The Failed Promise: Why Wages Are Not Keeping Up with Productivity

Author(s): Frank Levy

Source: *Challenge*, NOVEMBER-DECEMBER 2007, Vol. 50, No. 6 (NOVEMBER-DECEMBER 2007), pp. 6-13

Published by: Taylor & Francis, Ltd.

Stable URL: https://www.jstor.org/stable/40722480

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The Failed Promise

Why Wages Are Not Keeping Up with Productivity

Interview with Frank Levy

One of the implicit promises of capitalism is that, as output per hour of work increases, its benefits are shared by business and labor. In a recent paper, MIT economists Frank Levy and Peter Temin show that the relationship no longer holds. Productivity has grown more rapidly than wages since the 1970s. The authors argue that the reason may well be institutional failures to support wages. In this interview with Levy, we explore the problem, the causes, and what we should think about regarding solutions.

Q How did you and your coauthor, Peter Temin, become interested in analyzing the question of whether incomes were keeping up with productivity?

***FRANK LEVY** is the Daniel Rose Professor of Urban Economics in the Department of Urban Studies and Planning at MIT. His paper with Peter Temin, "Inequality and Institutions in 20th Century America," is available at http://web.mit.edu/flevy/www/.*

Challenge, vol. 50, no. 6, November/December 2007, pp. 6–13.
© 2007 M.E. Sharpe, Inc. All rights reserved.
ISSN 0577–5132 / 2007 $9.50 + 0.00.
DOI: 10.2753/0577–5132500601

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A. We had a general feeling that standard story that all inequality could be explained by educational differences in the workforce made sense during the 1980s, but it was increasingly only a part of the story. Educational attainment could not really explain what was going on at the very top. Somehow the demand for labor had evolved in ways that people were not quite talking about. There was a second issue as well. It had become a commonplace in the past twenty years to claim that productivity is the engine of rising living standards. But that really was an oversimplification. What the basic theory said was that productivity is the engine of aggregate rising living standards but that the distribution of that aggregate is up for grabs.

Q. You yourself were one of the most prominent advocates of the notion that the economy had changed in such a way that you needed a good education to get a good job.

A. That is right, and that still is true. One thing that our research paper has been criticized for, and fairly enough, is that some people have read it to say that education does not count for anything anymore. If people read the paper that way, that is our mistake. It is not that education does not count, it is just that there is a lot more going on in terms of inequality than just educational differences.

Q So, just to clarify, what drove the need for more education was a new bias in technology toward demand for greater skill—skill-bias technology. In the past, you would have argued that what economists call skill-bias technology was the dominant factor. And now you seem to be saying it is not the dominant factor, it is one of several factors. In fact, other factors may be more important.

A. The way I would put it is that there are many technological changes. But they cannot explain all of the inequality. We are saying that the institutions—government regulations, business norms, labor unions, and so on—have the power to some extent to moderate the underlying technology and its impact on wages. Those institutions performed that function in the 1950s and 1960s, but they were dismantled in the 1970s and 1980s. And nothing has taken their place. It

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is raw free market. Part of our message is that if you think you want an unmoderated free market, then take a look at the outcomes implied by that. One of these outcomes is that even males with a bachelor's degree are not doing all that well.

Q Could you describe your key findings?

A. We divided the labor market by age, education, and sex. We then computed median compensation, which is median earnings adjusted for fringe benefits like pensions and health care. We found that the median compensation of most of these groups did not grow as rapidly as did productivity since 1980 or perhaps a little earlier. The one exception was college-educated women. There is actually a second exception—Ph.D.s, MBAs, and so on—but we have not explored them in detail. We focused on high school and college graduates. In these data, the trends still favored college graduates. Median earnings for those with a bachelor's degree still grew faster than median earnings for those with only a high school diploma. On the other hand, median earnings of male college graduates were not keeping up with productivity gains.

Q So let us talk a little more specifically about what you found. Citing your paper, you find that weekly median earnings for full-time workers has risen by 14 percent since 1980.

