Economic Policy Institute

Briefing Paper

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PROFITS UP, WAGES DOWN

WORKER LOSSES YIELD BIG GAINS FOR BUSINESS

by Dean Baker & Lawrence Mishel

Growing inequality has created a wedge between economic growth and rising living standards, leaving the vast majority of American families no better off in 1995 than in 1989, the last cyclical peak. There are two types of inequality that have led to a disconnect between growth and middle-class living standards: (1) In the 1990s, overall wage growth has been dampened by a redistribution of income from labor to owners of capital as profitability, the economic return to capital (or assets), has reached historically high levels; and (2) The growth of wage inequality that began in the 1980s and persisted throughout the 1990s has prevented middle- and low-wage earners from achieving higher wages and has forced them to accept reductions in their real wages, as earnings failed to keep up with inflation.

Specifically, the findings show:

- After-tax profit rates in 1994 were the highest in 25 years and greater than at the end of earlier postwar recoveries. Profit rates have increased even further in 1995.
- The higher profitability, of the 1990s has not been associated with an acceleration of investment or productivity growth.
- Over the 1989-95 period and even during the recovery years since 1991, inflation-adjusted hourly wages have been stagnant or declining for the vast majority of the workforce, including: the bottom 80% of men. the bottom 70% of women, men with a four-year college education as well as those without college degrees, women with less than a four-year college degree.
- The hourly wage of the median male worker has declined 1% per year over the 1989-94 period, continuing the trend appparent over the prior business cycle from 1979-89. The wage of the median female worker declined over the 1993-95 period. a sharp contrast to the modest 0.5% annual growth experienced over the 1979-93 period.

- Increased profitability in the 1990s is the result of cost restructuring that has not led to greater efficiency but has increased the economic return to investments. Had profit rates remained at their 1952-79 average during the 1990s, hourly compensation would have been $120 billion, or 4.0%. higher for all workers in 1994, and 6.1% higher for noncollege-educated workers.

- Higher after-tax profit rates are partially due to lower taxation. Had the tax rate on capital income remained at its 1952-79 average then government revenue would have been $40 billion more in 1994. an amount equal to 25% of the fiscal deficit that year.

CONTINUED WAGE DETERIORATION AND INEQUALITY

It should not be surprising that whether or not families are able to improve their incomes depends on whether the wages of family members are improving. Lower to upper-middle income families depend almost entirely on wage income and do not receive much government cash assistance or capital income (interest, dividends. capital gains). Research (Blank and Card 1993) has shown that family income trends over the 1970s and 1980s were primarily driven by hourly wage trends (as opposed to annual wages which depend also on annual weeks worked and weekly hours). Analysis of recent wage trends shows that growing wage inequality and broad-based deterioration of wage levels still plague American families, creating economic hardship for low- and middle-income families in the 1990s.

This persistent growth in inequality, continuing even during the 199 l-95 recovery, has offset the benefits of economic growth since 1989, the last cyclical peak, and has prevented broad-based income gains. The result is that the bottom four-fifths of families had less income in 1993 (the latest family income data available) than in 1989 (see Mishel and Bernstein, 1994). For example. the median family's income fell $2,737 to $36,959 in 1993. 6.9% lower than what it was in 1989 ($39,696 in 1993 dollars). Given the poor wage performance over the 1993-95 period, it is likely that middle- and lower-income families have not made any significant income progress over the last two years, and middle-class family incomes in 1995 will still be below their 1989 levels. The 1991-95 recovery could thus be the first recovery where middle-class incomes did not surpass the level attained at the end of the prior recovery.

The data in **Table 1** show the wage growth of workers by wage level (i.e., decile) over the 1989-95 period. These data are based on our analysis of the Bureau of Labor Statistics' Current Population Survey Outgoing Rotation Group (ORG) files. We have converted these data into a historically consistent data series by adjusting top codes, education categories, and demographic weighting.'

Table 1 shows that between 1989 and 1994 there has been a continuous decline in real wages among the bottom 80% of men. Estimates for 1995. based on trends for the first half of 1995, suggest that this wage deterioration has persisted into 1995, despite the strong growth and relatively low unemployment that has prevailed. For instance, the hourly wage of the median male worker (the worker at the 50th percentile. who earns more than half of all men. but less than the other half) fell

TABLE 1
Wage Trends by Wage Level, 1989-95
(1994 Dollars)

