Economic Growth Program and Next Social Contract Initiative

Beyond the Low Wage Social Contract

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The issue of low wages has moved to the center of American public debate recently, thanks to protests against the low pay of fast food workers, the large share of poorly-paying and part-time jobs that have been created in the aftermath of the Great Recession, and proposals by President Obama and others to raise the minimum wage. But while the debate may be recent, today's low wages are neither new nor surprising. On the contrary, they are the result of decades of public policy. For better or worse, over the last few decades there has been a strong bipartisan consensus in favor of what we call the "low-wage social contract" as the preferred model of economic support and adequacy.

By "low-wage social contract" we mean an economic system that not only assumes but also accepts that many – if not most – jobs in the U.S. will pay poorly. Rather than try to raise market wages, proponents of the low-wage social contract across the political spectrum prefer to help low-wage individuals through other methods, such as lowering taxes or providing government subsidies in cash or in kind. This has been the logic behind many of the policy interventions on behalf of working Americans in the last few decades, including the earned income tax credit (EITC), the child tax credit (CTC), and the subsidies for the purchase of individual health insurance established by the Affordable Care Act (ACA). It was also clearly expressed during the budget debates of the last decade, in which tax cuts were implemented by one political party and made permanent by the other.

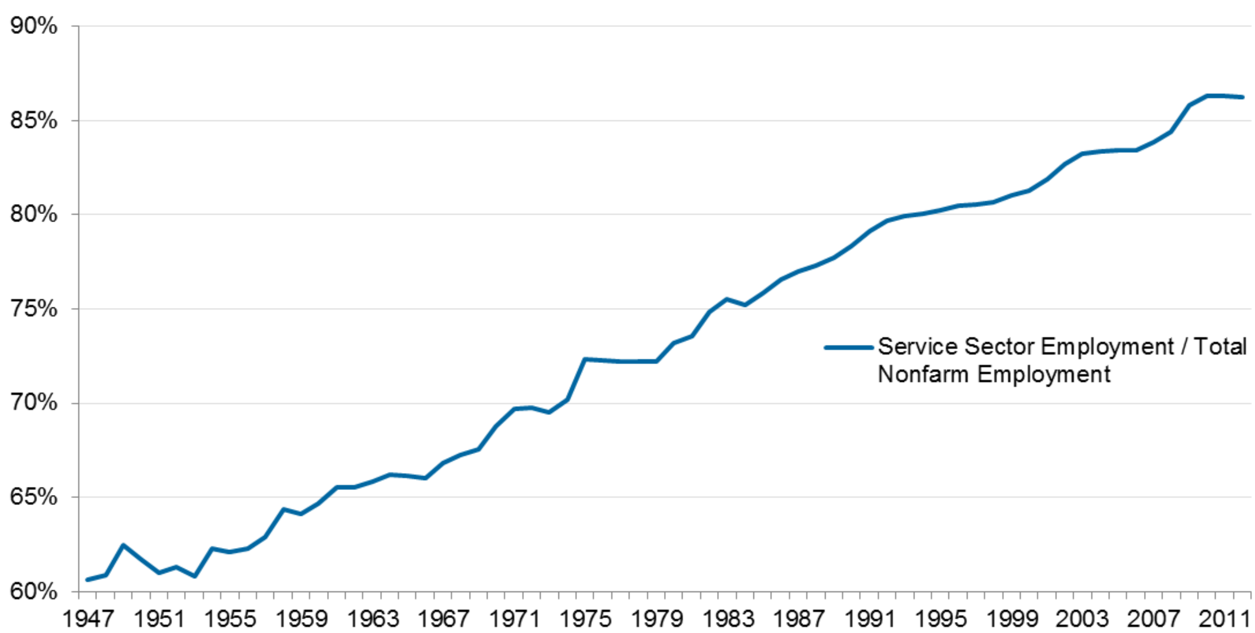
A return to the high-wage model of the American social contract characteristic of the mid-twentieth century, however, would be difficult if not impossible due to changes in the global economic structure. Even so, it is important to analyze the problems with the current model. The low wage social contract has failed. By means of well-designed demand-side interventions, public policy could modify and improve the social contract, even if the same high-wage, low-price system cannot exist in exactly the same form as before. In this paper, we lay out the history of the low wage social contract and the major options for thinking about how to reform the system.

The New Deal Compromise: High Wages, Low Prices, and Welfare Capitalism

The current low wage model lies in contrast to the high-wage social contract that prevailed in the New Deal era of the 1930s through the 1970s. High and rising wages spurred consumption as many more consumers entered the middle class and could afford a greater number of products. High-paying jobs in manufacturing and industry allowed workers without college degrees to earn a middle class standard of living, while unionization and the example that unionized firms set for others contributed to ensuring that wages stayed high.

