Is the Distribution of Income Shifting Away from Workers?

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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.

The development of a wealth gap, shown by a decline in worker compensation relative to household wealth, has caught the attention of many critics because it suggests that workers are falling behind compared with those with income from capital. This inference is questioned here.

Is there a growing wealth gap?

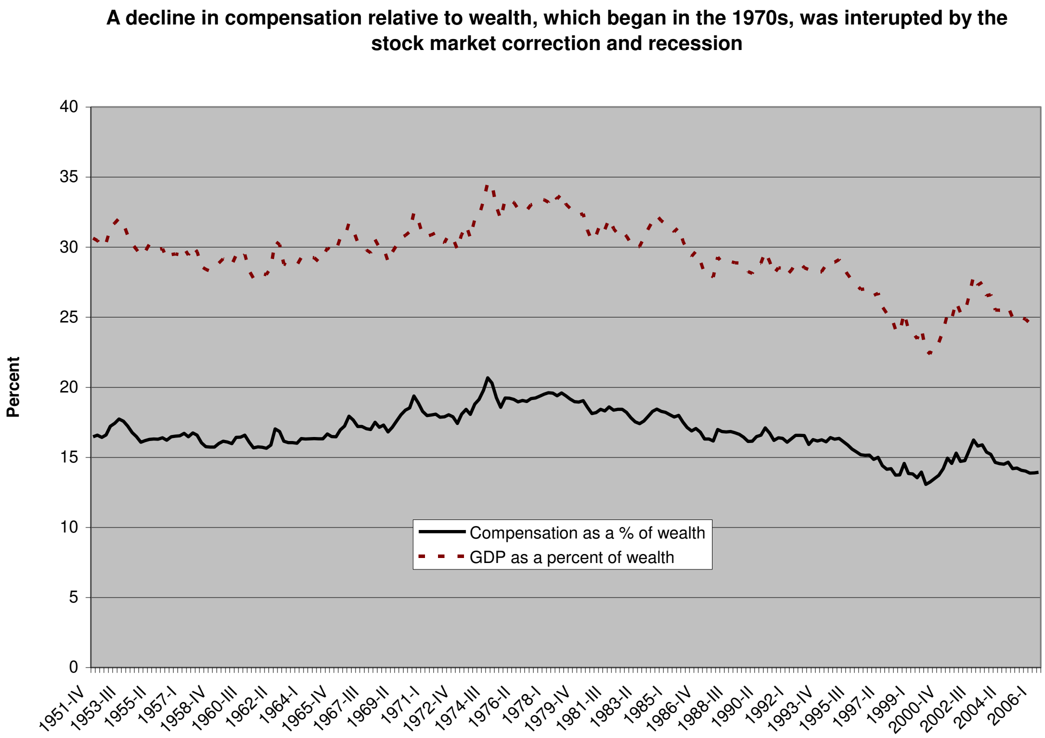
Senator Jim Webb and others argue that workers are not keeping up with the wealthy. They focus on the declining share of wages relative to overall wealth, or what they call the wealth gap. The solid line in Chart 1 shows that employee compensation as a percentage of wealth has been falling recently, but it has been falling since the 1970s, except in the early part of this decade (I/2000-III/2002) when the stock market correction boosted the ratio.

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 1. Advocates of the view that labor is falling behind suggest that labor is getting less, and that capitalists are getting more, of each dollar of income. But in fact it is the shortfall in overall income relative to wealth, not of wages, that is the proximate cause of the decline in compensation relative to wealth.

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 1 begin a more rapid pace of decline. When the share of compensation in GDP is set equal to its historical mean, instead of at the implicit actual measure in the wealth gap line, a plot of this adjusted ratio of compensation to wealth lies almost exactly on top of the actual ratio. 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 1
The wealth gap has been growing for almost 30 years

