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30 September 2006

Online at https://mpra.ub.uni-muenchen.de/17826/
MPRA Paper No. 17826, posted 13 Oct 2009 04:27 UTC

US Workers Are Seeing Strong Wage Gains

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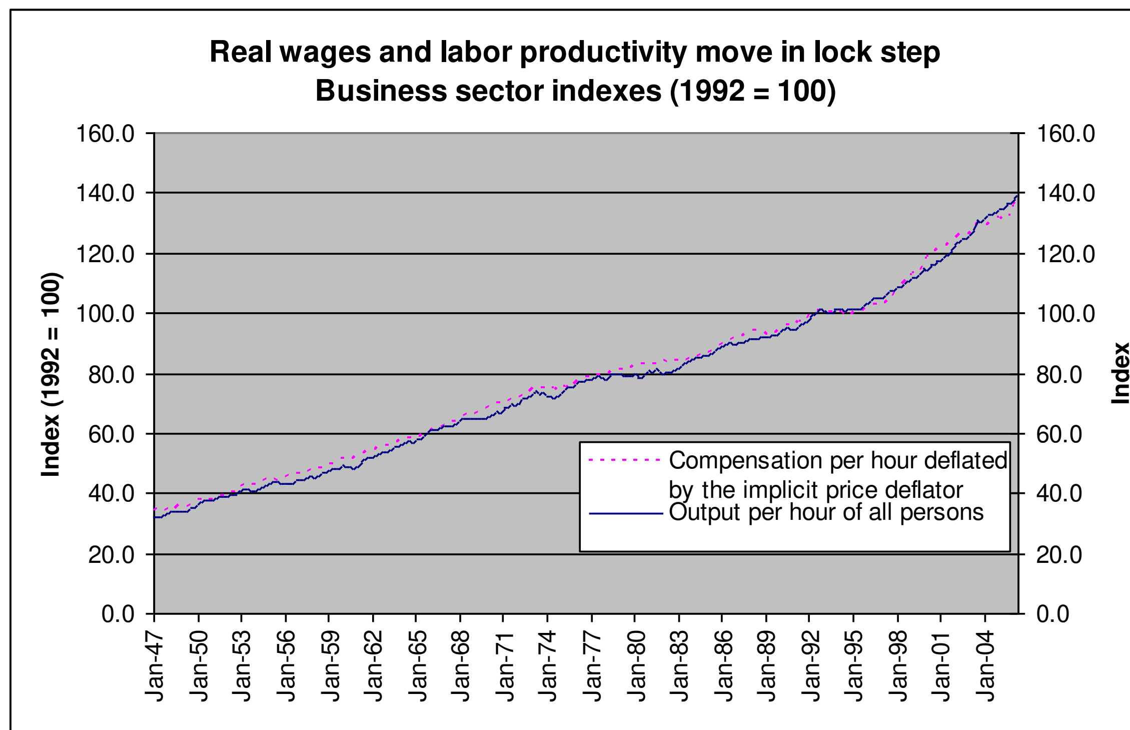
According to many recent press reports, the American worker faces a dismal picture of falling real wages, the purchasing power of worker compensation, and job opportunities, often linked to off-shoring or the availability of cheap foreign labor, especially in China. It is not going to get better either. The newly-launched Hamilton Project at the Brookings Institution promises to make "stagnation of wage growth for the majority of workers in the US economy" the subject of "a high-profile drive," according to the Financial Times (July 25, 2005). Notable economic authorities such as Robert Rubin and Larry Summers have joined the leadership of the effort. Former President Clinton repeated the claim the real wages were falling on CNN Presents, "The Poverty Trap: A Conversation with President Clinton" over the 2006 Labor Day weekend. The timing of this initiative is striking for several reasons. First, it is reminiscent of similar efforts in the 1992 political season when similar incorrect arguments were made to highlight the central role of purported poor performance of the economy. Second, it is striking because it may be well-timed to coincide with an actual slowing in real wages to be expected from the sharp run up in oil and energy prices in the past couple of years. So it could actually be correct, though as it turns out, it is not.

