FirstPoint Financial

WEEKLY MARKET THOUGHTS

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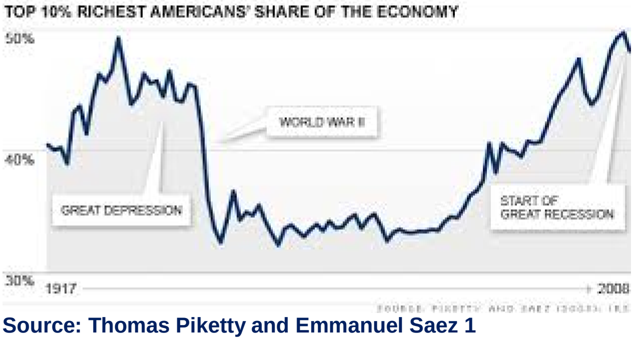
Where Has All the Income Gone – Part 2

Income disparity and labor market weakness are issues that are front-and-center for the economic leaders currently visiting Jackson Hole, Wyoming. Last week, I created the first of our Income Series, studying the history of income disparity in the U.S. Income disparity – the difference between the highest and lowest earners in our society –has always been with us, as most of the world employs a market-based compensation system, which pays one worker more than another due to job, skill level and location. Nothing new here.



Source: Thomas Piketty and Emmanuel Saez 1

What is new is that the spread between society's highest and lowest earners has become very wide. Is this due to greed or is the system somehow unfair? Last week, we explained that income disparity isn't stable – it changes over ***long*** periods of time. The chart to the left shows the top 10% richest Americans' share of the economy from 1917. Two points stand out. The current level of income disparity isn't new – income disparity was roughly at the current level prior to WWII. Also, income disparity was rather low and stable from the end of WWII until the early 1980's. ***Question – what happened roughly 30 years ago to widen income disparity levels? If we understand what happened at that time, perhaps we will start to understand why income disparity in the U.S. is currently rather wide.***

Digging Deeper – The Real Issue – Econ 201

I would like to address the issue of income disparity by looking at a deeper factor than income disparity – that being a major shift that has taken place since the early 1980's. Total labor compensation – irrespective of where one stands in the income disparity range – has been falling as a percent of national income. This issue (posed in his report The 30-Year Decline in Labor's Share of National Income: Why? by Dr. Horace "Woody" Brock) shows that labor's income pie has been shrinking in relation to the size of the economy, irrespective of income disparity.

A little economics lesson. There are a number of ways to calculate GDP and account for economic growth as measured by a change in GDP. One is the National Income method. National Income is comprised of two buckets, one being labor compensation and the other is return on capital. Labor income is fairly straight forward – compensation earned. Return on capital is basically business earnings. By definition, National Income = GDP. Return on Capital + Labor Costs = National Income. Here's the rub - return on capital has been rising more rapidly over the last 30 years than labor income and GDP. Bluntly, the percent of the national income pie that is going to labor costs has shrunk relative to capital income over the last 30 years. Consequently, the owners of the capital base in the U.S. (wealthy people and high income earners) have been gaining economic ground on those who don't own a large portion of the capital base. Income disparity has been occurring due, significantly, to the redistribution of the income pie in favor of capital income and away from labor income.

The Proof

From 1950 – 1980, the share of National Income (and GDP) accounted for by Labor Compensation remained fairly stable at 66%. The remaining portion of National Income – and GDP – was accounted for by capital income (business profits). Since 1980, the portion of National Income which has been driven by capital income has increased from 34% to 40%. ***In other words, income disparity has risen hand-in-hand with the fact that labor compensation, irrespective of how high or low that income is, now represents about 6% less of GDP annually than it did in 1980. This shift in income allocation between capital and labor started at the same time personal income disparity started to widen. The shift between labor and capital isn't small potatoes. With GDP now at $15 trillion annually, labor compensation (income) is currently $900 billion lower annually than would normally be the case, due specifically to the shift that has occurred between labor and capital incomes.***

Factors Which Led to Lower Labor Income and Higher Return on Capital Levels

As mentioned earlier, Dr. Brock of Strategic Economic Decisions has written on this issue extensively. Many of my thoughts mirror his imaginative works. While perhaps not exhaustive, it appears the following factors have led to a decline in labor income as a percent of National Income and, consequently in GDP, since 1980:

