, EPA and the Productivity Slowdown"; Hopkins, "The Cost of Federal Regulation."

40 William G. Laffer III, "How Regulation Is destroying American Jobs," Heritage Foundation *Backgrounder* No. 926, February 1993.

41 Michael Hazilla and Raymond J. Kopp, "Social Cost of Environmental Quality Regulations: A General Equilibrium Analysis," *Journal of Political Economy*, Vol. 98, No. 4 (1990), p. 867.

42 Legally required benefits include Social Security, unemployment insurance, and workers' compensation.

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

44 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).

- ☞ The increase in mandated benefits does not include the cost to employers and workers of complying with workplace safety and health regulations.[45] One study has estimated that 19 percent of the productivity slowdown during the 1970s is directly attributable to regulations published by the Occupational Safety and Health Administration (OSHA).[46]

Up to a certain point, government functions enhance economic well-being. Beyond that point, however, the burden of excessive government reduces economic growth.[47] Employers and workers are straining under unnecessarily burdensome regulations, mandates, and high taxes on labor and capital. This increasing drag on economic freedom has slowed growth, job creation, and wage gains. Government must roll back taxes, reduce the regulatory burden, and balance the budget to unshackle the economy and increase the real wages of all American workers.

CONCLUSION

The conventional wisdom is that wages are down, the middle class is shrinking, corporations are getting fat, and the rich are getting richer at the expense of the poor. Like most other examples of conventional wisdom, it is wrong.

The United States remains a nation of extraordinary opportunity and mobility. The real wages of high-income, middle-income, and low-income workers do not come at the expense of each other; they rise and fall together. The U.S. economy remains dynamic, open, and productive enough to enable most Americans to work their way up the economic ladder. To the extent that real wages are falling for some workers, the solution is not more government programs, trade restrictions, or job-killing increases in the minimum wage; it is policies that focus on the primary problems: high taxes and slow productivity growth. Only by correcting these problems can we increase job opportunities and real wages for all Americans.

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45 William G. Laffer III and Nancy A. Bord, "George Bush's Hidden Tax: The Explosion of Regulation," Heritage Foundation *Backgrounder* No. 905, July 10, 1992.

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

47 *The Impact of the Welfare State on the American Economy*, Joint Economic Committee, U.S. House of Representatives, 104th Cong., 2nd Sess., December 1995. This report suggests that the optimal level of federal government spending is about 17.6 percent of gross domestic product. Beyond this point, the private resources consumed by government impose more costs on the economy than benefits. The current level of federal outlays is about 4 percentage points of GDP higher than its optimal level.