	Hourly Wage							Percent Change	
Percentile	1989	1990	1991	1992	1993	1994	1995'	1989-94	1994-95*
Men									
10	$5.69	$5.58	$5.46	$5.36	$5.31	$5.32	$5.42	-6.4%	1.9%
20	7.14	7.04	6.92	6.77	6.74	6.77	6.76	-5.2	-0.2
30	8.66	8.56	8.40	8.23	8.14	8.04	7.99	-7.2	-0.6
40	10.30	10.18	9.95	9.76	9.82	9.73	9.60	-5.5	-1.4
Median (50)	11.98	11.64	11.55	11.47	11.36	11.24	11.24	-6.1	0.0
60	14.04	13.80	13.57	13.37	13.25	13.23	13.15	-5.8	-0.6
70	16.27	16.13	16.09	15.80	15.58	15.63	15.51	-4.0	-0.8
80	19.13	19.09	18.90	18.73	18.66	18.87	18.54	-1.3	-1.8
90	24.01	24.39	24.14	23.92	24.11	24.22	23.84	0.9	-1.6
Women									
10	$4.70	$4.76	$4.93	$4.92	$4.87	$4.80	$4.75	2.0%	-0.9%
20	5.71	5.71	5.67	5.67	5.71	5.67	5.70	-0.8	0.5
30	6.61	6.70	6.71	6.68	6.69	6.63	6.62	0.3	-0.1
40	7.66	7.71	7.71	7.71	7.71	7.63	7.59	-0.3	-0.6
Median (50)	8.76	8.81	8.80	8.84	8.95	8.82	8.74	0.8	-1.0
60	10.03	10.19	10.23	10.34	10.27	10.15	10.05	1.3	-1.0
70	11.79	11.66	11.90	11.96	12.14	12.02	11.90	2.0	-1.0
80	14.06	14.14	14.15	14.36	14.60	14.72	14.59	4.7	-0.8
90	17.71	17.90	18.19	18.45	18.57	18.97	18.65	7.1	-1.7
Wage Gap**									
Men	2.01	2.10	2.09	2.09	2.12	2.16	n.a.		
Women	2.02	2.03	2.07	2.09	2.08	2.15	n.a.		

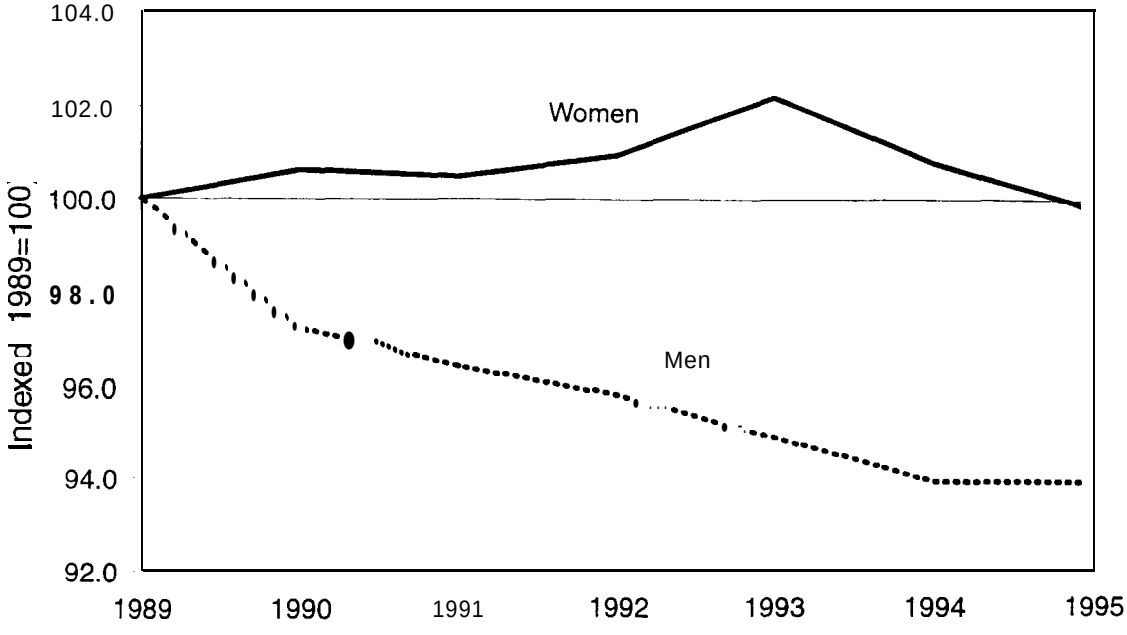
* Estimated based on trends between first half of 1994 and 1995.
** The ratio of the wages at the 90th and 50th percentiles.

