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Abstract: A popular and highly politicized theme today is that US workers are falling behind as their real wages fall and income gets redistributed to the rich. This article looks at some reasons that income inequality could rise, and then explores whether, in fact, workers are losing out. It looks at the suggestion that workers are falling behind relative to the wealthy, and at evidence on whether workers real wages have been falling, or perhaps only manufacturing wages. It also examines whether there is a growing "wealth gap" and whether it is due to falling labor compensation relative to wealth. Finally it examines the hypothesis that relatively inexperienced or unskilled workers are falling behind by fixing a skill level and seeing how real wages are changing over the recent past. The evidence here provides a perspective on why some analysts might believe that there is rising inequality or an emerging wealth gap, or that workers are falling behind, but generally it is not favorable to these pessimistic views of how well workers are doing. While inequality may have risen in recent decades, and there are strong reasons to think that the evidence for this is weak, there is also a strong reason to think that it would be a normal function of an aging population and nothing more. Short of population control or unexplainable and unfair redistribution from the old to the young, there may be nothing that can or should be done to reverse the rise in inequality. Finally the paper argues that there is a wealth gap, but it is due to falling real interest rates and a decline and not due to declining compensation, either absolutely or relative to overall income.

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Is Inequality Growing as American Workers Fall Behind?

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A popular and highly politicized theme today is that US workers are falling behind as their real wages fall and income gets redistributed to the rich. Newly-elected Senator Jim Webb (2006) has been a leader in espousing this view and the Hamilton Project at the Brookings Institution, led by Robert Rubin, Lawrence Summers and Roger Altman, is dedicated to the study of this problem. Fed Chairman Bernanke (2007) recently accepted the thesis that there is a rising inequality problem and admonished his audience and readers to be careful not to attack inequality with tax increases or trade restrictions that would damage the overall economy.

Bernanke's predecessor, Allan Greenspan, often warned of the seriousness of the rise in inequality; for example, in testimony before the Senate Banking Committee in June 2005, he said, "As I have often said, this is not the type of thing which a democratic society --a capitalist democratic society—can really accept without addressing."
Measuring inequality is difficult, however. Existing evidence is not strongly supportive that it has increased and there is little consensus on why it might have changed

This article looks at some reasons that income inequality could rise, and then explores whether in fact workers are losing out. In section 3, it looks at the suggestion that workers are falling behind relative to the wealthy, and at evidence on whether workers real wages have been falling, or perhaps only manufacturing wages. In the next section it looks at whether there is a growing wealth gap and whether it is due to falling labor compensation relative to wealth. Finally it examines the hypothesis that relatively inexperienced or unskilled workers are falling behind by fixing a skill level and seeing how real wages are changing over the recent past. The evidence here provides a perspective on why some analysts might believe that there is rising inequality or an emerging wealth gap, but generally it is not favorable to these pessimistic views of how well workers are doing.

I. Why could inequality have risen?

One of the principal explanations for the popular view that workers are falling behind at the expense of the rich capitalists of the country, is another popular view that holds that more skilled, more experienced and higher income workers have benefited from rapid technological change, boosting their incomes relative to the unskilled, inexperienced low-wage workers.[1] This explanation directly leads to the number one solution to rising inequality, which is to boost the income levels of those who would otherwise be at the bottom by attempting to equalize educational outcomes. This has proven very difficult in

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[1] The term "capitalists" is used here because of the common distinction in the work on the distribution of income and wealth between income from labor and from non-human capital. Here the term refers to those who earn income from non-human capital, including profits, dividends, royalties, rents, interest or similar returns. In reality, workers are capitalists too, both in the sense that their earnings are the return to human capital and also in the sense that most workers own non-human capital and earn capital income. .

recent years as high school drop-out rates have risen, but remains a key link to higher income of those otherwise destined to be relatively poor. Another popular view, certainly more questionable, is that rising inequality is due to globalization. *The Economist* (2007), among many others, takes this view suggests that rising inequality will pressure acceptance of future or even past steps to open trade. Bernanke (2007) downplays the possibility, arguing that globalization plays a "moderate" role in accounting for inequality and that skill-biased technical change has been more important.

A key neglected factor affecting inequality is the aging of the population. In the US the baby boom has caused the median age of the population to rise from about 28 years old to about 36 years old today, and it will peak near 38.6 percent in 2040 as the baby boom is disappearing as the latest cohort in the US population. What has this to do with inequality?

