

RESEARCHBUZZ

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.

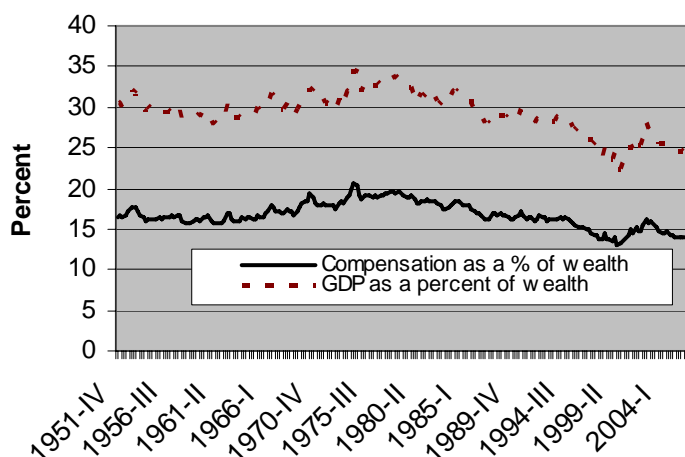
Movements in GDP relative to wealth account for the entire decline in compensation relative to wealth and reflect the decline in real interest rates that has been going on for a long time, but especially since early 1995 when both lines in Chart 1 begin a more rapid pace of decline. When the share of 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 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

A decline in compensation relative to wealth, which began in the 1970s, was interrupted by the stock market correction

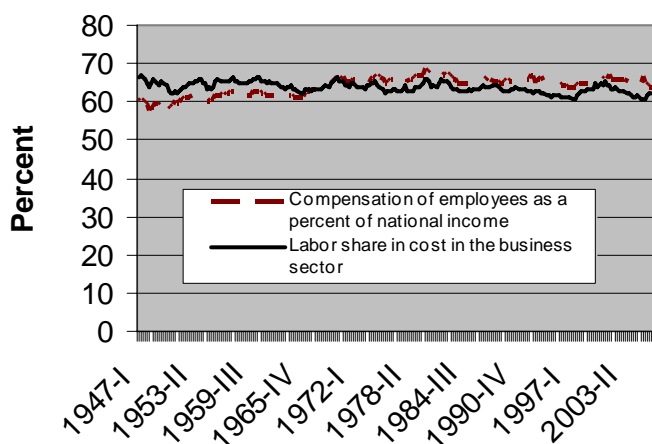


The wealth gap has been growing for almost 30 years

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.

Chart 2

The share of labor compensation remains relatively steady



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 sig-

nificant 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 its compensation component excludes a large part of compensation.

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.

Labor share in income is not unusually low

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 dis-

cussion about social policy, it helps to identify the problem correctly.

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Refund Anticipation Loans in Indiana

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A number of taxpayers would rather not wait for a check to arrive from the federal government but instead prefer to use refund anticipation loans. Refund anticipation loans (RALs) are short term loans secured by the taxpayer's expected refund and usually last between 7 to 14 days. Taxpayers can get their refund in less than two weeks by using electronic filing and choosing the direct deposit option when filing. If a taxpayer doesn't have a bank account or wants to receive a check rather than using the direct deposit option, it could take another week for him or her to get a refund in the mail. In addition, not filing electronically could add another one to two weeks to a taxpayer's waiting period before getting a refund back.

Refund anticipation loans usually cost \$30 to \$115 in loan fees and there could be more charges such as administrative charges or bank fees. If taxpayers have bank accounts and can file electronically, RALs would be more expensive for them, since they could get their refunds in less than 2 weeks compared to a taxpayer who would need to wait 3 to 4 weeks. Some tax preparers offer loans of a small amount up front and the rest of the amount in 8-15 days. Applying for these loans would cost more, since a taxpayer would be paying all those fees just to borrow the up front amount. In some cases, fees could exceed the up front amount that a taxpayer can receive.

A taxpayer should remember that RALs are still loans. There is always a chance that your actual refund amount could be less than what you have received or your refund amount could be denied or frozen for several reasons such as child support payments. In these circumstances, taxpayers will be re-

quired to pay back RALs and will be charged high interest rates.