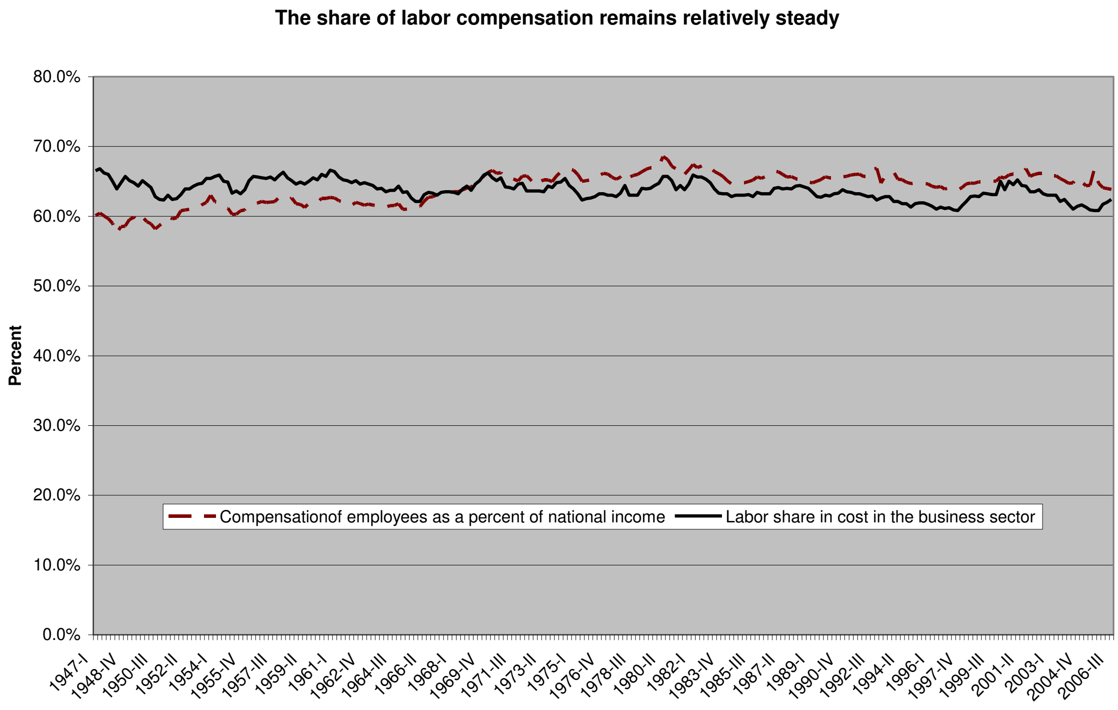


Source: US Bureau of Labor Statistics and US Bureau of Economic Analysis

Chart 2 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. 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 even in those tests the share of wages in cost is "stationary," or tends to gravitate toward its mean or its trend without falling away from either. The national income measure in the chart includes the government and household sectors but excludes some components of benefits.

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 than 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.

Chart 2
Labor share in income is not unusually low



Source: Bureau of Labor Statistics and Bureau of Labor Statistics

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.

Summary

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 falling for several decades. Indeed, in mid 2006, the latest available data, compensation was 5.2 percent higher relative to wealth 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, but remains close to its average. More importantly, it has a tendency to return to its average. When the share is low, wages tend to grow faster than productivity, pulling the share back toward its mean. When wages are relatively high, 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.

The only meaningful driver of the wealth gap 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 it 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. To have a serious discussion about social policy, it helps to identify the problem correctly.

Recommended Readings

Bernanke, Ben S., “The Level and Distribution of Economic Well-Being,” paper presented in remarks for the Greater Omaha Chamber of Commerce, Omaha, Nebraska, February 6, 2007.

Piketty, Thomas and Emmanuel Saez, “Income Inequality in the United States: 1913-98, Quarterly Journal of Economics, February 2003; updated data are available to 2004 at elsa.berkeley.edu/~Saez/TabFig2004prel.xls.

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Reynolds, Alan, “The Top 1% … of What?” *Wall Street Journal*, December 14, 2006.

Solomon, Deborah, “Democrats’ Risky Strategy: Trumpeting the Wealth Gap,” *Wall Street Journal,* October 2, 2006.

Sala-i-Martin, Xavier, “Global Inequality Fades as the Global Economy Grows,” in Timothy Kane, Kim R. Holmes, and Mary Anastasia O’Grady, Eds., *2007 Index of*

Economic Freedom, Heritage Foundation and Dow Jones & Co., Inc., Chapter 1, pp.15-25.

Webb, Jim, "American Workers Have a Chance To Be Heard," *Wall Street Journal*, November 15, 2006.