If we focus on only two sources of earnings, wage income and income from capital—profits, dividends, interest or rents, the distribution of income depends upon the distribution of ownership of labor and capital resources. If there were no physical capital and all workers were age 20 and had the same basic educational levels, say just starting out in life, the sources of income variation would be very small, basically arising from differences in basic intelligence, learned skill differences, willingness to participate in the labor force or inherited social capital. There would be relatively little inequality of income among this population.

As this group ages, however, the sources of inequality would multiply. Workers would invest in education and skills to different degrees leading to different occupational choices and in turn to different paces of wage gain due to industry or occupation specific technological change. Larger wage dispersion among the group would emerge over time. Moreover, even if the young group had the same saving rate and inheritance prospects, differences in capital ownership and income from capital would emerge because of differences in asset allocation, especially risk tolerance and luck and timing. Moreover, they would not have the same saving rates or inheritance levels at every point in time or income level, boosting the inequality among them. Attendance at a high school or college reunion is sufficient to drive home the point.

If the population ages, inequality will increase as older less equal groups come to dominate the population. Similarly, populations that become younger are likely to have more equal incomes, other influences remaining the same. During the 1950s and 1960s as the population became younger, inequality fell, according to many estimates, and not surprisingly as the median age began to rise, especially after the baby-boomers had fully entered the labor force around 1980, income inequality began to rise. There may be many other factors accounting for rising inequality, but this one is glaring and potentially has huge effects on the distribution of income and wealth.

Piketty and Saez (1998) have produced estimates of the inequality from 1913 to 2004 that have attracted considerable attention because it they show that inequality has risen back to levels last seen in the 1930s. Most famously, both Jim Webb (2006) and Alan Reynolds (2006, 2007) have taken up their charge that "the top 1% now takes in an astonishing 16%

of national income, up from 8% in 1980," the former acceptingly and the latter critically. Reynolds (2006, 2007) focuses on several problems with the income measure that they use to assess growing inequality, including rising income in retirement and other accounts that is not taxed until it is distributed. In fact, what is more significant is the fact that the growing new savings accounts have removed larger and larger shares of income from being reported by low and middle income earners giving rise to the appearance that they are getting smaller shares of income, to the benefit of the rich, that more and more business income is being shifted to be realized on individual tax returns instead of business tax returns and that the use of reported income for tax purposes excludes transfer payments that are relatively more beneficial to the non-rich. Bernanke does not avoid these problems by the use of the distribution of after-tax income, though the larger tax cuts for low-o and middle-income taxpayers ameliorates the shift observed by Bernanke, compared with that reported by Piketty and Saenz.

Piketty and Saez (2007) responded to Reynolds, but miss his major point that the reported income they use has been increasingly biased over time because more and more of income is not reported for tax reasons. One factor that Reynolds notes is the increasing share of income that accrues in IRA, 401k programs and other plans that allow income to accumulate without taxation. What is even more important is the growing omission of income on tax returns because pre-tax income is being invested in various defined contribution plans. Also, neither Piketty and Saenz or Reynolds note that increasing amounts of income are now being realized through payments for fringe benefits, especially health care insurance, employer contributions for retirement income, vacations, sick leave and other benefits. These benefits are more equally distributed across income levels. Thus the rise in benefits is giving rise to the appearance that wages and salaries excluding benefits are rising much more slowly among lower wage workers, as Bernanke highlights, and that higher income workers have disproportionately higher reported income for tax purposes.

Focusing only on the employee contributions for health and retirement saving programs, especially for example, 401K programs, the largest share of this "unmeasured" income accrues to the middle class, giving rise to the appearance of a disappearing middle class and a rising share of income among the top income recipients. In 2006, for example, a worker over 50 could contribute a maximum of $20,000 ($15000 for employees under age 50) to a company-sponsored plan such as a 401K program. This would reduce the measured income from tax reports by 40 percent for a worker earning $50,000 per year, but only 10 percent for a worker making $200,000. For some public employees and teachers, the case is even more impressive. They can contribute twice as much as other workers resulting in double the understatement of their incomes for estimating shares of income. For the top 1 percent of workers, making over $300,000, the maximum allowable contribution would lower their measured income by less than 7 percent. The result is the appearance that relatively more measured income is accruing to those at the top. As Reynolds points out, other measures of income do not produce such a doubling of the share accruing to the top 1 percent, though many experts accept the notion that there is a rise.