Productivity and Real Wages are Locked Together

One of the most fundamental and reliable facts about the US economy is that real wage cost and productivity are very strongly tied together. This is not surprising because economic theory indicates that labor productivity—the amount of output per worker or per hour—is the fundamental factor determining the demand for labor and that, in turn, is the most important factor determining real wages, at least in the aggregate, or for a nation as a whole. Chart 1 shows indexes of output per hour and real wages in the business sector, where more than 80 percent of the nation's output is produced. It excludes government and the households and institutions sector labor and output. Real wage cost is measured by total compensation per hour deflated by the implicit price deflator for business sector output, and so is a measure of the real wage paid to workers measured in terms of the goods and services that workers produce.

First, note that the two measures have climbed in near lockstep since 1947. Indeed it is difficult to see the two lines separately in most years because they are so closely related. Second, it is apparent in the chart that productivity has accelerated sharply for the past decade or so. The famous record of rapid productivity during the "New Economy" period has continued, and actually accelerated through the subsequent recession and rapid growth since then. The strong historical relationship between productivity and real wages, coupled with rapid productivity growth over the past decade makes it unlikely that real wages in the US are stagnant or declining, and indeed, the chart shows just that.

Chart 1
US real wages and productivity are very closely related



Source: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis and Networks Financial Institute

There is a visible gap between productivity and real wages in recent years, reflecting a short-fall of wage growth relative to productivity. In the second quarter of 2006, productivity stood 38.7 percent higher than its 1992 average and real wages were up only 36.9 percent, one of the larger gaps shown. Following the economic slowdown and recession in 2000-01, real wages and productivity have accelerated, especially in 2001-04. Since the end of 2000, business sector productivity has risen at a 3.1 percent average annual rate, a pace not seen from 1968 until 2002 for a comparable period and generally equaled or exceeded since then. Real wage growth has been somewhat slower, registering a 2.3 percent rate over the same 5.5 year period, still a pace that also was not seen from mid-1974 until 1999.

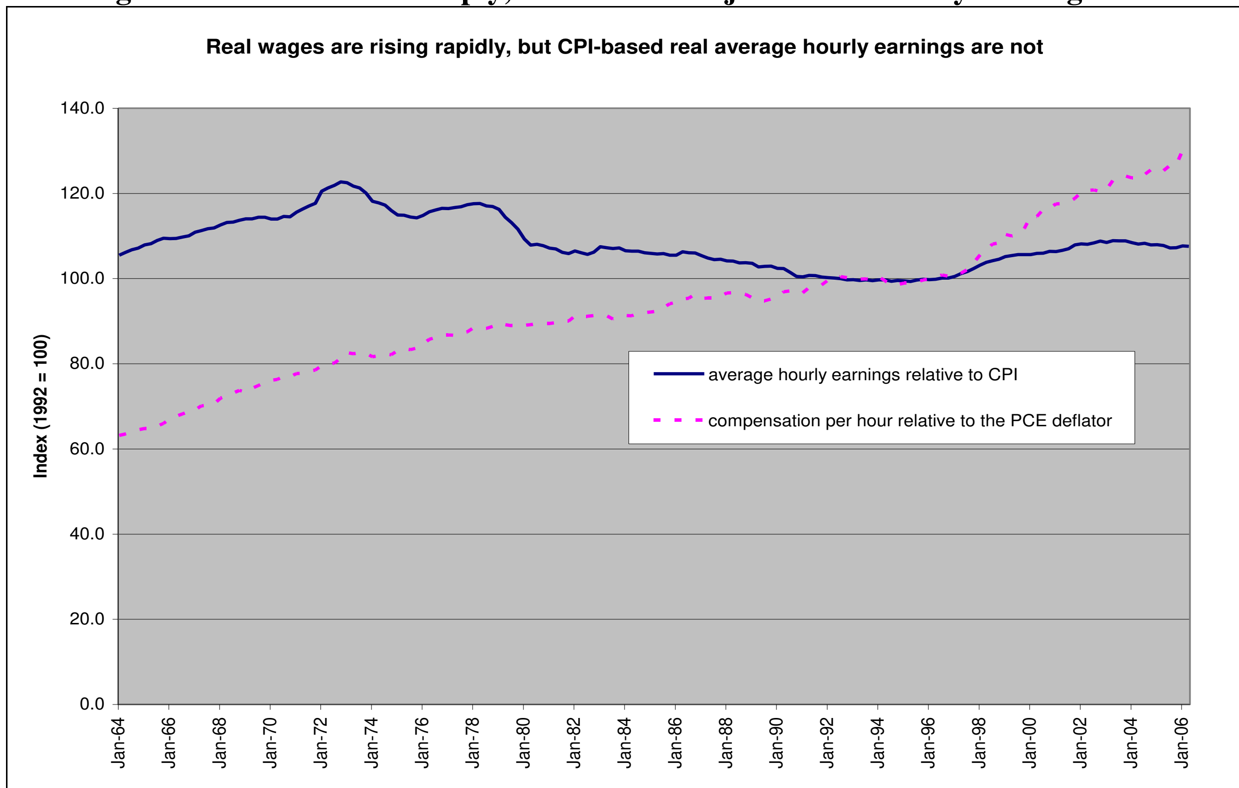
Real wage performance is affected by how it is measured

