The Sin Of Wages

Those who forget history are condemned to repeat it. Alas, those who study history and inflict it upon others are condemned to repeat it, too, and suffer the additional burden of understanding the gruesome parallels unfolding in their lives.

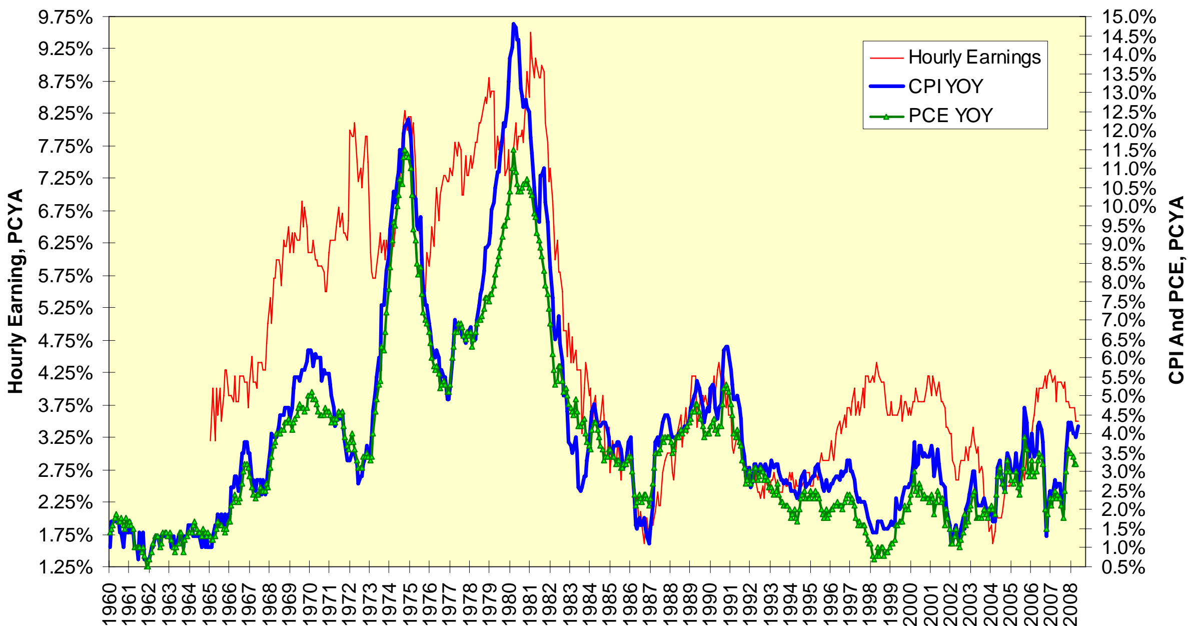
Take inflation, please.

The vocabulary of the 1970s is being resurrected: Stagflation, core inflation, commodity inflation, cost-push inflation and our subject here today, the wage-price spiral. Current apologists for the ongoing macroeconomic mess are congratulating themselves that while the cost of living may be rising, wages have yet to rise in recompense. This is imbecility of the first order and quite possibly the second order as well, for this means the American worker, fantastically productive financial commentators included, is being impoverished. This is anything but bullish.

It also flies in the face of the work of two Nobel laureates in economics, Milton Friedman and Edmund Phelps, who studied how labor shifts its wage demands in the face of expectations about inflation, but that is a subject for another day. Let's just say the American worker is, sooner or later, going to adopt another shibboleth of the 1970s: They will be as made as hell and won't take it anymore.

Earnings And Consumer Inflation

What has been the historic relationship between hourly earnings, announced in each month's employment situation report, and consumer inflation? Here we will use both the Consumer Price index and the Personal Consumption Expenditure deflator.



The answer is the worst answer of all: It changes. Prior to the late 1970s, hourly earnings led the inflation measures. The U.S. work force was both more unionized and less subject to global wage competition then, so workers had far more bargaining power then than they do today. Small wonder policy makers who cut their teeth on this history look to higher wages as a cause of inflationary pressure rather than the result of inflationary policies.