Source: Analysis of Current Population Survey Outgoing Rotation Group files.

from $11.98 in 1989 to $11.24 in 1994. a drop of 6.1% (see **Figure A).** Even the wages of relatively high-wage male earners at the 80th percentile (earning $19.13 in 1989) fell 1.3% over the 1989-94 period. Our wage estimates for 1995 suggest no improvements for these middle- and high-wage men over the last year.'

The only exception to this pattern of declining wages among men is that the highest wage earners (at the 90th percentile) have seen their wages stagnate. rather than fall. This disparity of wage trends between typical middle-wage workers. such as the median worker, and high-wage workers (90th percentile) is illustrated in **Figure B,** which shows the growth of the wage gap (between high- and middle-wage workers) over the entire 1973-94 period. Figure B shows that wage inequality has

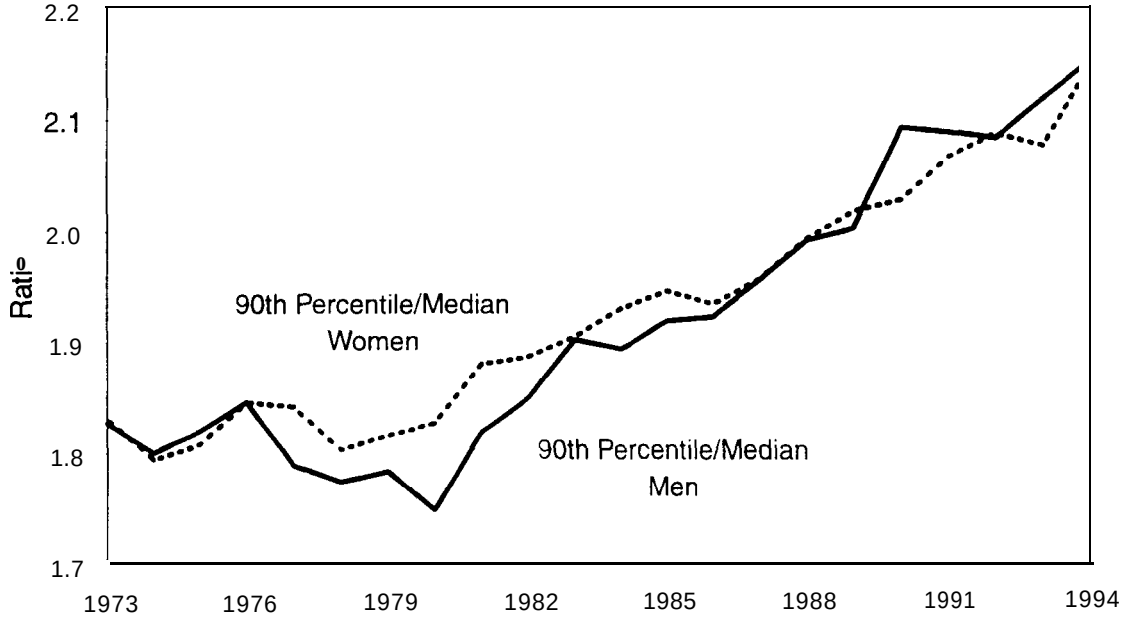
FIGURE A
Median Hourly Wages for Men and Women, 1989-l 995*



* Estimated from the first half of 1995.

Source: Authors' analysis of Bureau of Labor Statistics data.

FIGURE B
Wage Gap for Men and Women, 1973-l 994



Source: Authors' analysis.

grown strongly over the 1989-94 period, continuing the inequality trend that began around 1979.

Table 1 shows a somewhat different wage pattern among women in the 1989-94 period: wages have been relatively stagnant among the bottom 70% of women. while higher wage earners (at the 80th and 90th percentiles) achieved wage growth of from 4.7% to 7.1%. It is especially noteworthy that middle-wage women, typified by the median woman. had no wage growth over the 1989-95 period and even had declining real wages over the 1993-95 period. In contrast, the median woman worker achieved steady modest wage growth of 0.5% per year over the 1979-89 period (Figure A). It is also noteworthy that the lowest wage women (at the 10th percentile) saw significant wage growth when the minimum wage was increased in 1990 and 1991, but have lost significant ground ever since. The persistent growth in wage inequality among women, over the 1979-94 period. is also shown in Figure B.