The growing angst over real wage performance arises from a focus on an inappropriate measure. Real wage measures depend upon the measure of wages used and on the measure of prices of goods and services with which it is compared. Pessimists often use average hourly earnings to assess wages, though the number excludes the fastest growing component of compensation and the earnings covered are those of only about 60 percent of workers. The average hourly earnings measure covers cash earnings of hourly and non-supervisory workers in the non-farm private sector, about 60 percent of all workers. Moreover, benefits (including paid leave, overtime, bonuses, insurance, savings and retirement and legally required benefits), are excluded from the earnings measure, but account for 30 percent of total compensation for non-farm private and government

employees. Also to assess what wages will buy, the market basket of goods and services used to deflate wages can affect the outcome. The most pessimistic assessment of real wage performance arises from the use of the most questionable data sources: using the consumer price index to deflate average hourly earnings.

The better measure of consumer prices that is measured consistently over time and that is regarded as less biased is the chain-type personal consumption expenditure (PCE) deflator. Note that this price index also differs from that used in Chart 1. Workers do not buy only the goods that they produce, nor do they buy them in proportion to the goods and services they produce. Employers must assess labor cost relative to the price of output, but if workers buy a different mix of goods and services they will assess the purchasing power of wages, or real wages, using the measure of the prices they pay for the goods and services that they buy. That measure is the PCE deflator. Chart 2 shows the divergent movements in real compensation and the CPI-based measure of real earnings.

Chart 2
Real wages have accelerated sharply, but not CPI-adjusted real hourly earnings



Source: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis and Networks Financial Institute

Note that the CPI-based average hourly earnings actually peaked in late 1972. While there was some advance from early-1997 to early-2003, this measure has generally declined since then. The more accurate measure of real wages, which includes all compensation of business sector workers measured relative to the prices that consumers pay, in contrast, has grown more rapidly since 1997 than it did before and is up 61

percent since 1972, more in line with growth of real income per person or other measures of income of the typical worker or consumer. Only in 1993-1997 (and before 1973) did both measures show a similar pattern and in both cases the real wage measure stagnated. Since 2000, the real compensation measured relative to the PCE deflator has risen at a 2.1 percent annual rate.

Real wages have shown strong growth in the past decade, reflecting unusually strong growth in productivity, especially in 2003-04. The outlook for real wages is mixed, however. Normally when real wage growth has fallen below the growth rate of productivity, as in the mid-1990s and now since 2003, real wage growth accelerates sharply and can even overshoot productivity growth for awhile. Unfortunately, however, real energy prices have risen sharply over the past two years depressing productivity growth and this has and will hold down the growth of real wages. The net effect so far has been rapid, but slower, growth of productivity than in the previous three years, but some recent acceleration in real wages. More likely than not, over the next couple of years real wage growth will fall short of its 2.9 percent pace of increase over the past two years, but will equal or exceed the 2.1 percent pace of real wage gain since 2000, which also is the pace of productivity growth registered over the past two years. Such a pace would be far in excess of the dismal 1973-97 record.