II. Are workers falling behind?

Real compensation per hour of workers has been growing very rapidly in this decade, contrary to popular opinion. This should not be surprising because of the unusually rapid growth in productivity that is occurring and the fact that real wage gains are tied to productivity advances. Chart 1 shows that manufacturing compensation per hour is also rising rapidly compared with the business sector. The manufacturing data are only available since 1987.

Chart 1
Real compensation per hour is not falling

Some analysts who think that workers are falling behind focus on manufacturing wages, where globalization might have taken its biggest toll on less well-educated and less-competitive workers.[2] This conception of developments in manufacturing could not be further from the truth. Manufacturing real wages have risen at a 3 percent annual rate since mid-1997, somewhat faster than in the overall business sector where real wages rose at a rapid 2.7 percent pace. Since the end of 2003, manufacturing real wage growth has been slow, but this offsets the 6 percent annual pace of growth in 2002-03. Focusing only on the wage argument, manufacturing compensation has been rising faster than consumer

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[2] Studies by Bhagwati and Kosters (1994), Bhagwati (2004) and by Feenstra, alone and with and Gordon Hanson, discussed in Feenstra (2007), have looked at whether globalization has accounted for declining real wages of unskilled workers and concluded that there has been little effect. Feenstra and others focus on the distinction between production and non-production workers in manufacturing to assess the effects on workers with different skills, assuming that the production workers have less skill. Another way to look at workers with less skill is to use entry level salaries; see section 4. The use of manufacturing workers is attractive because this sector is expected to be more affected by trade.

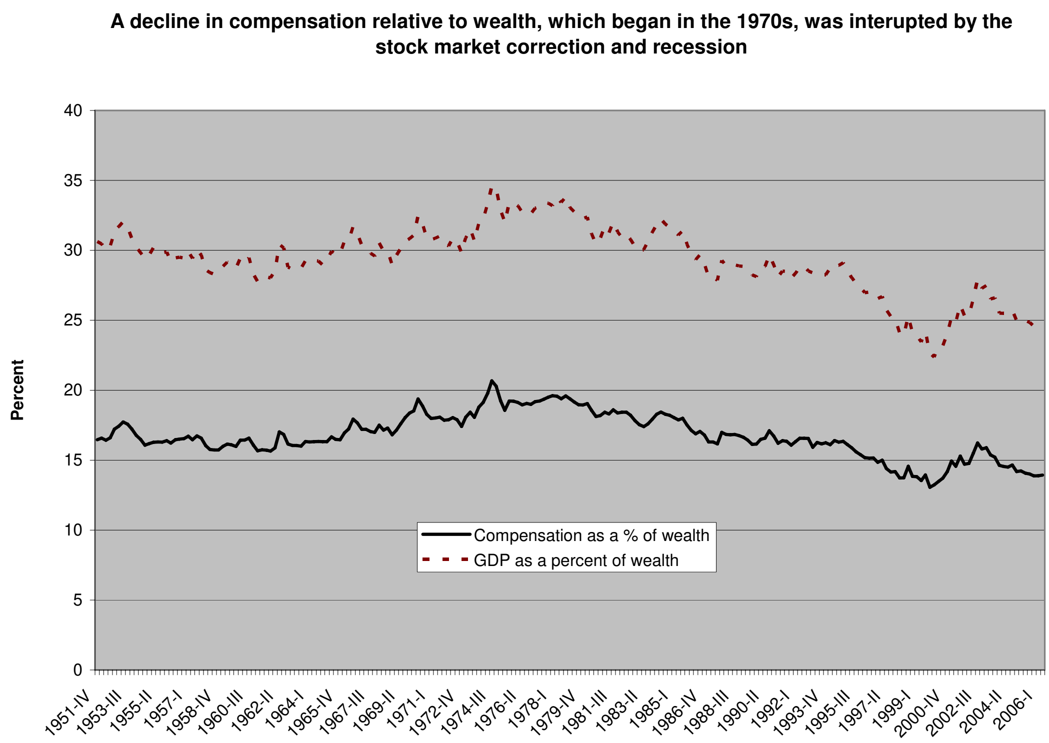
prices (measured by the personal consumption expenditure deflator) and actually rising faster than in the overall business sector of the economy for almost 10 years.