On top of this high-wage driven economy, the government acted to spur additional consumption and provide benefits indirectly. The GI Bill offered scholarships and subsidized loans for returning veterans that allowed them to purchase major items like houses.[1] And while the New Deal did create some universal programs, like Social Security, much of the provision of benefits ended up in the hands of employers rather than the government. This arrangement was the outcome of conflicts between progressives, who favored universal programs; unions that supported the creation of separate associations to pool benefits; and paternalistic corporations that wanted to maintain control of benefits as recruitments and rewards.[2] With large profit margins and limited competition – and an eye for benefiting all stakeholders, rather than shareholders alone[3] – companies in the dominant industrial sectors contributed to a fairly robust social contract that was partly public and partly private. The ability to automate and innovate in the tradable sectors, combined with limited global competition and the ability of organized labor to extract wage concessions from employers such as manufacturing companies and regulated public utilities, made high wages and low prices possible at the same time. Large businesses tended to support the high wage social contract even more than small businesses until deregulation and the rapid advance of globalization led large corporations to distance themselves from the New Deal-era social contract and favor the low wage model.

Figure 1: Service Sector Jobs Have Grown Steadily as a Share of Total Employment

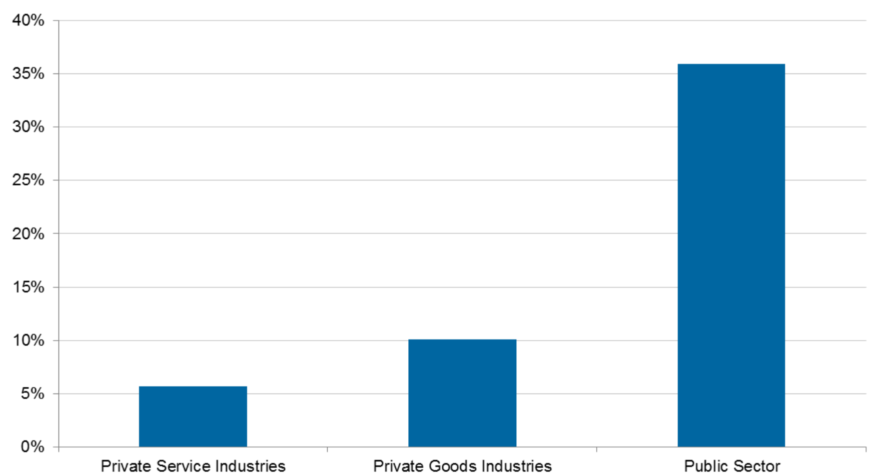


Source: Bureau of Labor Statistics

Unfortunately, the preconditions that contributed to high wages and rapid productivity increases do not exist in the same form today as they did half a century ago. Innovation is still the linchpin of economic growth, but it will be more difficult to make large productivity leaps in the untradeable, technology-resistant sectors in which many new jobs are being created. Industrial sectors like manufacturing continue to shed jobs even as we attempt to retain their important value-added economic functions.[4] An increasing role for what economist William Baumol termed the 'stagnant sector' means a greater share of employment and consumption will take place in services.[5] We have already seen this taking place: more than 86% of the workforce is now employed in the service sector (see Figure 1).[6] Service sector jobs are divided between higher paying professional and business services, like finance, and low-wage "final demand" industries like food service and hospitality. Most of the recent job growth has come in the low wage service industries, and many potential sources of future employment in childcare and health assistance also predominantly pay low wages.[7]

Unlike many of the big automakers and manufacturing titans of the time that drove the previous economy, low wage service industries like food service often have lower profit margins.[8] At the same time, service sector jobs are more difficult to unionize because they often involve smaller individual firms and do not have the historical precedent of unionization that manufacturing does.[9] Union membership in the private service-providing sectors is 5.7% in the U.S., compared with 10.1% in private goods-producing sectors.[10] Instead of attempting to lift wages along with these economic shifts, the response in the last four decades has been policies that have replaced the New Deal model with the low wage social contract.

Figure 2: Union Membership



Source: Bureau of Labor Statistics

The Low Wage Social Contract: Low Wages, Low Prices, and Benefits Through the Tax Code