A. Yes. If you include fringe benefits, they rose by 19 percent. In the so-called Golden Age between 1947 and 1973, both productivity and median earnings more than doubled—a rise of more than 100 percent.

Q. Higher-end people have done much better since 1980?

A. Yes. The best evidence comes from work by Emmanuel Saez and Thomas Piketty. They show that the top 1 percent of tax filers earned 17.4 percent of gross personal income in 2005, compared with 8.2 percent in 1980.

Q. What is going on, then?

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A. I think a combination of factors. Technology is a part of it; also the development of capital markets and the opportunities for Wall Street traders and so on to make enormous sums. But on top of that, the social norms and the kinds of institutions developed to try to equalize incomes have eroded. If you go back to the 1950s and 1960s, there was a high minimum wage, strong unions, and national support for those policies. There was also a general Washington presence overseeing what was acceptable and what was not. That went out the window in the 1980s.

Q. You use John Kennedy as an example, when he famously jawboned against the steel industry for raising prices.

A. We should review the episode. It was a period in which the government, perhaps Democrats more than Republicans, believed that it was appropriate to be quite involved in the economy and in wage and price setting. So you have the wage-price guidelines proposed by Kennedy's Council of Economic Advisers. Then you have Kennedy, so worried that a round of inflation might derail his Keynesian stimulus program, working with the steel union leaders to hold down wage hikes. He gets a moderate settlement, and shortly after that contract is ratified, US Steel announces a six-dollar-a-ton price increase. Kennedy is furious and holds a press conference in which he scolds the business leaders. The jawboning works, and he persuades the industry to back down.

Now, go ahead two years. There is a big tax cut, started under Kennedy and passed under Lyndon Johnson. There were significant rate cuts for the high-income tax brackets—all the more reason to take big raises. I think it is a reasonable guess that if someone thought that he had the power to take an exorbitant salary, he would have. But there was no huge surge in the income share of the top 1 percent. They were likely worried that they would be jawboned down, and they did not want to tarnish their image.

Q. Right. Now let us move forward to the 1990s.

A. In the 1980s and 1990s, with all the industrial restructuring and,

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more important, the explosion of the bond market due to government deficits, Wall Streeters started paying themselves ever-higher salaries. It was clear the government was not going to say boo to an increase of any size. And tax rates were even lower than under Kennedy.

Q. In particular, you and Peter Temin contrasted the jawboning of the Kennedy period to the lack of jawboning under Clinton. He actually raised taxes on the higher end, and yet incomes did not fall.

A. Well, by the 1990s, institutional forces—rules, norms—on Wall Street favored high salaries. For example, I think most financial economists would agree that the proper way to award incentive stock options includes expensing them in the corporation's income statement. But institutions allowed corporations to avoid expensing them. And it is clear from various pieces that we have read that this lack of transparency contributed to very big corporate bonuses. Boards of directors were much more reluctant to give huge cash payouts to CEOs than largely invisible stock options. So this reflects the environment, and then you have Clinton, who raises taxes on the better off but has no inclination to jawbone against the high salaries on Wall Street or for CEOs. So despite the increase in taxes, the share of income of the top 1 percent continues to rise.

Q. The unions were also clobbered beginning in the mid- to late 1970s and then by Ronald Reagan in the early 1980s.

A. Yes, unions were clobbered. You can make a case that during the 1970s the institutional impact that was a holdover from the New Deal and into the 1950s and 1960s went too far. There was a full cost-of-living pass-through in earnings for steel and auto workers. This affected other workers. The country also indexed social security in the early 1970s. No one anticipated that inflation could go so far. And labor's share of GDP rose rapidly. The stock market was doing terribly, while real wages were doing quite well and some kind of correction was inevitable.

But the pendulum swung very far the other way. In the 1970s, there was what geographers called a Rural Renaissance as prices for agriculture and oil rose and the falling dollar boosted manufacturing exports. It

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reversed sharply in the early 1980s, turning the old industrial areas into the Rust Belt. Old-line industries took a beating in that period from 1979 to 1985, and they took union membership down with them.