Manufacturing compensation per hour has been relatively high since 2002. From 1987 to the third quarter of 2001, manufacturing wages fell from over 112% of business sector compensation to about 106 percent. Since then it climbed to over 114 percent at the end of 2003. While relative wages fell subsequently, they have been higher in 2004-06 than they were in 1996-2001. At their lowest in 2006, manufacturing wages were over 10 percent higher than the average level for the business sector, a level achieved in only a few quarters from 1987 to 2002.

III. Is there a growing wealth gap?

Senator Jim Webb and others argue that workers are not keeping up with the wealthy, which is a key reason why inequality is rising and workers are falling behind. They focus on the declining share of wages relative to overall wealth, or what they call the "wealth gap." Chart 2 shows that employee compensation as a percentage of wealth has been falling recently, but that it has been falling since the 1970s, except for in the early part of this decade (I/2000-III/2002) when the stock market correction boosted the ratio.

Chart 2
The wealth gap has been growing for almost 30 years



The chart also indicates why compensation has not kept pace with wealth. The size of compensation relative to wealth can be thought of as the product of two measures, compensation as a share of income or GDP, and the size of GDP per dollar of wealth. This second measure is also shown in Chart 2. Advocates of the view that labor is falling behind suggest that this decline is occurring because labor is getting less, and that capitalists are getting more, of each dollar of income. But in fact it is the shortfall in income relative to wealth, not of wages that is the proximate cause of the decline in compensation relative to wealth.

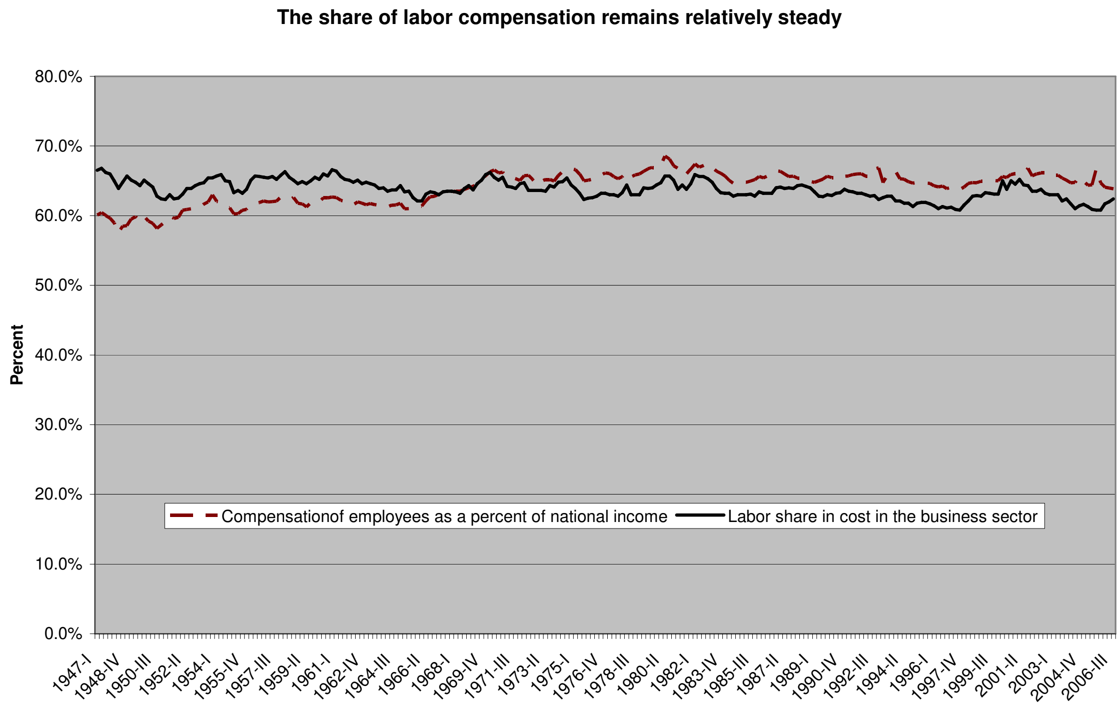
The nation’s income has not kept pace with wealth growth according to Chart 2. Moreover, movements in GDP relative to wealth account for the entire decline in compensation relative to wealth and reflect the decline in real interest rates that has been going on for a long time, but especially since early 1995 when both lines in Chart 2 begin a more rapid pace of decline. When the share of wage gap line in Chart 2 is constructed with a constant ratio of compensation to GDP, the historical average ratio, the adjusted wealth gap, with the unchanged compensation-GDP measure, the adjusted series lies almost exactly on top of the actual ratio shown in the solid line of Chart 2. This means that nearly all of the variation in the actual data is due to the movements in GDP per dollar of wealth. This is understandable because the only other source of change, compensation as a percent of GDP, shows little variation around a constant over time.