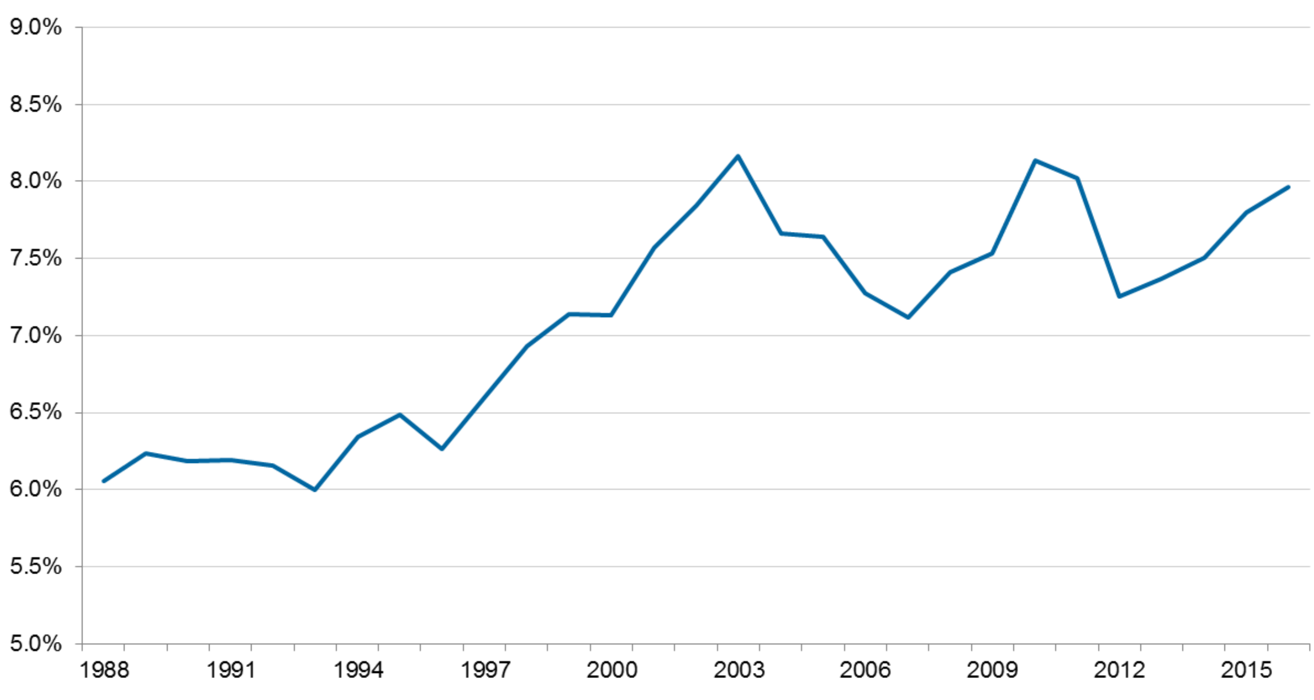
It is rare when an economics paper gets particular attention, but the recent nomination of Jason Furman to chair of the President's Council of Economic Advisers this year brought back to life a paper he had written in 2005. The paper, entitled "Wal-Mart: A Progressive Success Story," argued that Wal-Mart's ability to keep prices low for consumers made low-income Americans better off even if the wages it paid were very low.[11] Furman claims that Wal-Mart could not raise wages of its workers without also raising prices on consumers, which would be worse for the low-income consumers that shop at the store. Correct or not, Furman's approach illustrates the logic of the system that policymakers of both parties have embraced in the last generation.

Rather than promote high wages, the current low wage social contract seeks to compensate for low wages by means of low prices, low taxes and wage subsidies. In theory, this should mean that the consumer has similar spending power to a high-wage, high-price model.

Consumer prices have been lowered not only by technological innovation, as in the past, but also by means of cheap imports from emerging markets with government-subsidized export industries and by low pay for American domestic workers. Companies that pay low wages to workers can sometimes provide lower prices for consumers.[12] As the Department of Labor noted in 1999, "The presence of low-wage jobs in the economy helps keep production costs and prices low, thereby benefiting all consumers."[13] A 2005 study by Jerry Hausman and Ephraim Leibtag found that Wal-Mart – notorious for its low wages – offered food prices that were 8% - 27% lower than supermarkets.[14] For many large employers, James Surowiecki notes, "The grim truth [...] is that low wages are a big part of why these companies are able to stay profitable while offering low prices."[15] This is particularly applicable to the food service sector, which has had very low productivity growth in the last quarter century.

Under Democrats and Republicans alike, public policy has also sought to compensate for low wages with low taxes. In recent years, conservatives have begun to criticize the fact that many low- and middle-income Americans pay no federal income taxes. But in the late twentieth century, both conservatives and progressives collaborated on the project of lowering taxes on low-wage workers. The result of taking nearly half of the workforce off of federal income tax rolls[16] was achieved by means of tax expenditures, including two refundable tax credits: the Earned Income Tax Credit (introduced in 1975 and expanded in 1990 and 1993)[17] and the Child Tax Credit (1997 and expanded in 2001).[18] (A refundable tax credit means that the IRS pays a subsidy to individuals who do not make enough to qualify for the

Figure 3: Tax Expenditures as Share of GDP (including money paid out for refundable credits)



Source: Authors' calculations of Tax Policy Center analysis, based on Budget of Federal Government data.

income tax credit otherwise). The number of tax expenditures has increased nearly 60% since the late 1980s[19] and the cost has grown from about 6% of GDP to more than 8% of GDP.[20] While refundable tax credits have been a major contributor to this growth, other increasing tax expenditures, such as the home mortgage interest deduction, do not primarily affect low-income workers and do not help compensate for low wages.[21]

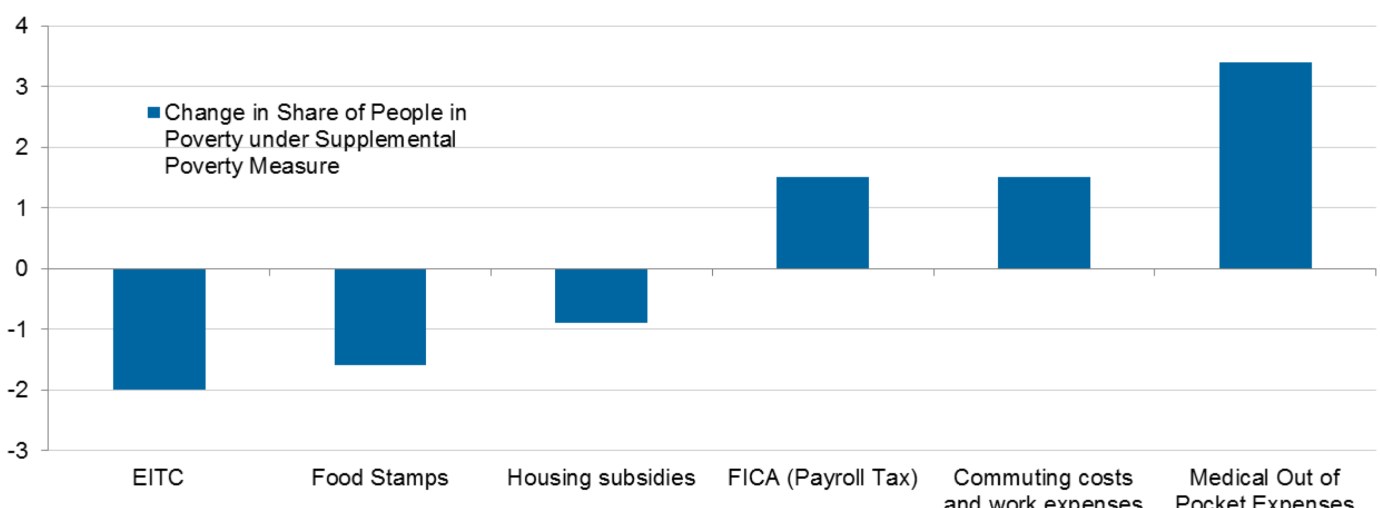
Problems with the Low Wage Social Contract