Table 2 presents wage trends over the 1989-94 period by workers' education levels. Wages have declined steadily among men with less than a four-year college degree (those with "some college,"

TABLE 2
Wage Trends by Education Level, 1989-95
(1994 Dollars)

	Hourly Wage							Percent Change	
Education Level	1989	1990	1991	1992	1993	1994	1995*	1989-94	1994-95*
Males									
Less Than H.S.	$9.68	$9.36	$9.08	$8.90	$8.74	$8.59	$8.33	-11.2%	-3.1%
High School	12.01	11.79	11.61	11.57	11.45	11.57	11.29	-3.6	-2.5
Some College	13.75	13.79	13.59	13.07	13.00	13.06	12.68	-5.0	-2.9
College	18.84	18.89	18.50	18.67	18.55	18.78	18.54	-0.4	-1.2
Advanced Degree**	23.47	23.89	24.06	23.49	23.60	24.45	24.70	4.2	1.0
Females									
Less Than H.S.	$6.76	$6.73	$6.79	$6.76	$6.68	$6.65	$6.31	-1.6%	-5.1%
High School	8.69	8.71	8.79	8.77	8.76	8.75	8.58	0.7	-1.9
Some College	10.36	10.47	10.45	10.41	10.41	10.45	10.08	0.8	-3.6
College	13.50	13.92	13.76	13.92	13.93	14.09	14.23	4.4	1.0
Advanced Degree**	17.80	17.78	18.14	18.34	18.40	19.74	19.16	10.9	-3.0
College/High School Wage Differential* **									
Men	42.3%	42.7%	42.3%	43.6%	43.8%	43.6%	n.a.		
Women	40.8	42.5	41.0	42.1	42.4	44.6	n.a.		

* Estimated based on trends between first half of 1994 and 1995.
** Those with two or more years of higher education beyond college.
·*t Regression adjusted controlling for age as a quartic, race, marital status, Industry, and region.

Source: Analysis of Current Population Survey Outgoing Rotation Group Files.

high school graduates, and those not completing high school), a group comprising 75% of the male workforce. Male college graduates have seen their wages fall slightly over this period, while men with advanced college degrees (roughly 8% of all men) have experienced 1% annual wage gains. These simple descriptive trends suggest that male college-educated workers continue to gain economic ground compared to those with less education. However. when these trends are adjusted for other demographic factors (such as the age, racial, and regional composition of the workforce) through regression analysis it appears that the college/high school wage differential has been relatively flat over the 1989-94 period (see the bottom panel of Table 2). This suggests that male college- and high school-educated workers may have seen their wages decline at a comparable rate in recent years."

Wages have been stagnant over the 1989-94 period among women with less than a college degree. paralleling our earlier finding among the bottom 70% of women wage earners. On the other hand, women with college or advanced degrees have made significant wage gains. The regression adjusted college/high school wage differential among women was flat over the early 1990s but jumped up between 1993 and 1994.

Rising Profitability

In 1994, the after-tax rate of return to capital investment approached its highest levels in the last forty years (see **Table 3** and **Figure C).** For instance. the after-tax return in the nonfarm business sector was 7.5% in 1994. By comparison, it averaged just 3.8% in the period from 1952 to 1979. Moreover, the profitability of the non-financial corporate sector surged ahead during the first quarter of 1995 from its 1994 level, suggesting that profitability in 1995 will exceed that achieved in earlier postwar business cycle peaks.

This higher profitability has not been associated with any noticeable surge in productivity growth or gains in efficiency. Productivity growth in the current recovery has been about the same as its 1970s and 1980s trend rate. There also has been no acceleration of investment growth, as investment as a share of output has reached historically low levels. In short, this upturn in profitability has greatly benefited the owners of capital, without creating social gains in the form of accelerated growth in efficiency or productive capital.

That the return to capital has reached historically high levels can be documented in two data series (shown in Table 3). One series is for the nonfarm business sector and is based on the data used by BLS to measure productivity (particularly multifactor productivity) trends. The second series draws on the Bureau of Economic Analysis' National Income and Product Account (NIPA) data for the corporate sector.' The methodology employed here follows that of Feldstein and Summers (1977), which documented, and lamented. the fall in the returns to capital that occurred in the 1970s (see Figure C). (For further details on measurement issues and a more extensive analysis of the trends see Baker 1995.) The terms profitability. profit rate, and rate of return are used interchangeably to refer to the rate of all capital income (from interest. dividends. profits, etc.) per dollar of capital (as measured by the capital stock).

