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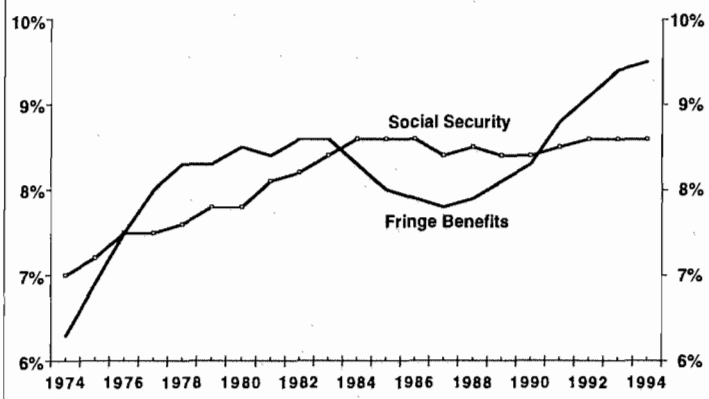
The Truth About Wages

In June, the Bureau of Labor Statistics released its annual report on employer costs for employee compensation. Based on a survey taken in March, the report stated that employer costs averaged $18.38 per hour for workers in private industry and state and local governments. Of this amount, $13.12 per hour went to wages and salaries and $5.26 to employee benefits and taxes.

Press reports ignored fringe benefits and made much of the fact that although wages had risen since 1994, after adjustment for inflation they had fallen by 30 cents per hour. A former Clinton Treasury Department economist, Professor Bradford DeLong of the University of California at Berkeley, told the *New York Times* that the decline in real wages was the greatest since the 1840s. In fact, the decline in real wages was almost totally offset by an increase in nonwage compensation.

FIGURE I

Social Security and Fringe Benefits as Shares of Employee Compensation



Source: Department of Commerce.

Under Republican administrations, liberal critics would have laid the blame for any decline in wages directly on the doorstep of the president. However, Labor Secretary Robert Reich attempted to deflect blame by pointing the finger at Big Business. "The owners of capital are registering huge gains while ordinary working Americans are seeing their incomes fall," he said.

The spin worked with the media. Instead of asking whether the Clinton administration's policies of raising taxes, increasing spending and expanding government regulation were to blame for the decline in real wages, they turned their attention to business. For example, columnist Morton Kondracke wrote, "In the manufacturing sector...productivity increased by 4.9 percent from 1993 to 1994, but wages and benefits dropped by 2 percent. The difference went into corporate profits."

The Role of Nonwage Compensation. The Department of Commerce divides total employee compensation into three major categories: (1) wages and salaries, (2) employer contributions for social insurance (i.e., Social Security), and (3) other labor income, which consists mainly of such fringe benefits as pensions, health and life insurance and workers' compensation.

As Figure I indicates, both of the nonwage portions of compensation have risen sharply over the last 20 years.

- In 1974, employer contributions for social insurance took just 7 percent of total compensation.
- By 1994, it had risen to 8.6 percent, the result of numerous increases in Social Security tax rates and the taxable wage base.

The percentage of compensation going to fringe benefits has risen even more.

- In 1974, fringe benefits accounted for 6.3 percent of employee compensation.
- By 1994, they had risen to 9.5 percent of compensation.

In short, workers have chosen to take more of their compensation in the form of benefits, and their choice is not surprising. Benefits are tax free, whereas wages are taxable.

That workers will substitute tax-free benefits for taxable wages when tax rates rise is a phenomenon well documented in the economic literature. For example:

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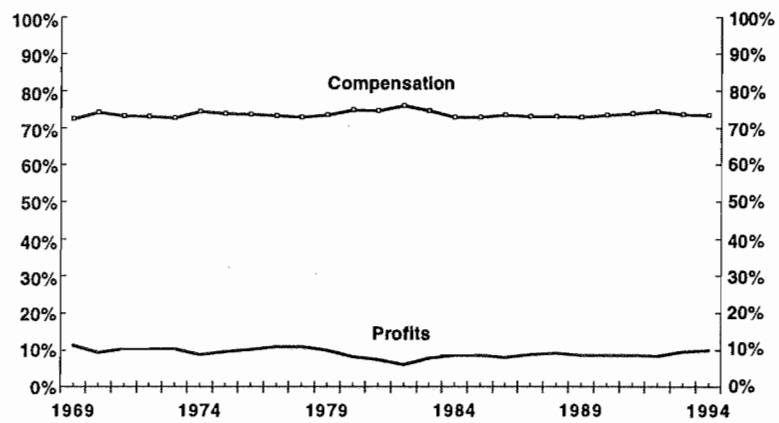
- A 1978 study by Professor Henry Farber of MIT found that union workers valued an additional $1 of fringe benefits 40 percent more than $1 of discretionary income.
- A more recent study by Professors William Gentry and Eric Peress of Duke University found that a 1 percentage point tax increase raises the percentage of blue-collar workers offered employer-financed life insurance and pensions by between 1.21 percentage points and 1.33 percentage points.

Responding to Higher Tax Rates. The steepest rise in benefits came during the 1970s, when inflation was pushing workers into higher and higher tax brackets. In the early 1980s, after the Reagan administration got inflation under control, indexed tax brackets to inflation and cut tax rates, workers shifted out of benefits and took more of their income in the form of wages.

FIGURE II

Compensation of Employees and Corporate Profits as Shares of National Income



Source: Department of Commerce.

Since 1990, tax rates have been rising again, as the result of the Bush and Clinton tax increases. Workers have responded by increasing the share of their compensation from tax-free benefits. Thus President Clinton's 1993 tax increase was a major contributor to the relative decline in wages that his labor secretary so decries.

Employee Compensation and Corporate Profit. As Figure II shows, workers receive almost three-quarters of national income, while corporate profits amount to less than 10 percent. These numbers are very consistent over time. There is certainly no trend toward higher profits at the expense of employee compensation.

While it is true that the stock market has hit record highs in recent months, the principal beneficiaries are not fat-cat businessmen, but workers. More than 25 percent of all corporate equities are held by employee pension funds — up from just 9 percent as recently as 1970. And this figure is very conservative because it measures only pensions that are institutionally managed — mainly defined-benefit plans — thus excluding many defined-contribution plans that workers manage themselves.

In general, labor and capital do not compete with each other for a share of the pie. Their fortunes rise and fall together with the general health of the economy. Ultimately, what is good for profits is good for wages and vice versa.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett.

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