RESEARCHBUZZ

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.

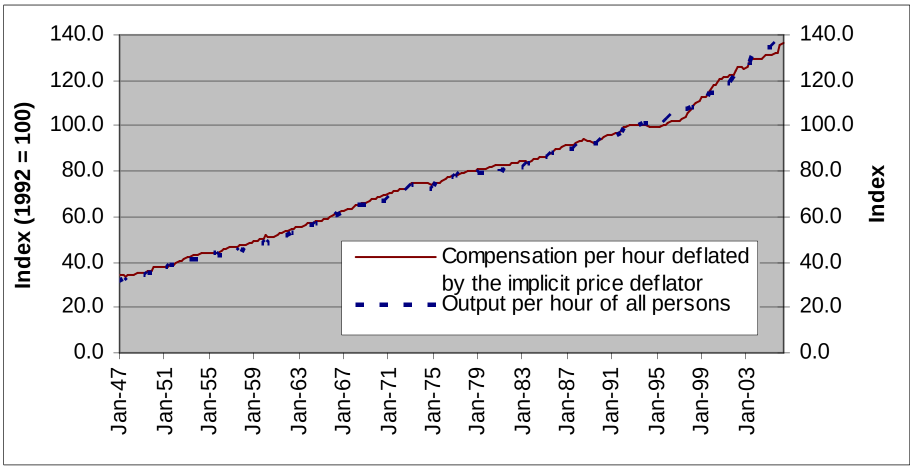
It is not going to get better either. The newly-launched Hamilton Project at the Brookings Institution promises to make "stagnation of wage growth for the majority of workers in the US economy" the subject of "a high-profile drive," according to the *Financial Times* (July 25, 2005). Notable economic 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. 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

Chart 1: US real wages and productivity are very closely related
(Business sector indexes (1992 = 100))



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

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.

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.

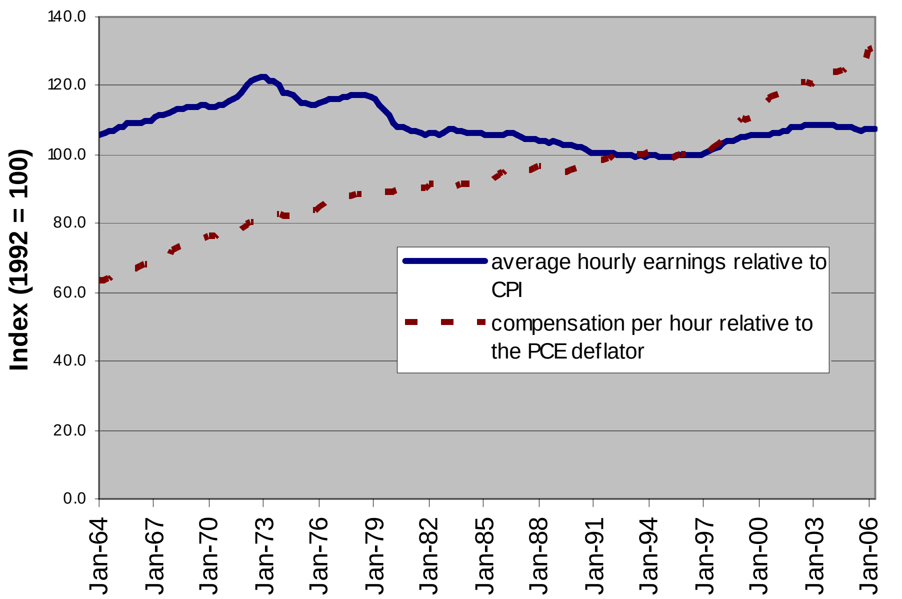
Real wage performance is affected by how it is measured

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.

Note that the CPI-based average hourly earn-

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 ings 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.

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Uninsured in Indiana

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A new report by the U.S. Census Bureau indicates that there were 897,000 or 14.3 percent of Hoosiers without any type of health insurance in Indiana between 2004-2005.[1] This represents a 0.2 percent increase in the number of uninsured compared to the 2003-2004 period.

Indiana fared relatively well compared to the nation. On average, about 46.5 million Americans, or 15.7 percent of the population, didn't have insurance in 2004-05.

Table 1: Percentage of People without Health Insurance Coverage (2 year averages)

	3-year average	2003-2004	2004-2005	Ranking
U.S.	15.7%	15.6%	15.7%	-
Indiana	14.2%	14.1%	14.3%	24
Illinois	14.2%	14.2%	14.2%	25
Kentucky	13.6%	14.1%	13.5%	29
Ohio	12.0%	11.8%	11.9%	36
Michigan	11.3%	11.3%	11.5%	37

Source: U.S. Census Bureau, Current Population Survey

However, compared to neighboring states, Indiana did not fare as well. Indiana had the highest uninsured rate. Although, Indiana's uninsured rate hasn't changed much over the years, due to the population growth, the number of uninsured has been increasing.

It is true that Indiana has lost many manufacturing jobs which provided health insurance coverage to many. However, most of the people who lost their manufacturing jobs were eventually able to find new jobs, but many of those jobs were lower paying service sector jobs. In addition, big manufacturing companies usually provide health insurance coverage to their employees and to their families. However, this is not the case for the people who find jobs at smaller service companies which are less likely to offer health insurance.