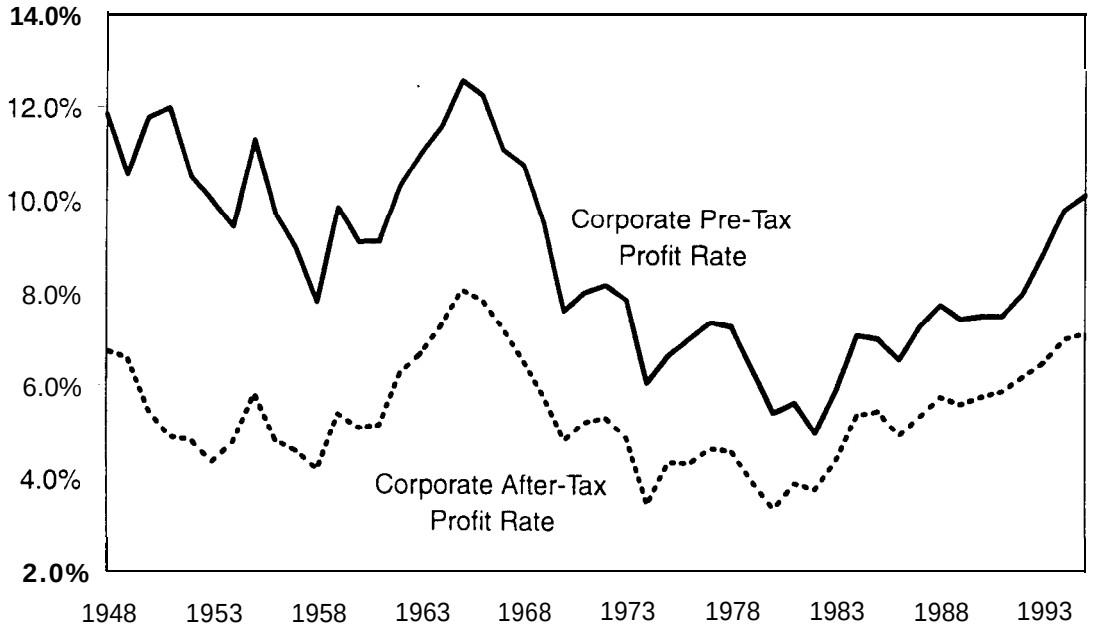
TABLE 3
Profit Rates at Business Cycle Peaks, 1958-95

	1958	1968	1973	1979	1988	1992	1994	1995*
After-Tax Profit Rate**								
Nonfarm Business***	7.6%	4.8%	7.5%	3.6%	5.4%	6.9%	7.5%	N.A.
Manufacturing	8.9	6.6	10.0	4.6	5.8	6.2	8.0	N.A.
Service	7.0	4.0	6.2	3.2	5.3	7.5	7.7	N.A.
Non-Financial Corporate*+**								
Before-Tax Profit Rate**	7.8%	10.8%	7.9%	6.4%	7.8%	8.1%	9.9%	10.2%
After-Tax Profit Rate	4.2	6.6	4.9	4.0	5.8	6.3	7.1	7.3
Capital-Output Ratio	**1.87**	1.59	1.78	2.01	1.83	1.50	1.43	1.39

* First quarter only.
** Bureau of Labor Statistics multifactor productivity data.
*** Excludes real estate.
""Analysis of NIPA data and Federal Reserve Board Balance Sheets for the U.S. Economy.

Source: Baker (1995). Profit rate is the ratio of all capital income (interest, rent, profit, etc.) to the capital stock.

FIGURE C
Profitability, 1948-95*



* Estimated from the first quarter of 1995.

Source: Baker (1995).

The increase in the rate of profit began in the early 1980s and is attributable to two distinct factors. The first factor is a decline in the rate of taxation of corporate income that dates from the early 1980s—a fall in tax rates means that comparable rates of pre-tax profitability will generate higher after-tax profit rates. The percentage of corporate income paid out as taxes has fallen sharply from an average of 44.3% between 1952-79 to 32.4% in the 1980-89 period. It fell slightly further to an average of 3 1 .O% in the current 1990s cycle. This decline occurred in part because of a reduction in legislated tax rates, and in part because of a shift in the manner in which investment was financed: investment in the 1980s was increasingly financed by debt rather than equity. Interest payments rose from 14.5% of capital income in the corporate sector in the 1974-79 business cycle to 30% of capital income in the 1980-89 cycle and have fallen back slightly to 27.3% of capital income in the current cycle. Since interest paid by a firm to its debtors is treated as an expense and not taxed, the higher share of interest in total capital income in recent years has contributed to a decline in the tax rate on all capital income.