The low-wage social contract of the last generation has enjoyed robust bipartisan political support. Thanks to cheap imports and low-wage employers, prices have been kept lower than they might otherwise have been, while tax expenditures have lowered the burden on low-income workers of federal taxes (though not of more regressive state and local taxes). The benefits to employers of low wages and subsidies have buoyed small businesses and led to job creation, albeit low wage job creation. And the wage subsidy that is the EITC has supplemented poverty-level wages for millions of American workers and boosted their standard of living.

Even so, the low-wage social contract is highly problematic.

The total level of after-tax income is still far too low for many Americans. Using the Census Bureau's Supplemental Poverty Measure, which incorporates additional costs and after-tax benefits, the United States has about 50 million people living below the poverty line.[22] Tax credits and welfare programs under the current version of the low wage social contract have not come anywhere near covering the gap in incomes created by low wages. These wage supports are inadequate to compensate for low incomes. (See Figure 4 below, which omits childcare, another very large expense for low-income workers).

Figure 4: Medical Expenses Put More People in Poverty Than EITC Covers



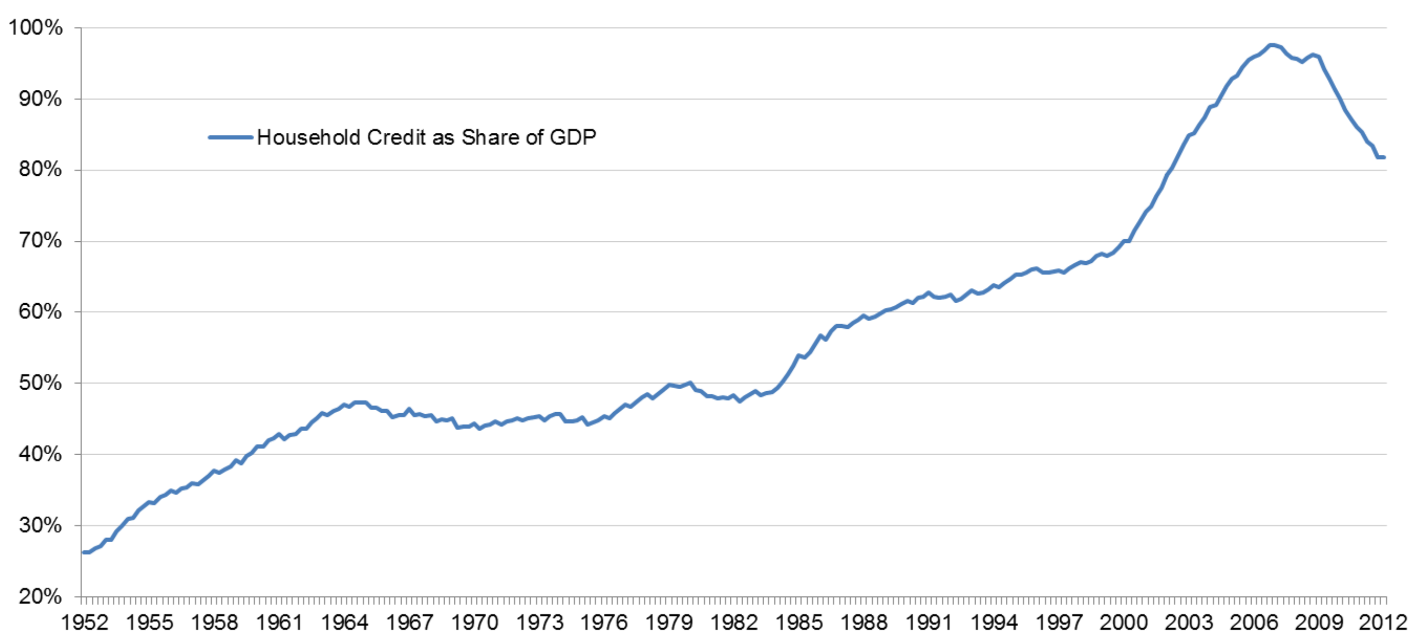
Source: Census Bureau

Under the low wage contract, the economy has struggled to create enough aggregate demand. Workers are also consumers in the economy, so low wages inhibit the consumption-driven demand that powers the rest of the economy. A century ago, this problem was dealt with through the "virtuous circle" now often associated with industrialist Henry Ford, who agreed to pay his workers enough so that they could afford to buy the cars they were producing.[23]