In order to calculate the cost of RALs in terms of effective percentage rate, we will use the table on the next page and take the mid point between the 4 to 14 days during which the IRS usually pays back to tax preparers. We will also take the mid point of total cost estimates. According to our calculations, without taking into consideration any extra fees such as tax preparation fees, a taxpayer will be paying the effective annual rate of 353.6% at H&R Block, 1227.6% at Jackson Hewitt and 915.55% at Liberty for a loan of \$2,000. These are considerable higher rates than someone would be charged for a personal loan at a bank branch.

According to the most recent data¹ that we have, in 2004, there were 336,102 or 12.1 percent² of taxpayers who applied for RALs in Indiana. Compared to the 11.9 percent in 2003, this represents a slight increase in the number of applications for RALs. Generally about 90 percent of the RALs applicants are approved and it costs on average of \$100 per RAL. By using these numbers, we can estimate that in 2004, Indiana taxpayers spent \$30.2 millions to get RALs.

Low income taxpayers constitute the highest percentage of RAL users. Analyzing the data by zip codes, we found that as income levels decrease in a particular area, the number of RAL applications increases. For example, a 2 percent decrease in income level will increase the number of RAL applications by 1 percent. Our data indicate that the highest percentage of RALs occurred in zip codes with income levels between \$20,000 and \$25,000, with the exception of 3 areas. These neighborhoods also had higher levels of Earned Income Tax Credit (EITC) applicants. Percentage of EITC applications were in the range of 30 to 60 percent for the same zip codes. The EITC is a tax credit available for low income families whose income is less than twice the federal

poverty line.

Before we look at the alternatives of using RALs, it is important to understand why low income families are applying to RALs given their high costs. Some of the reasons behind the consumer rationale can be listed as:

- ◆ Real or perceived need for immediate cash for low income households.
- ◆ Lack of information about the product, specifically its costs and alternatives.
- ◆ Windfall effect in treating tax refunds as found money rather than earned and therefore willing to pay a higher cost for immediate cash.
- ◆ Inability to pay for tax preparation out of pocket, which may range from \$100 to \$250.
- ◆ Peer effects - high usage of RALs within the community influences others to do so³.

There are cheaper alternatives to using RALs for low income families. For example, the IRS Free File program is available to taxpayers who earn \$52,000 or less a year. By going to the IRS web site, taxpayers can choose among 19 different companies who partnered with the IRS to file their taxes. Ac-

ording to the IRS web site since Free File's debut in 2003, more than 15.4 million returns have been prepared and e-filed through the program.

In addition, taxpayers can also utilize Volunteer Income Tax Assistance (VITA) programs in their areas. The VITA Program offers free tax help to low- to moderate-income people who cannot prepare their own tax returns. In order to locate the nearest VITA site, you can call 1-800-829-1040. For military service men and women, the VITA Program is also available through The Armed Forces Tax Council (AFTC).

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References:

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- (2) 2007 Refund Anticipation Loan Report, National Consumer Law Center and Consumer Federation of America, January 2007
- (3) Gregory Elliehausen, "Consumer Use of Tax Anticipation Loans," Credit Research Center McDonough School of Business, Georgetown University, Monograph #37, April 2005

Cost of "Instant" Tax Refund Loans

Tax Preparer	Bank partner	Loan Amount	Bank fee for Loan	Bank Fee to Set up Re-fund Account	Bank Fee to get money by check	Fees to get money on card	Total Cost
H&R Block	HSBC	\$2,000	\$48.35	\$39.95	\$21.60	-	\$78.30 to \$99.90
Jackson Hewitt	HSBC or Santa Barbara Bank	\$2,000	\$95.00	\$29.95	-	\$30 to \$50	\$124.95 to \$174.95
Liberty	HSBC	\$2,000	\$110.00	\$19.95 to 29.95	-	-	\$129.95 to \$139.95

- Chart shows total cost for same-day or Instant Refund Anticipation Loans only

- Total cost does not include fees for tax preparation (which averages \$150) or other products

Source: Community Reinvestment Association of North Carolina