The cost of health care is rapidly increasing in the U.S. The uninsured are especially negatively affected by this increase. One of the issues raised at NFI's Financial Forum on health care financing, held in Indianapolis at the Columbia Club on August 29, 2006, is the issue of more transparent hospital and medical services pricing. The Indianapolis Star discussed the issue of opacity in pricing and payment differentials for insured vs. uninsured parties in a September 4 article: "Clarian Health Partners, the Indianapolis area's largest hospital system, charges about $8,143 for an uncomplicated birth, compared with the $2,200 to $2,700 that Anthem Blue Cross and Blue Shield would typically pay."[1] A Star editorial[2] a few days later explained the major reason for this discrepancy as the fact that big insurance companies can demand deep discounts from hospitals, and government programs such as Medicare and Medicaid can set similarly low price limits. As a result, hospitals set artificial and inflated prices for the services they provide to other users.

One could ask, if the uninsured cannot get health insurance for themselves and their families, how they are going to pay these inflated prices for hospitals and other medical services? In a report by Institute of Medicine of National Academies, it has been reported that about $34 billion worth of "uncompensated" services are provided by hospitals to the uninsured.[4] Below are some of the other findings listed in the same report:

- "The United States spends nearly $100 billion per year to provide uninsured residents with health services, often for preventable diseases or diseases that physicians could treat more efficiently with earlier diagnosis."

- "The uninsured are 30 to 50 percent more likely to be hospitalized for an avoidable condition, with the average cost of an avoidable hospital stayed estimated to be about $3,300."

According to a report by Family USA, families and employers pay an extra $922 on average to cover the unpaid expenses of health care for the uninsured. In the same study, it has been reported that approximately one third (35 percent) of the health care costs incurred by uninsured people are paid by the uninsured themselves.

So, the situation is a vicious circle that deteriotes as time passes. The uninsured cannot afford to pay high medical bills, hospitals further increase their prices to compensate for the amount that they haven't been paid, the government sets additional limits (or lowers the current limits) and insurance companies negotiate further to get more discounts. This makes the gap between what somebody with insurance and without insurance pays for the same service larger each year. At the end of the day, working families with health insurance coverage pay more in insurance premiums each year to cover the unpaid expenses of health care provided for the uninsured.

Most insurance plans cover certain preventive treatments and, in some cases, encourage people to take screening tests. The uninsured are more likely to skip these preventive services than are people with insurance. However, as one can expect, skipping some of these test and procedures, such as going without cancer screening tests, increases the risk of having a major health-related problem in the future. Due to these and other reasons, the uninsured's dependence on emergency rooms increases. Emergency room visits are more expensive than community clinics and doctor visits. This creates additional burden on the hospitals and the state economy.

Health insurance premiums grew by 9.2 percent in 2005 and 11.2 percent in 2004. For most of the past 20 years, the growth rate of health insurance premiums far exceeded the overall inflation rate and the increase in workers' earnings.[5] In the near future, it doesn't look like the situation will improve. Although different scenarios are debated by the regulators, there is no one solution to the lack of affordable health insurance.

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1. Associated Press. "Uninsured can face bigger hospital bills than insured." Indianapolis Star, September 4, 2006.

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3. Institute of Medicine. Hidden Costs, Values Lost:

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4. Families USA, "Paying a Premium: The Increased Cost of Care for the Uninsured." June 8, 2005.

5. Employer Health Benefits, The Kaiser Family Foundation and Health Research and Education Trust, 2005.

Don't miss NFI's "In Search of Effective Corporate Governance Reform" Forum.

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Join NFI on November 28, 2006 for our second Financial Forum of the 2006/07 series, In Search of Effective Corporate Governance Reform. Government regulation of corporate governance has taken major and controversial strides forward since the crisis of corporate governance and scandals that contributed to the high-tech boom of the 1990s and subsequent stock market crash. Sarbanes-Oxley was passed in 2002, but its most onerous provisions, section 404, have only recently come in to effect for most firms. Meanwhile, the regulatory burden on mutual funds, hedge funds and perhaps even derivatives have mushroomed, with little end in sight for new rules and constraints on actions related to corporate governance. The notion that new government mandates for corporate governance have and will improve corporate performance has achieved widespread acceptance.

This Forum will address these issues and whether the steps taken in recent years should be revisited. Questions being addressed include:

Are corporate Boards of Directors providing effective governance of financial activities and reporting? Do Boards lack financial literacy? What is required to improve Board performance?

Is the current approach to government regulation of financial institutions effective? If governments are going to regulate, how can they do so more effectively? Can market forces be harnessed to provide effective corporate governance? Or are they already?

What constitutes good corporate governance financial practice? Does it respond to market incentives? Can market performance predict the quality of governance?

Speakers include Ken Lehn, Samuel A. McCullough Professor of Finance in the Katz School of Business at the University of Pittsburgh; Roman Weil, Duane Rath Professor of Accounting, Graduate School of Business, University of Chicago and Director of the Chicago/Wharton/Stanford Law School Directors' Consortium; and Lawrence J. White, Arthur E. Imperatore Professor of Economics, Stern School of Business, New York University.

Further information, full speaker biographies, and online registration is available on NFI's website at http://isunetworks.org/calendar.asp?Action=DETAIL&id=3328. We are able to accommodate large student groups, if any professors have classes that may benefit from participation in the forum. The venue for the event is the Columbia Club, on Monument Circle in downtown Indianapolis. Direct inquiries to Martha Henn McCormick, Research Coordinator, at **martha.mccormick@isunetworks.org**, or telephone 800.603.7113, x708.

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