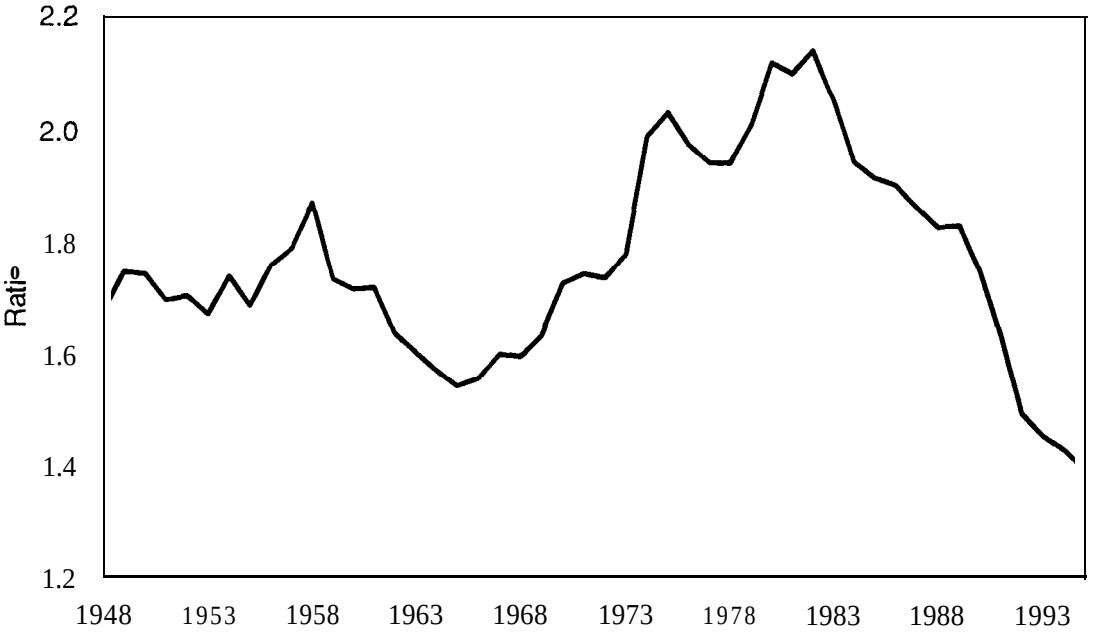
The second factor to increase profitability is the growth in the pre-tax rate of return to capital that began in the late 1980s (Figure C). The pre-tax return on capital fell only slightly in the early 1990s recession, a stark contrast to the large fall-off in profitability that occurred in prior recessions. As the economic recovery proceeded, the returns to capital surged higher. As the data in Table 3 show, the after-tax profit rate in the entire nonfarm private business sector jumped to 7.5% in 1994, equivalent to the high rates achieved in 1958 and 1973 .[5] The corporate-sector data for early 1995 indicate a further growth in profitability.

What is critical to note, however, is that this surge of profitability in the 1990s was in pre-tax profits and not related to any changes in taxation. Rather, profit rates went up because firms were able to reduce their costs, essentially labor costs, and achieve their trend growth in productivity. This cost restructuring permitted a rise in profitability even though there was no greater growth in efficiency or productivity over the 1989-95 period than in either the 1970s or 1980s.

The ability of firms to restructure costs so as to obtain historically high profitability reflects the dominant power of employers in labor markets. Wage increases among both white-collar and blue-collar workers and among both union and nonunion workers have been very weak, and below the inflation rate, for several years, despite an unemployment rate so low that the Federal Reserve Board felt it necessary to slow the economy. This high profitability is simply the reflection of the dominance of employers in the shaping of wages and working conditions in today's labor market.

Higher profitability is not a reflection of improved productivity based on increased investments. In fact, recent growth has been accomplished with much less capital investment. For instance, net investment as a share of GDP (Gross Domestic Product) has been at a postwar low in the current recovery, averaging about 1.5%. This has led to a very large decline in the capital to output ratio (see **Figure D).** The falloff in the ratio of the capital stock to output — which reflects the size of the capital stock relative to the output, or GDP, in a given year — began in 1982. It had fallen from a peak of 2.14 in 1982 to 1.83 in 1989.[6] However. the falloff accelerated dramatically in the current business cycle.

FIGURE D
Capital to Output Ratio, 1948-94



Source: Baker (1995).

so that the capital to output ratio was down to 1.43 by 1994, a postwar low (see Table 3).

This fall in the capital-output ratio explains why our finding that profitability is historically high is compatible with the observation that capital's (and labor's) share of income has remained relatively constant. As illustrated in **Box A.** capital has been able to maintain its share of income even while its relative contribution to the production process (as seen in the capital-output ratio) has fallen by approximately one-third. Mathematically, a higher rate of return on a proportionately smaller capital stock can yield the same share of aggregate income.