The declining ratio of GDP to wealth is essentially the ratio of income to the assets that generate that income, thus it is an indicator of the rate of return on the nation’s wealth, or the real rate of return on wealth. It is tied to the real rate of interest. There can be many reasons why this has declined, but a shortfall of compensation is not among them.

Chart 3 makes this clearer. It shows the share of business sector compensation in total cost and national income account measure of the compensation of employees as a percent of national income. The national income measure in the chart includes the government and household sectors but excludes some components of benefits and the compensation measure from the National Income and Product Accounts (NIPA) is for employees only. The line is included for comparison purposes only, although its compensation measure is the same as that used in Chat 1 to show the wealth gap. .

Both lines are relatively stable though the former is more stable, illustrating the well-know relative constancy of the share of labor in cost and in the nation’s output and domestic income. Most importantly, there is no significant drop in recent years. In some periods it does appear that there is a statistically significant negative trend, such as when the data set ends in mid-1997 or in early 2006, but statistical tests find that the share is “stationary,” or tends to gravitate toward its mean for all periods, or when a trend appears that it is statistically significant, the share tends to gravitate toward its trend without falling away it.

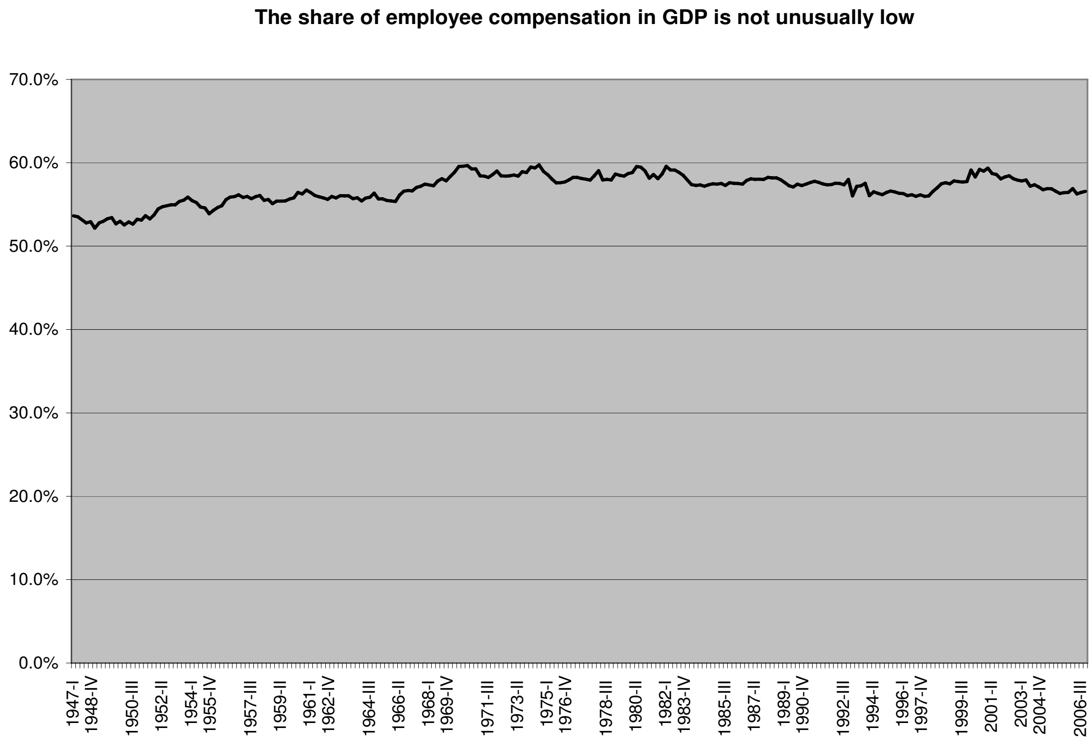
Chart 3
Labor share in income is not unusually low