- **Decline in relative price of investment goods**. Since 1980, interest rates have declined significantly and stayed low for an extended period. Additionally, through technological advances, the ability of business owners to make decisions favoring capital spending relative to increased labor compensation has occurred. The combination of these two developments has driven the traditional labor vs. capital spending decision dramatically towards capital spending and away from hiring more employees.
- **Rise in the manufacturing prowess of China.** As Dr. Brock states: "is it a coincidence that the timing of the decline of labor's share in National Income coincided with the ascendency of the Chinese economic empire?" The rise of China as an economic powerhouse has partially been accomplished by looser trade standards. Arguably, consumers globally have benefited by this shift, but the price has been shrinkage in labor's share of National Income.

- **Loss of labor's bargaining power with management.** The unionization of the workforce grew from the early 1900's until the late 1960's. During most of the 1970's and until this day, union membership in the private sector has contracted, leaving the individual worker to fend for him/herself when dealing with management. Unionization in the private sector is at its lowest level in 70 years.
- **The skills gap driven by the state of K-12 public education**. With unionization on the wane for decades, individual workers are on their own to gain higher wages through training, experience and location. Over the last 30 years, it has been critical for the public education system to step up, providing a strong education base for students. By almost any global ranking, this has not occurred. The typical workplace of today demands workers who are literate, in tune with technology and strong in science and math. There exists a wide skills gap between the needs of today's industry and financial systems and the abilities of our youth.
- **Impact of adverse government legislation on the labor market.** In Dr. Brock's piece, he expands his views on good and bad forms of taxes. According to Dr. Brock, the best form of taxation is the value-added tax, for example, sales tax. He believes the worst form of tax is a tax on labor income. Labor tax creates an adverse incentive that discourages hiring and working on the margin. Labor taxes have been rising on balance over the last 30 years through increased income taxes, Social Security and Medicare taxes.
- **Lastly, between the years 2000 and 2013, the number of part-time jobs increased by 3 million, while the number of full-time jobs decreased by a similar amount**. This action, of course, lowered Labor Income as part-time workers earn less than full-time employees. Why has this shift from full-time to part-time jobs happened? Global outsourcing of labor and the lowering of labor's long-standing bargaining power with management has led to the labor market becoming much more flexible than in the past. To add insult to injury, the imposition of significant new labor/management regulations over the last number of years has provided incentives to employers to hire part-time workers over full-time. The Affordable Care Act is a case-in-point. This act has promoted the use of part-time labor due to unknown costs that will be imposed on employers as they expand their full-time work force. As a reminder, the ACA defines full-time employment as working 30+ hours per week. The traditional definition of full-time work has been 40 hours per week. This, in itself, has led to the hiring of more part-time workers, lowering labor income levels.

Given the six hurdles labor incomes have had to face over the last 30 years, it is no wonder that labor compensation as a percent of National Income (or GDP – again, they are one in the same) has declined by 6%. ***As the total GDP pie is growing and the piece of the pie attributed to Labor Income shrinks, laborers, in general, tend to suffer – and believe they are getting the short end of the stick. Honestly, they are. As the pie slice is shrinking, it is no wonder that the lower-paid and less productive workers face the brunt of the loss in Labor Income.***

Consequently, we contend that the genesis of the widening compensation gap between the highest and lowest paid in our society has literally nothing to do with greed or a broken economic system. Rather, the widening of earning disparity is primarily due to the reduction in Labor Income, as compared to Capital Income and the factors that have led to this development.

So, is all lost? What can be done from a social standpoint that will allow all income earners a fair shake? Next week, we will outline some steps and actions that could be taken to create a more even playing field, leading to a narrowing of earnings disparity.

Just for Fun

Our trilogy piece on National Income and income disparity will be wrapped up next week, during Labor Day weekend. We close today with some thoughts on labor by those with great insight into labor and life, in general.

It is only through labor and painful effort, by grim energy and resolute courage, that we move on to better things.

Theodore Roosevelt

All labor that uplifts humanity has dignity and importance and should be undertaken with painstaking excellence.

Martin Luther King, Jr.

A wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned.

Thomas Jefferson

We will be back next week.

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