The error made by many analysts is in assuming that profitability has not changed based on evidence that capital's share of income has not risen appreciably. For instance, the *Washington Post* recently editorialized that:

> [Robert Reich] charges that the productivity improvements are going disproportionately into corporate profits. 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 this country's poor wage performance lie elsewhere. (July 29, 1995)

It is understandable that many analysts have used trends in the capital and labor shares of

BOX A: Rising Profit Rates, Constant Profit Shares

There has been some confusion between a rise in the profit rate, which has occurred in the last 15 years, and a rise in the profit share of income, which has not occurred. To see how this can be the case it is worth breaking up income into a labor and capital component as follows:

$$(K*r)+(W*L) = I$$

where K is the capital stock, r is the rate of return of capital or profit rate, W is the average hourly wage, and L is the number of labor hours.

With this notation, capital's share is calculated by dividing capital income, K*r, by total income, I. If the capital share remains constant then the quantity (K*r)/I doesn't change (nor does the labor share, (W*L)/I). Capital's share, (K*r)/I can also be written as (K/I)*r, where the quantity WI is equal to the ratio of the capital stock to total income. If WI falls, as it has over the last 10 years, then r can rise, even if capital's share remains constant.

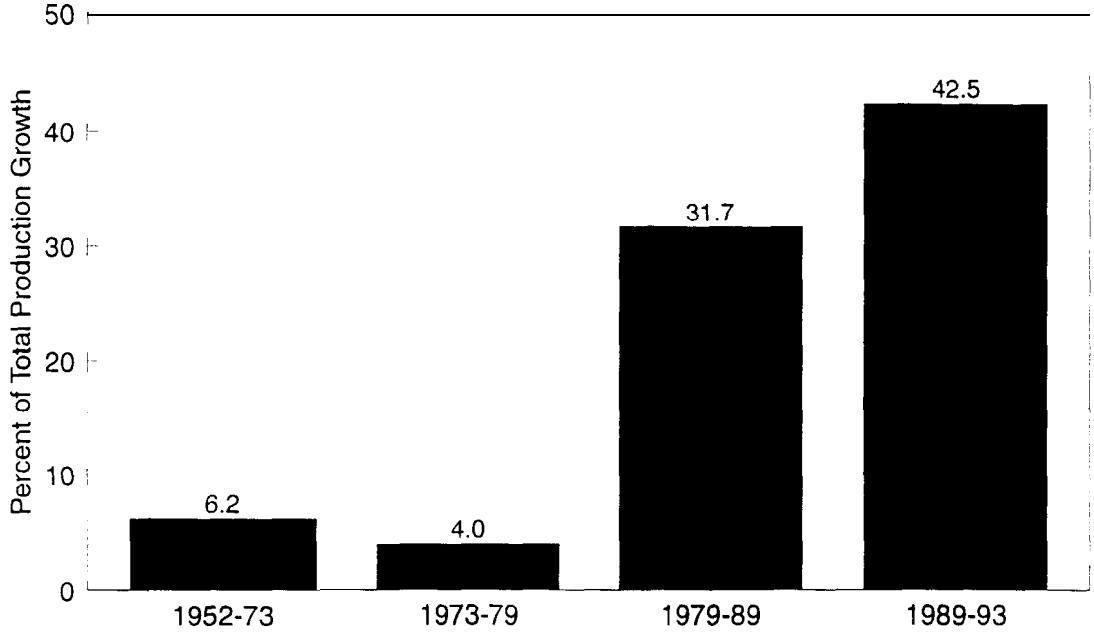
For example, if K = $2000, r = .05, and I = $1000, then the capital share of income would be 10% ((K*r)/I = ($2000*.05)/$1000 = $100/$1000 = .10).

If the capital stock fell to $1000, so that K' = $1,000, but the profit rate had risen to 10%, so that r' = .10, and income had not changed I' = I = $1000. The capital share would still be 10% ((K'*r')/I' = ($1000*.10)/$1000 = $100/$1000 = .10). In this example, the profit rate doubles, but the capital share of output doesn't change since the capital stock fell by exactly 50%. In the last 15 years, the rise in the profit rate has been roughly proportional to the fall in the capital to output ratio, so there has been little change in the capital share of income.

income to make a first approximation of whether one factor (capital or labor) can be considered to be making progress at the expense of the other; these data are readily available. However, the analysis should go further and ask what the trends in the capital and labor shares are relative to what we would expect given ongoing economic trends.

There are two reasons why we would expect that labor's share would have grown while capital's share declined. First, the trends in the capital-output ratio discussed above suggest that capital's share of income should have fallen if profit rates were stable. Second, since the growth of human capital (which BLS measures by levels of education and experience) accelerated in the 1980s and 1990s and made a far larger relative contribution to total productivity growth (Figure E) in recent years, we would expect that labor's share would have risen (reflecting the greater stock of human capital).'