Focusing on the business sector measure, it is the case that the labor share matched its lowest earlier level in the first quarter of 2006, but it was no lower that in the comparable cyclical period in mid-1997, before wages surged moving the share up quickly to above average. In early 2006, this share at 60.8 percent was not much below the 1947-06 mean of 63.7 percent. By the third quarter of 2006 it was 62.4 percent, only one standard deviation below the mean.

To be more accurate, the share of labor compensation in GDP implicit in the ratio of compensation relative to wealth in Chart 2 is not the same as either of the shares shown in Chart 3. The latter ratio is shown in chart 4. It differs from the share of labor in the business sector because of differences in the compensation measure and because of movements in the share of the business sector relative to overall GDP. The share of the NIPA measure e of employee compensation in GDP is not a constant, unlike that for the business sector, and it also does not have a clear trend. Statistical tests of the stationarity of the ratio, that is, whether it fluctuates around a given and fixed mean, a constant, or perhaps is trend stationary, fluctuating around a given deterministic trend, show that it is neither. Presumably this is the case because the share of the business sector output in GDP is not stationary.

Chart 4
The share of NIPA employee compensation in GDP is not unusually low



Source: US Bureau of Economic Analysis

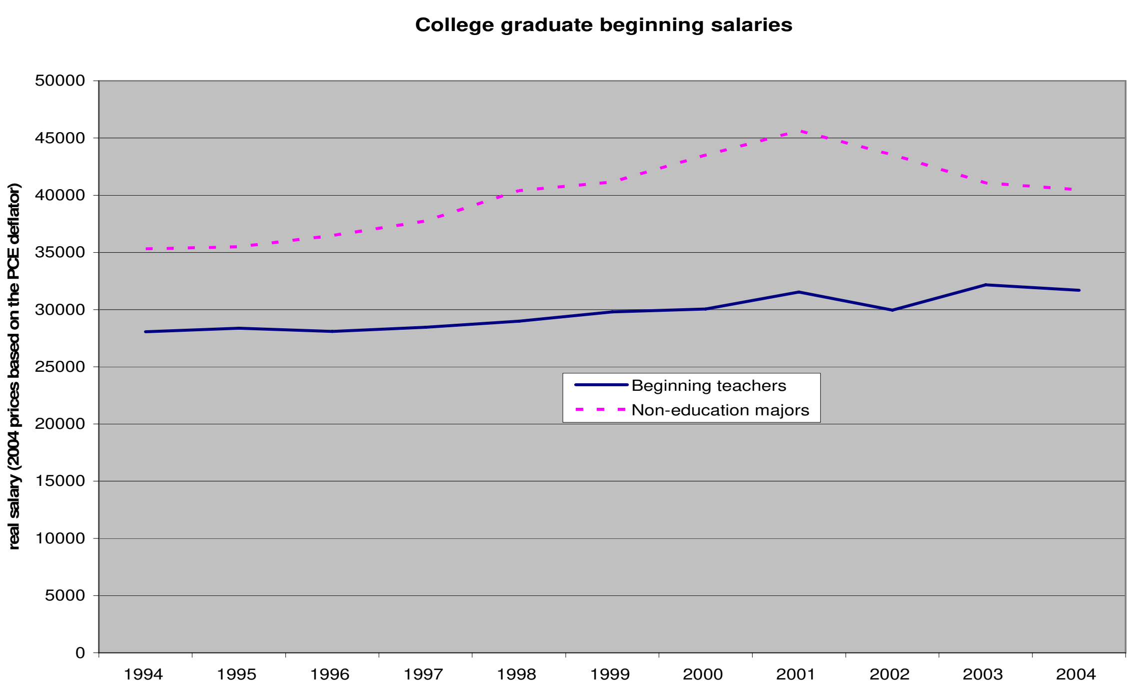
But the share of employee compensation in GDP also has not fallen unusually in recent years, nor is it at historical lows, as some analysts have suggested. The latest observation is 56.4 percent of GDP, down from the most recent peak of 59.0 percent in IV/2000. The lowest ratio shown in the chart was in mid-1948 when the ratio hit 52.2 percent. So the level of compensation has declined 4.4 percent relative to GDP sine the end of 2000, but the recent ratio is less than one standard deviation below its 1947-06 mean of 57.2 percent (standard deviation equals 1.32%). Note the ratio was lower in 1997 than it has been recently. Note also that when it was so low, it subsequently surged up beyond its mean, just as it has begun to do lately. Again this is not simply the vagaries of the chart; instead it is based on standard economic behavior that boosts the demand for labor and wages whenever there is a discrepancy between real wagers and productivity. More importantly, fluctuations in the share of compensation in GDP have not played any role in accounting for fluctuations in compensation relative to wealth.

