Welfare Payments Have Pushed Down Labor's Share Of Income

By Alan Reynolds

November 15, 2013

London's normally temperate Economist recently featured a striking headline, "Labor Pains: All around the world, labor is losing out to capital."

Labor costs are said to be a declining percentage of nominal GDP, in the U.S. and elsewhere.

The Economist assumes without proof that this means "an ever larger share of the benefits of growth accrues to owners of capital."

Writing about similar statistics for the U.S., Washington Post columnist Robert Samuelson said, "In the struggle between capital and labor, capital is winning." Unfortunately, the measure he cited, comparing payroll costs to business profits, always shows labor's share falling when the economy is recovering and reaching a peak whenever recessions begin.

The peak labor share in fall 2008, for example, was not because workers were doing well but because business profits turned to losses.

In reality, income is not merely divided by labor and capital. As will soon be shown, a rapidly rising share of income comes from government transfer payments. Taxes to pay for those benefits, plus interest on added debt, drive a wide wedge between pretax incomes and what workers and investors actually receive.

The Economist attributes labor's falling share of GDP to "trade and technology's toll on wages." That may delight protectionists and Luddites, yet it is inconsistent with the magazine's claim that labor's shares are also falling in countries with trade surpluses (China, Germany and Japan), low unemployment (South Korea), and simpler technology (Mexico).

Besides, labor income largely depends on how many people work, not just "wages." Hourly compensation has been rising in the U.S., but labor force participation is at a 35-year low.

When anyone gripes about labor's share, we need to ask, "Labor's share of what?" The Economist divides "labor costs" by gross domestic product (GDP). But GDP isn't just income. Depreciation of buildings and equipment, which is not income for anyone, accounted for a record 16% of GDP in the past 5 years.

GDP also includes income that foreigners earned in the U.S., but Americans can't spend that either. GDP even imputes rental income to homeowners, but you can't spend that without renting your home and living on the street.

And it includes retained corporate earnings, which (unlike dividends and interest) are also not available for U.S. residents to spend.

Personal income fixes these problems, making it a much better gauge of actual earnings of actual U.S. persons.

And unlike GDP, personal income includes the ignored elephant in this room — nearly $2.5 trillion of government transfer payments.

The graph above compares employee compensation as a share of personal income with other sources of personal income, such as proprietorships, investments (dividends, interest and rent) and transfer payments from taxpayers.

Transfers aren't just for seniors: Social Security and Medicaid were less than 43% of government benefits in the third quarter, or about 40% if we included refundable tax credits.

Labor's share has indeed declined — from a 2000 peak (swollen by stock options) of 62.7% of personal income to 61% in 2007, before dropping steadily to 58.1% in the first three quarters of this year (shown as 2013 in graph above).

Contrary to media reports, the drop in labor's share after 2007 had nothing to do with any rise in capital's share. Income from investments (dividends, interest, rent and proprietor incomes) made up 25.7% of personal income in 2000 and 2007, and then dropped to 23.8% in 2009-2010 before recovering to 25.3% in 2013.

Proprietors' incomes dropped from 8.8% of personal income in 2002-2004 to 7.6% or less from 2007 to 2009, so lumping proprietors together with employees (as the Economic Report of The President does) exaggerates the drop in labor incomes. Because about 40% of proprietor income is a return to investments in property and equipment, the chart lists it separately from income to employees or investors.

So far in 2013, employee compensation is up 11.5% from 2007, proprietors' income is up 3.7%, and income from transfer payments is up 41.5%. Investment income, by contrast, was barely 1% higher this year than in 2007, and that gain was entirely due to rental income. Interest income is down because of the Fed, and dividends have not regained their 2007 level.

In short, the only reason income from work has fallen as a share of personal income in the past six years is not because investors have been collecting a larger share (they haven't), but because the U.S. government has been energetically transferring a much larger share from those who earned it to those who didn't.