FIGURE E
Contribution of Increased Human Capital to Productivity Growth, 1952-93



Source: Authors' analysis of Bureau of Labor Statistics data.

PROFITS, WAGES, AND TAXES

The higher after-tax profitability achieved in the mid- 1990s meant that wage levels and taxes were lower than what they would have been had profit rates in the current business cycle remained at their average for the 1950s, 1960s, and 1970s. For instance. wage growth would have been considerably more rapid if capital's income share had remained proportional to its contribution (i.e., capital's share fell in tandem with the capital-output ratio at the same profit rate). For example, if over the course of the current business cycle the before-tax return to capital in the nonfat-m business sector had remained at its 1952-79 average of 6.8%,[8] labor income could have been approximately $120 billion higher in 1994. This would have raised overall labor compensation by 4.0%. Since higher pre-tax profitability grew primarily over the 1989-94 period, the average hourly compensation could have grown 0.8% more each year if profitability had not grown. a near doubling of compensation growth. If all of this transfer to capital came at the expense of the non-college-educated workforce, this amount would have allowed for 6.1% higher labor compensation in 1994 and provided a growth in real hourly compensation for the noncollege-educated workforce over the 1989-94 period." In addition, if the tax rate on capital income had remained at its 1952-79 average of 44.3%. it would have increased government revenue by approximately $40 billion in 1994. and could have potentially eliminated nearly 25% of the deficit for that year.

CONCLUSION

The period since 1989, the end of the previous recovery, has been one characterized by broad-based income deterioration driven by falling real wages. This characterization holds for the period of rising unemployment, 1989-92, and for the period of falling unemployment, 1992-93. Data on family income in 1995 will not be available until the fall of 1996; at that time, however, it will almost certainly reveal that there was little, if any, growth of middle-class incomes over the period of economic recovery, 1992-95. The reason that middle-class incomes will not have risen by 1995 is not that the economy did not expand nor that productivity did not rise sufficiently: rather. the income growth that did occur accrued to owners of capital and to the highest wage earners, those in the upper 10%-20%. The persistent growth in wage inequality and the recent surge in profitability have created a wedge between economic growth and improved living standards for the majority. Neither type of inequality is inevitable or associated with trends that can be considered progress — such as higher productivity growth. The challenge facing policy makers is not only to maintain or improve current productivity growth but to ensure that future increases in efficiency translate into gains for the vast majority.

September 1995

ENDNOTES

1. See the Appendix to Mishel and Bernstein (1995) for details on the wage data. We have made one further improvement by assigning a wage to the topcoded wage earners, using the same method as Gittleman (1994). Several imputations were necessary to make the 1994 data compatible with that of earlier years. A small share (3%) of the observations did not report an hourly wage or their hours worked last week (they reported "hours vary"). We imputed weekly hours for this group based on the rest of the sample and obtained an hourly wage using their reported weekly earnings. The new demographic weights used in the 1994 CPS (based on the 1990 census) also create a discontinuity. We used the 1994 weights to impute an equivalent weighting scheme for the 1989-93 data. All of the reported 1989-95 trends are thus based on demographic weights reflecting the 1990 Census.

2. We estimate wage growth between 1994 and 1995 based on the ORG samples for the first six months of each year. This is necessary because the data are not seasonally adjusted. Because these trends are based on smaller samples we rely on them more for the direction of change rather than the magnitude of change.

3. For instance, the aging of the college-educated workforce tends to obscure the fact that each age group among the college educated has wage declines greater than that for the group as a whole.

4. However, the data underlying both series are from NIPA. The BLS does make imputations and adjustments to develop its series.

5. We exclude the real estate sector because the profit rates are exceedingly volatile because of measurement problems for capital income and the capital stock. This exclusion does not materially change our results.

6. These numbers are the ratio of the wealth capital stock to output for the non-financial corporate sector.

7. Productivity growth calculations come from the output per hour services in the private nonfarm business sector in a table of the BLS release. "*Multifactor Productivity Trends,* 1993." Labor contribution to productivity was calculated by multiplying the growth rate of labor composition (from labor composition column of table NFB 3 in the February 1995, *Multifactor Productivity Tables)* by the labor share of costs (Table NFB 4). This is the procedure described in the notes to Table 5 of *Multifactor Productivity Trends, 1993.* The percentage of productivity growth attributable to the improvement in labor quality was calculated by dividing the labor contribution calculated in step 2, by total productivity growth, calculated in step 1.

8. This assumes that the tax rate on capital income for the nonfarm business sector was the same as the tax rate within the corporate sector.

9. Based on total business compensation of $2,989.9 billion times 65%, the non-college educated share of weekly wages in the ORG files in 1989.

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