To deal with the lack of aggregate demand under the low wage system, the government has attempted to promote lower- and middle-class consumption in other ways. The proliferation of tax credits and deductions is one way, but this alone has not been enough. To allow households to keep pace with consumption, public policy has also subsidized credit and encouraged borrowing. The personal savings rate averaged around only 2-3% during the late 1990s and early 2000s, and after a brief rise due to the global financial crash and recession, has dropped again to similar levels in 2013.[24] Low interest rates, financial innovations, and easy access to credit have promoted consumption even as total buying power (wages and benefits minus taxes) has not increased in turn. On the eve of the crisis, household debt reached almost 100% of GDP, up from 66% just a decade earlier.[25] Compounding the problems that have arisen from the reliance of low-income Americans on credit, deregulation has allowed for an unchecked proliferation of the financial sector, which has created more middlemen and actually made financial intermediation more costly, rather than less.[26]

The biggest shortcoming of the low wage social contract is that it failed to compensate for – and even increased the prices of – the changing set of goods that contribute to improving citizens' quality of life. Even if low wages are able to keep prices low for clothing and food or other items that might be found at Wal-Mart, they make other necessary goods – health care, daycare, eldercare, postsecondary education – often unaffordable. Health care and education/childcare combined accounted for 6% of the costs of raising a child in 1960; now, in inflation-adjusted

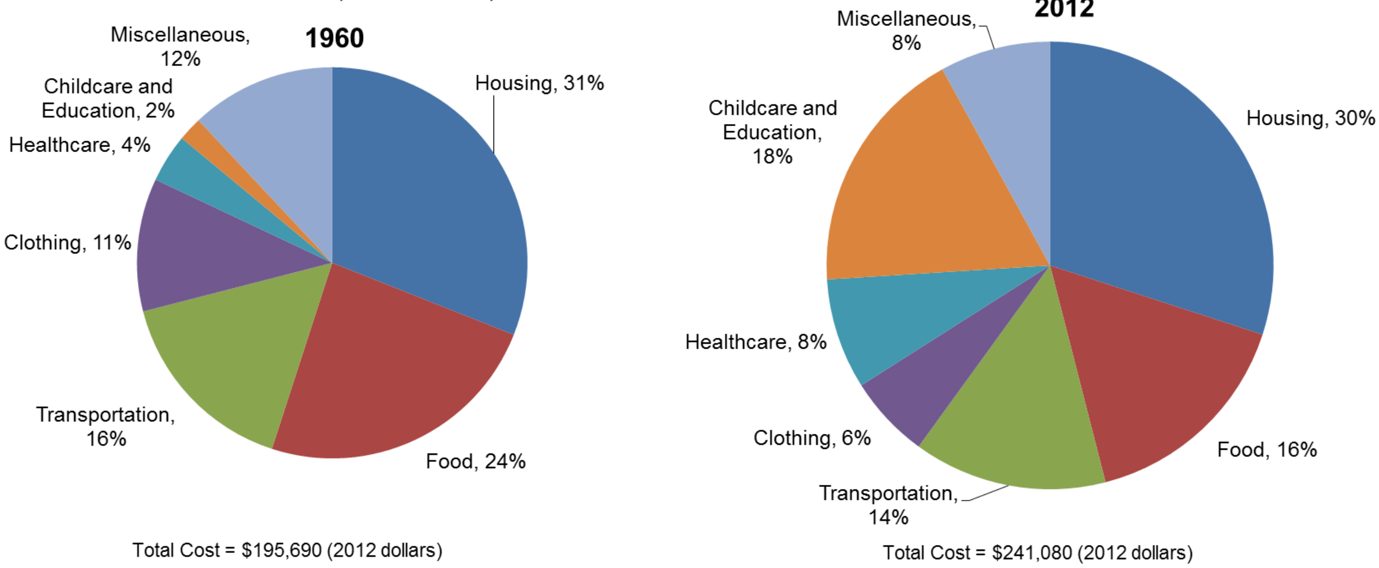
Figure 5: Americans Turned to Credit to Compensate for Low Wages, Culminating in the 2007 Financial Crisis



Source: Bank of International Settlements terms it is fully 26%.[27] The total cost of raising a child is 23% higher than it was in 1960, causing families below the official poverty line to spend 30% of their income on childcare.[28] The low-wage social contract only allows workers to have enough wages to buy goods in low-price industries, excluding an increasing share of important household expenses.