The relationship reversed to inflationary indices leading hourly earnings after the early 1980s. We can attribute this to the combined pressure of a string of recessions, a stronger dollar, declining marginal tax rates, accelerated depreciation and increased global competition. Did we mention Paul Volcker's tight monetary policies? We might as well, because before this cycle is complete and in the history books, you will see them again.

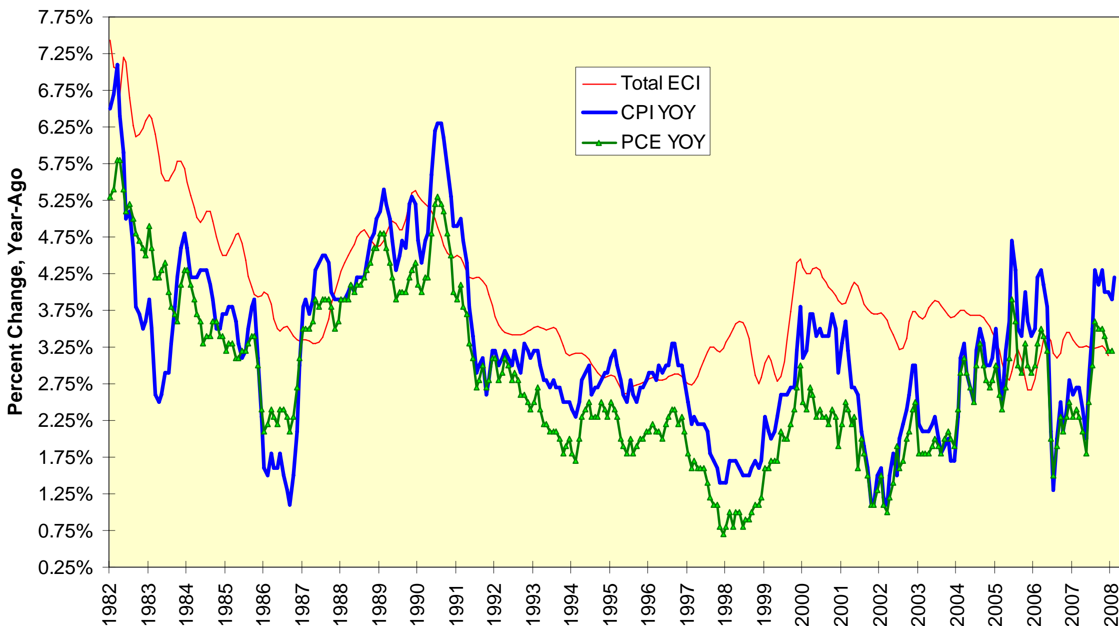
The relationship changed again to an indistinct muddle after the mid-1990s. The causes of this change included globalization, including the North American Free Trade Agreement that some politicians want to abrogate unilaterally and the increased replacement of labor with capital and technology. The present situation has hourly earnings increasing at a decreasing rate while inflation is accelerating. The electorate will go to the polls in four months feeling as if they have stepped on the proverbial banana peel, which at the rate food prices are increasing may be the only part of the banana they can afford.

Employment Costs

However, the cost of employment is more than hourly earnings. Think about your own true income; it includes benefits as well as wages. We can attribute much of this tilt in compensation to our tax code; benefits are deductible to employers and are non-taxable for employees. Small wonder things such as medical insurance costs have spiraled out of control for decades with this asymmetry. Non-wage compensation includes stock and options as well.