While the share of labor compensation has been low recently, it is not unusually low relative to its past history and certainly was not so low as to suggest that the hypothesis that it is essentially constant has been refuted nor has its low level played a notable role in accounting for the decline in compensation relative to wealth. While there is some evidence that the labor share fluctuates around a slight negative trend for some sample periods ending after 1996, this would not alter the conclusions that the labor share of income is not unusually low in recent years or that its movements have not shown a significant break from past performance. Standard statistical tests show that it fluctuates around its mean, or sometimes around a slightly negative trend, with no tendency to drift off or fall sharply off from its past behavior. The decline in compensation relative to wealth has been fully accounted for by the decline in the real rate of interest in recent years, in particular the decline in GDP per unit of wealth.

IV. Have the wages of the least experienced workers fallen?

Part of the story of the workers falling behind suggests that workers with the least education or the least experience are suffering the largest relative decline in real wages. If manufacturing workers are not falling behind, then perhaps it is entry level workers with the least skills. It is difficult to assess the wages of workers with a common level of little or no experience. One such group that is clearly middle class or destined to be so are new college graduates and beginning teachers. They are more homogeneous at least as far as their occupational choice where they are the least experienced in their field. While relatively inexperienced, these workers are better educated than the average worker. Nonetheless, their wages may provide some insight about wage trends and inequality. The American Federation of Teachers collects information on beginning teacher salaries of new college graduates and their non-education major contemporaries. Chart 5 shows these wages adjusted for price movements from 1994 to 2004. Prices are measure by the personal consumption expenditure deflator and wages are expressed in 2004 prices.

Chart 5
Wages of new teachers and other graduates have not been weak



Source: American Federation of Teachers

Both wage series show rising real wages over the period, although wages of non-education majors are more cyclical rising more in 1998-2001 and falling in 2002-04. The real wage of beginning teachers also fell in 2002. For the whole period, wages of teachers started at 79.4 percent of non-education majors in 1994 and were little different, at 78.3 percent, in 2004, the latest data available. For the full period 1994-2004, wages of non-education majors rose at a 1.37 percent annual rate, slightly faster than the 1.23 percent rate for beginning teachers. Both figures are slower than the pace of real compensation growth over the same 10-year period in manufacturing (2.41%) or the business sector (2.28%), which suggests that relatively inexperienced college graduates may be falling behind relative to the average worker.

The comparison could simply reflect the fact that the beginning wage data ignore benefits such as health insurance, while the compensation data for manufacturing and the business sector do not. Since benefits are the fastest growing component of compensation, it is not clear that beginning wage data show that the less experienced receive lower compensation gains. The employment cost index for manufacturing "wages and salaries only" suggest that this is not the reason. From 1994 to 2004, the employment cost index for wages and salaries, deflated by the PCE deflator, in manufacturing rose at a 1.22 percent rate, about the same as for teachers and only slightly below the 1.37 percent pace for a group that the Bureau of Labor Statistics (BLS) employment cost index data that benefits rose faster than wages and salaries over the period as well, about 0.62 percent to 0.85 percent per year faster, depending upon the group. Thus it would appear that real wages and salaries and probably real compensation are growing at about the same pace for beginning teachers and other college graduates as for the manufacturing or civilian sectors. This work result should be taken only as suggestive, but it is certainly not consistent with the notion that the least experienced workers are falling behind more experienced workers.