Health and education illustrate this problem. More than 20% of the population has trouble paying for medical expenses each year, and medical payments are the largest cause of bankruptcy in the United States.[29] Thanks to the increasing cost of college and more widespread attendance, student loan debt has surpassed credit card and auto debt to become the second biggest source of consumer debt.[30] By reducing aggregate demand, low wages in combination with high debt have hurt the economy: preliminary data suggests that individuals who have student loan debt are consuming less, including delaying important purchases like houses and cars.[31]

Figure 6: Cost of Raising a Child Has Increased and Shifted to Childcare, Education, and Health



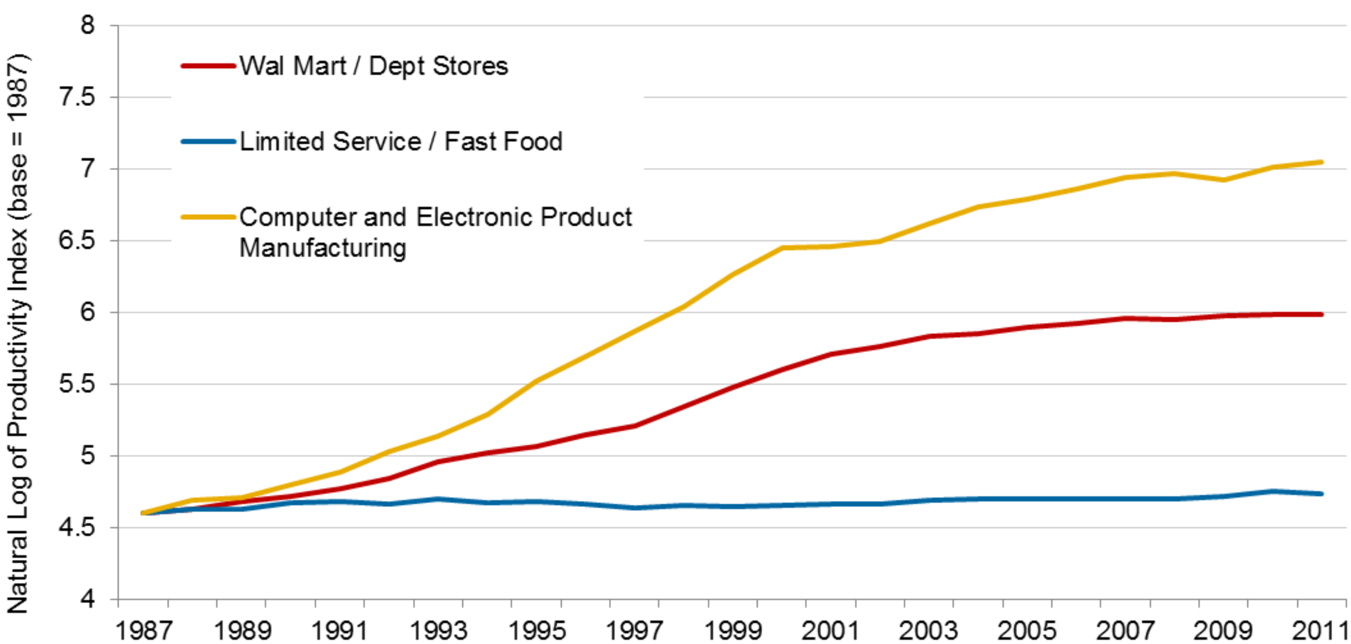
Source: Center for Nutrition Policy and Promotion, USDA

The low wage social contract has also fueled extreme inequality, as the gains from economy-wide economic growth have not been shared with most Americans through wage growth. Between 1979 and 2007, the top 5% of tax units took 81% of pre-tax income.[32] The wealth distribution is even more unequal: the wealthiest 10% own 77% of all wealth, and the bottom 60% of households have actually lost wealth since the mid-1980s.[33] The low wage contract has created what analysts have termed a "plutonomy," in which the wealthiest individuals are responsible for a greater portion of both income and consumption in the economy.[34] This plutonomy has contributed to more instability in the system and starker class divides between the haves and the have-nots. Excess wealth is not returned to the system in the form of consumption of manufactured goods and quality of life services, but rather in the form of purely speculative finance, which also contributed to the imbalances that led to the financial crisis of 2007.[35]

Part of the growing inequality stems from the fact that the profits of many employers are increasing, even in the service sector. Corporate profits are at an all-time high while wages are at an all-time low.[36] Clearly something is broken in the theory of the low wage social contract: if profits are rising while wages are falling, the cost savings of lower wages are not being passed onto consumers. Instead, they are flowing to the top.

One reason is that not all service industries are created alike. Many service industries have substantially increased their productivity through the implementation of information and communications technology (ICT). While productivity has not increased at the same rate as it has in manufacturing, the retail sector has used ICT to improve coordination with suppliers, inventory management, and sales tracking (See Figure 7).[37] This has led to growing profits for corporations at the same time as wages are stagnating or declining. The ratio of compensation to productivity, also known as unit labor costs, has declined consistently since the early 1990s at places like Wal-Mart and other big department stores.

Figure 7: Productivity Growth (Output Per Hour)



Source: Authors' analysis of Bureau of Labor Statistics data

If the low wage contract is to work in practice, the gains from productivity either need to be shared with workers in the form of higher wages or passed on to consumers in the form of lower prices. Currently, only a limited share of certain industries' cost savings from low wages and productivity increases are being spread around.

The Neoliberal Contract: Doubling Down on the Low Wage Model (Plus Means Testing)

One alternative to the low wage system in its current form is what we call the "neoliberal contract" or the "modified low wage contract." Building on the low wage model, the neoliberal contract is comfortable with increasing gains flowing to capital – and subsequent low wages – so long as the redistributive mechanisms for those who end up worst off in the system are stronger than we currently have. Neoliberals tend to favor means tested programs, which target benefits at low-income recipients, rather than universal programs that give benefits to all. Means tested programs are the most directly redistributive, as they ensure that affluent individuals do not receive benefits. Under an ideal neoliberal system, taxation and benefits would both be very narrow: taxes would flow predominantly from the richest and benefits would only be available to the poorest.