Q. Part of that result also is a function, you and Temin argue, of a higher dollar, which undermined manufacturing competitiveness.

A. Some of this was the result of the unintended or unanticipated interaction between Paul Volcker's monetary policy and the big Reagan budget deficit. These old-line industries had to deal with two things: the deep recession and the fact that they could not export because Volcker's high interest rates boosted the value of the dollar and made U.S. exports very expensive abroad.

Q. So that undermined worker bargaining power even further.

A. Yes, in the traditional durable manufacturing industries where unions were so strong, that is what happened.

Q. So here we are somewhere in the 1980s, and the institutional props under wages were cut away—strong unions, constant increases in the minimum wage, oversight by the central government . . . by the president, for that matter. Those were gone, and workers were left on their own in the marketplace.

A. Much more so than they once were. It is a much freer market now. But there are other changes. Today, a free labor market means something different than it did in the 1950s and 1960s: first, there are rapid advances in computerized work and, second, there is a lot more potential for substitution to other countries for offshoring and imports. You cannot just say, whatever the context, that the free market does the best job at setting incomes. You have to consider the context because in a democracy, the free market rests on the consent of the governed. So today, when the free market seems to mean stagnant wages for most workers, you have to ask yourself whether that is a politically feasible outcome.

Q. Then do you think that we did not need strong unions and higher minimum wages to support wage increases in keeping up with productivity back in the Golden Age?

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A. We probably did, but the potential to maintain some of those institutions was a lot easier in the Golden Age. The job that institutions had to do was a lot easier then than it is now.

Q. Have you thought about which institutions we might need to put back in place or new institutions to put into place?

A. We are still trying to work that through.

Q. In general terms, what areas are you thinking about?

A. The basic question is whether to let the market work and redistribute afterward, compensating for market failures and biases, or to start directly modifying how the market actually works.

Q It seems to me that the preferred choice right now, Democrat or Republican, is not to interfere with the market but to supplement or ameliorate the damage done by the markets after the fact. So policymakers favor earned income tax credits or more progressive income taxes or some social programs over direct intrusion.

A. That is right. The question you have is whether the economists' preferred choice is viable in a political sense. If the market produces a very high concentration of income and the political system is still greatly influenced by money and powerful lobbying, then the question is whether you can ever get that kind of ex-post distribution without direct interference. Policymakers in the new environment of money may say they are just not interested.

Q Are you worried about the current distribution of income? Are you worried that it will undermine our political stability?

A. I am not quite there yet, no. Is it something that needs correcting? Yes. And we have been at various points like that in the past. But I also think that things have gotten out of hand. Let us be a little explicit about that. This issue about inequality, I think, is not really the right way to phrase what is going on. Inequality can describe a number of different situations. In the late 1990s you had a situation in which most people were becoming better off and top incomes were rising

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more rapidly, and so inequality was growing, and I think most people just did not care.

Q. Now, that is not the case.

A. An important economic foundation of American life is mass upward mobility, in which each generation does better than the last and people see gains in purchasing power throughout their career, and gains over what their parents earned at a similar age. And in fact for all the talk about how economically mobile a nation we have been, most of what people have in mind by mobility is not that they have moved up radically within the income distribution but that they are living a lot better than their parents lived. What it meant to increase the middle class in the 1950s and 1960s was not that incomes became radically more equal but that productivity gains were shared in such a way that many more families could attain a middle-class standard of living. Well, if you have evolved to a situation where most productivity gains are going to the very top of the distribution and most people do not experience that mass upward mobility, then you are undermining an important feature of American life. That is trouble.

Q. Did all this become clear to you especially because of the experience of the past five or six years? The 2000s?

A. Yes. That really got us thinking.

Q. And what made you, a labor economist, and Peter, an economic historian, link up?

A. Peter has written a lot on the Great Depression and understood the history well. And we both come from a generation with pretty clear memories of the 1950s and 1960s. Compared to younger people, who were familiar only with the experiences of the 1970s and forward, that gave us a different perspective on current times and a sense of what is possible.

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