V. Conclusion

There are many reasons why inequality could have risen in recent years, but perhaps the most neglected one is the aging of the US population. Older workers have more diversity in education, experience, accumulated wealth and income from wealth than young people. Not surprisingly, indicators of inequality of retraced its decline following World War II when the population became younger, as the median age rose. But measures of inequality are suspect in themselves, and certainly overstate the rise in inequality since the 1980s. This is because most measures of income that are used to assess distributional shares exclude the large share of income that lower and especially middle income workers are able to save as before tax income. Moreover, the income from these assets is also not included in assessing the distribution of income. Similarly, health insurance and other benefits, which are distributed more equally across income levels at most firms have dominated compensation trends in recent years making comparisons of reported taxable or after-tax income biased in favor of observing rising inequality.

One of the most widely used measures that suggest that rising inequality is occurring due to workers falling behind is the wealth gap, or the declining ratio of compensation to wealth. Compensation has fallen recently relative to wealth, supporting the claim that there is a growing wealth gap. Except for a brief period associated with the stock market correction, recession and recovery from early 2000 to mid-2002, however, the ratio of compensation to wealth has been for several decades. Indeed, it has been falling since the mid-1970s and fell especially sharply in the late-1990s and again since 2002. IN mod-2006, the latest available data, compensation was 5.2 percent higher than it had been in mid-1997, its previous low.

Not only is the behavior of compensation relative to wealth not a new phenomenon, it does not merit being called a "wealth gap," at least not in the sense that it shows that workers are somehow losing out to the wealthy. The share of compensation in income is remarkably stable in the US economy. Thus the share going to labor fluctuates slightly but remains close to its average; more importantly, it has a tendency to return to its average so that when the share is low, wages tend to grow faster than productivity pulling the share back toward its mean, and when wages are relatively high compared with productivity, wage growth slows pulling the share back down toward its mean. In recent years the labor share has been a little low, so, not surprisingly, wage growth is accelerating and the share is rising, much as occurred after mid-1997, the last time the labor share of income was a little low relative to its mean.

A declining compensation-wealth ration also does not imply that real wages are falling. The evidence here show that wages overall and in manufacturing have shown stellar advances over the past seven years. Declining manufacturing wages, feared by some, have not occurred. Another theme, that rising inequality has occurred because the least experienced or educated workers have fallen behind, also does not get support from the data here. Beginning wages for teachers and non-education college graduates, two groups with little or no experience in their chosen fiends have mover up and done so for 1994-2004 at the same pace as earnings in manufacturing or the business sector as a whole.

The only meaningful driver of the wealth gap, the share of compensation on wealth, is overall income relative to the nation's wealth, or the ratio of GDP to wealth. This is a rough indicator of the rate of return to capital in the economy. This ratio has been declining for many years and accounts for the wealth gap. Since the ratio of GDP to wealth is closely tied to the real rate of interest, one can conclude that tit is the decline in the real rate of interest that accounts for the so-called wealth gap, not some weakness in compensation. Just as any weakness in compensation might suggest serious social problems and public policy issues, so too with the decline in the real interest rate.

Another argument that purports to show that income of capitalists is rising relative to workers is the boom in corporate profits since end of the recession. Corporate profit shave climbed to over 12 percent of GDP, a level not seen since occasional peaks from 1950 to 1965. But that issue has already been addressed, at least implicitly. The constancy of the share of labor, or the fact that its small decline since 2000 did not reduce it to unusually low levels, imply that the share of capital did not rise unusually either. Remember that corporate profits are not the only return to capital. Lower interest income and rental income relative to GDP have offset the rise in the return on equity (as a percent of GDP). Moreover, lower real interest rates, in this case, on corporate debt, have played a role in redistributing income from creditors to owners of corporations. The net result has been little change in the share of income to capital.

A low real interest rate also explains why stock and other asset prices are relatively high, but it would also mean that the cost today of promised future retirement benefits represent a much larger cost today that we might have expected in the past, both for the businesses and the governments that made them. It also means that accumulating wealth to use in our retirement years, especially to make up for a current shortfall, will be much more difficult because the same saving effort will be met with much smaller returns that might have been the case in the past. Either way—weak compensation, or weak returns to capital—some individuals are losing out relative to past expectations. And either way it is important to know why and with what effect, before dashing off to develop a public policy aimed at correcting any perceived problem. But most of all, it matters whether we have found the culprit in falling wages or whether the problem is the exact opposite of what it appears to be, at least to some.

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