This has been a common position for many centrist liberals and Democrats in recent years. Through redistribution, this model does attempt to rectify some of the concerning trends toward increasing inequality. However, the efficacy of the system can be called into question. First, means testing is a fragile endeavor – means tested programs often lack political support because the benefits and burdens are completely distinct and the middle class does not share in the gains.[38] Universal programs, on the other hand, enjoy much stronger support from broader populations.

Second, the neoliberal project is much more indirect than the use of more overt labor market interventions such as a mandated minimum wage. If increased wages only come about by letting wages decrease and then using a variety of ex-post mechanisms to bring it back up, complexity in the system is increased to achieve the same goal as a more direct high-wage model.[39] Complexity also tends to disadvantage workers and the poor, as knowledge of how to deal with complexity flows to those with money and power, which suggests the neoliberal avenues of equality will be more difficult to achieve than more direct ones.

Additionally, to buoy the consumption of lower- and middle-income workers and boost aggregate demand solely through redistribution will likely be a difficult endeavor. While the EITC, for example, has helped increase the incomes of low wage workers, the largest gains accrue to low wage employers, not workers.[40] The EITC is a very popular program; because its effects are indirect, however, many scholars have argued that it would work most effectively in tandem with direct labor market regulations like a higher minimum wage.[41] Using tax-favored or means tested programs alone to redistribute income will, like the EITC, only boost wages part of the way and will add complexity to the system. Direct cash transfers from rich to poor, while less complex, tend to be opposed on the left for violating basic norms of dignity and equality and on the right for acting as a work disincentive.[42]

Moreover, the method of subsidized, means tested support for benefits has made it more difficult to provide low-cost social benefits. Even if enough redistribution can be achieved to ensure that low- and middle-income workers have enough income to keep aggregate demand high, subsidies for private sector provision of benefits have not been able to keep costs down. Rather than increase access, much of the subsidization has actually led to cost inflation as providers raise prices to collect more of the gains from subsidized programs. In health care, it is now clear that the U.S. attempt to provide insurance through the private sector has led to higher prices than in any other similar country.[43] And tuition subsidies for higher education have likely allowed colleges to increase tuition in turn and capture the subsidy rather than increase access.[44]

The Social Democratic Contract: High Wages, High Prices, Broad Benefits

It is now commonplace in discussions of welfare states to pre-emptively hear one side issue a warning: “Don’t compare us to Sweden!” Nordic countries have created successful social democracies with high wages and widespread universal social programs (health insurance, higher education, pensions, unemployment, paid leave, and more); however, as many commentators are quick to note, Scandinavia has a different set of demographics and resources than the United States.

In what we term the ideal "social democratic contract" or "high wage contract," the low wage-low price paradigm would be replaced by a high-wage, high-price system with universal public benefits. High wages would enable workers, as consumers, to afford high prices, which in turn would be translated into high wages for other workers. High wages would also enable high, broad taxation to be used to fund universal social programs like health care/insurance, education, and unemployment.

Under this alternative, workers might have less spending money when high prices and high taxes are taken together, but many of the expenses of a household budget in a low-wage, low price economy would be covered by public programs in a social democratic system, freeing remaining resources for discretionary consumption. As noted above, an increasing share of families' expenses is going toward costs like health, education, and care for dependents. Guaranteed access to consumption in these sectors is both important to increasing individuals' standards of living and supporting overall demand in the economy.

The high-price, high-wage model of an idealized social democratic system is very appealing because it empowers labor, increases consumption, and ensures access to public benefits. But it could be difficult to transplant to the United States. While the broad taxation is hugely beneficial in creating universal, middle-class programs, its success is dependent on relative pre-tax equality. Because broad taxation is less progressive, the tax system does not act as strongly as a redistributive mechanism as narrow, more overtly redistributive government funding. The United States has extremely high levels of pre-tax (and post-tax) inequality,[45] which makes a less progressive tax system less appealing and far more difficult to implement.

Even in Sweden, the social democratic model is under increasing pressure. Since the financial crisis of the early 1990s, Sweden has been gradually moving away from its historical social contract to a more market-oriented system through tax cuts, decreased wage bargaining power, and more open trade.[46] The center-right coalition has defeated the social democratic alliance in the last two elections.[47] The Nordic system, while appealing in the abstract, is itself is shifting toward a more middle-of-the-road system.

Middle Income Social Contract: Medium Wages, Medium Prices, Universal Benefits

Another possible alternative is a compromise that sorts out some of the flaws of both the current and alternative systems. A "middle income social contract" or "mid-wage social contract" could exist to move past the low-wage model while incorporating the important universal benefits of social democracy and also working to redress the inequality in the system.