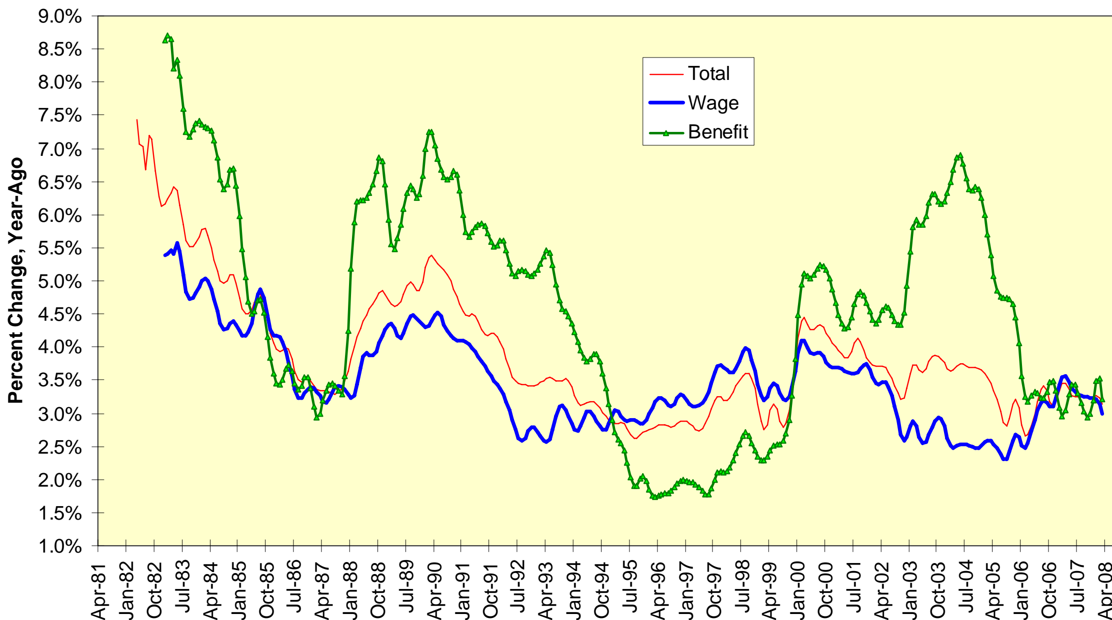
If we compare the Bureau of Labor Statistics' total employment cost index adjusted for its restructuring in 2001 and distributed down to a monthly from a quarterly frequency to our inflation measures, we confirm the observations made above. Whatever lead-lag relationships extant before the mid-1990s have disappeared, which is to say employment costs and inflation are unrelated to a rather surprising extent. Those who wish to attribute rising inflation to wage demands should look elsewhere.

Employment Costs And Consumer Inflation



Now what happens if we split total employment costs into wages and benefits for the reasons cited above and compare them to the total index? Here we see the two periods when year-over-year gains in benefit costs were greatest were during the late 1980s and again in the late 1990s, both periods of relatively restrictive fiscal policy. It appears when the government is running irresponsible fiscal policy, workers prefer tangible wage gains to amorphous benefit gains; this is one way of attempting to preserve purchasing power.

Civilian Employment Compensation Cost Changes



Going Forward

Regardless of this election's outcome, no one should expect their tax burden to decline. In fact, if one proposal to lift the cap on income eligible for Social Security payroll taxes from the present $102,000 takes effect, we could be in for one of the largest tax increases in our history, one that would affect the marginal tax rates whose importance to economic growth has been demonstrated.

The effects could be devastating. First, high-income earners will have a massive increase to shift compensation from wages and salaries to non-taxable benefits and to stock and options. Second, we will return to the days before the Tax Reform Act of 1986 when excessive and otherwise non-productive effort went into gaming the tax system. Third, while there are no distinct relationships between the volatility and growth rates of employee benefits and financial markets (sorry, I have no stocks you should buy en route to Armageddon), there are relationships between marginal rates of taxation on capital and on high-income earners and the returns on equities. The late Walter Wriston of Citibank said it best: "Capital will always go where it's welcome and stay where it's well-treated."

Some of the best work done at the time on explaining stagflation focused on marginal tax rates and their effect on productivity. We learned, or at least should have learned, the importance of a sober monetary policy combined with a stimulative fiscal policy. Robert Mundell was awarded the Nobel Memorial Prize in economics for his work in this area.

Those who find reassurance in sub-inflation wage growth go under many names; I prefer "idiots," but I never was gifted with words. Personally, I find high wage growth and low inflation a preferable state of affairs.

And as far as learning from history and having an empty list of recommendations given the present policy mix, I can tell you what worked in the 1970s: Pretty much nothing. We are not condemned to repeating that tawdry history unless we choose to do so. Long-term investors are advised to remain as defensive as possible.