Rather than embrace the low-wage option, as the United States currently does, under a middle income social contract public policy might focus on lifting market wages at least part of the way. A higher minimum wage would be a first step. Even if these higher wages were entirely borne by consumers, the effect on prices would likely be limited. A study by the Center for Labor Research and Education at Berkeley found that increasing the minimum wage to $12 an hour would raise prices by only 1.1% at most, or $12.49 per year for the average shopper.[48] For fast-food restaurants like McDonalds, research by the Political Economy Research Institute at the University of Massachusetts estimated that increasing the minimum wage to $10.50 would mean a 2.7% increase in costs, which they say could be covered by an increase of 13 cents per Big Mac.[49]

A possible middle income social contract might borrow from the neoliberal vision and increase the progressivity of the tax code by raising taxes on higher earners. There is plenty of room for increased progressivity in the tax code. Despite a very progressive tax system, taxes are still relatively low in the U.S. Both income and capital gains taxes are much lower than they were in the mid-20th century.[50] Among high-income countries over the last 50 years, the United States has lowered its top tax rate by 47 percentage points while the share of income accruing to high earners has increased nearly 10 percentage points, far more than any other country.[51] This unilateral shift in favor of high earners leaves room for future policies to shift the distribution part of the way back toward equality and gain more revenue.

On the benefits side, a middle income social contract would take the form of broad, universal social programs similar to those of social democracies. Instead of means testing benefit programs, the mid-wage model might offer widespread benefits to rich, middle class, and poor alike. In some cases, services like health care might be directly provided by the government — for example, via local public hospitals rather than subsidized and delivered by middlemen in the private sector. Given the difficulties that the United States has faced in providing benefits through the private sector, simpler, more universal programs would address this problem.

Table 1: Ways of Providing Benefits

	Indirect/Direct	Example
Wage Subsidies	Indirect	EITC
Subsidized Credit	Indirect	Student Loans
Goods Subsidies	Indirect	Health Insurance
Direct Provision	Direct	K-12 Education

Universal benefit programs would also counteract the difficulty of rising consumer prices in sectors outside of tradable goods in which technology, imports, or a combination of both continue to reduce prices. Low-wage workers who currently cannot afford health care, education, or dependent services would have access to these under a system based more on universal, tax-funded provision. And direct provision, or, where appropriate, provision by regulated private utilities, would help keep costs down at the same time.

Providing widespread social benefits offers a direct subsidy for consumption of public services like health care and education, while employer subsidies to offset low pay offer an indirect subsidy for consumption via the production of low cost consumer goods and fast food. Often these low cost goods are less healthy or of worse quality; by using the same level of funds to instead provide public services, the government would more directly and efficiently be supporting longer-term quality of life investments for all.

A middle income social contract would seek to create a broader, more supportive social contract within the difficult confines of an unequal and complex country like the United States. On the taxation side, it would be progressive, combating inequality and redressing the increasing share of the gains going toward capital. On the benefits side, it would be universal, using the benefits of direct provision and universal programs to spread the gains as widely as possible and ensure widespread support for programs while minimizing costly rent-seeking by private sector providers.

Any social contract that seeks to be more progressive on the revenue side will require a greater share of funding for programs of all types to come from income and capital gains taxation. Because state taxes are more regressive, the social contract will also benefit from shifting funding from the state and local level to the national level. National funding sources would additionally limit the temptation for states to use excessive tax incentives to undercut other states, a tactic that has led to a negative-sum game for workers and local governments.[52] As states compete with one another to attract businesses, owners of capital have arbitraged the differences and left the public with a hefty bill to pay to those who are already coming out on top. It is possible to keep program administration at a more local level even as funding is nationalized to ensure that the programs remain responsive to local needs.

It is time to move past the low-wage social contract, which has not lived up to its promise to be better for lower- and middle-income Americans. The United States needs a successor to the failed low-wage contract of today. In creating this new contract, public policy needs to analyze the alternatives and build a social contract that is more equitable, empowers American wage earners, and creates efficient universal programs.

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[42] First, it creates a "pity" dynamic in which part of the population is dependent on a quasi-benevolence of the rich to get their income. Sometimes called "pity-charity liberalism" and included in part of the debate over makers versus takers, the pity

dynamic is incompatible with equality. Philosopher Elizabeth Anderson writes, "Pity is incompatible with respecting the dignity of others. To base rewards on considerations of pity is to fail to follow principles of distributive justice that express equal respect for all citizens." (Anderson, Ethics, 1999) Second, direct cash transfers are a work disincentive – particularly as a person's income nears the means-tested cutoff. AEI's Andrew Biggs argues this point in a piece in National Affairs, noting that the main conservative objection to means testing is that "reducing a person's government benefits as his outside income increases creates a disincentive to work and save."

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44 The literature is somewhat mixed on this topic. For evidence that aid programs inadvertently cause higher prices, see: Nicholas Turner, "Who Benefits from Student Aid? The Economic Incidence of Tax-Based Federal Student Aid," University of California – San Diego, October 2010. See also: Stephanie Cellini and Claudia Goldin, "Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges," NBER Working Paper No. 17827, February 2012. For a broader rundown, see Dylan Matthews, "Is Government Aid Actually Making College More Expensive?" Washington Post, September 3, 2013.

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About the Project

The Next Social Contract Initiative *aims to rethink our inherited social contract, the system of institutions and policies designed to empower and support citizens from childhood through work and retirement. Inspired by the premise that economic security and opportunity are mutually reinforcing, a new social contract should foster innovation and openness, encourage long-term growth and broadly shared prosperity, and engage individuals and families not only as participants in the economy but also as citizens.*

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