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# Where Has All the Income Gone – Part 3

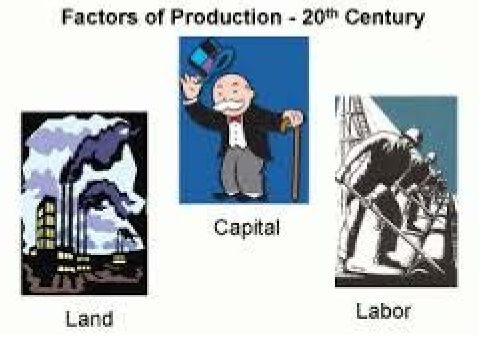
Much has been made in the popular press regarding income disparity (you may have heard the spread being called *income inequality)*. I have attempted to dig deeper into the issue of income disparity. I have come to the conclusion, after reading studies completed by Dr. Horace "Woody" Brock of Strategic Economic Decisions (picture left) that income disparity is the *result* of another, deeper economic phenomena, rather than a phenomena in itself. ***In other words, income disparity is a symptom of an economic problem rather than the core problem which needs investigation.***

I have followed Woody's work for the last number of years, and have found his work to be extraordinarily insightful. Some wonder if there are people in the world who are true "original thinkers" – economists so bright they are considered "economists' economists'". Yes, Woody fits that mold. A graduate from Harvard (three separate degrees) and Princeton (two separate degrees), Dr. Brock is truly an "original" thinker, an advisor to many corporations and investment managers.

Today's piece is the third and final installment of our conceptual work regarding income disparity in the U.S. ***Income disparity is the spread in income between the top and bottom earners in our country.***

Income disparity has historically been present in most countries, and over short periods of time the spread is somewhat stable. Over long periods the spread isn't stable. The spread in the U.S. narrowed between 1940 and 1980, when it widened back again to where we are today. Why is income disparity important? ***If the level of disparity becomes wide, social "contracts" tend to alter, workers become discouraged and eventually politicians start to develop public policies to alter disparity – many of these policies tend to be anti-competitive and non-economic in their application.***

I outlined these thoughts in detail in Part 2 of this piece where I laid out the basic economic maxim that GDP = National Income. National Income = Labor Income + Corporate Profits (see diagram below). Since the 1980s the percentage of National Income accounted for by corporate profits has risen by about 6% of GDP, and now stands at roughly 40%. ***The fact that the top 10% of earners own the vast majority of the corporate stock in the U.S. has led to that group of people "benefiting" more in wealth/income over the last 30 years as compared to the folks who don't own a significant portion of the corporate "stock" in the U.S. With GDP now at $15 trillion per year, the "transference" between personal income and business profits has been an annual shift of about $900 billion in "income"***. ***With this massive shift in resource allocation, it is no wonder the lower earning segment of our population is feeling the pinch.***




***Now – what to do about this issue.***

## What Not To Do About It

According to Dr. Brock what *not* to do about this resource allocation is for the government to tax incomes of the "wealthy". That isn't the issue at hand. What is the issue is the fact that business profits (return on capital) have risen much more rapidly than have the overall growth in the economy or earned incomes.

Workers might get fed-up with the system as they see the "rich" getting richer, and elect a group of politicians who would raise taxes on businesses and wealthy individuals. Would this drive income distribution more towards the workers and away from capital? Of course it would. The problem with this solution is that business would respond by investing less here and more elsewhere, where capital is treated more kindly***. GDP growth itself would stall***. We have seen this outcome recently under the policies of Harold Wilson in the U.K. and François Mitterrand in France. France is still trying to find a way to stay out of recession. Nobody wins.

***Now that we understand the true "problem" at hand (shift from personal income growth to corporate profit growth, leading to social unrest) we can address the true problem, and not simply the "symptoms" of the problem.***

## What To Do About It

If we understand that the problem is not one group of people getting richer while others don't – but rather that the share of national income attributed to corporate profits has risen much more rapidly than personal income – then we can start to address that real issue.

Our piece last week stated the problem of personal income-to-corporate income shift exists due to 5 factors:

- The decline in the ***relative price*** of investment goods to labor.
- The ***rise in manufacturing prowess*** of China (and other emerging economies).
- The ***loss of labor's bargaining power*** with management.
- The ***"skills gap"*** driven by the state of K-12 public education in the U.S.
- The impact of ***adverse government legislation*** on the labor market.

In our estimation, the factors above are the drivers behind the personal income-to-corporate profit growth shift which has occurred over the last 30 years. In his essay, Dr. Brock highlights the following ***possible remedies*** for this problem:

- ***Higher interest rates***. Capital is cheap. If a credit-worthy business wishes to invest in a new business, or expand their current business, they can do so at very low interest rates. As a matter of fact, more than 50% of the world's central banks are supporting *negative "real" short term interest rate structures.*
- ***Loss of Emerging Market Export Power***. Rising wages in emerging economies are making the outsourcing of production and jobs less attractive, on the margin. Manufacturing is already "on-shoring" here in the U.S. I believe this trend is well in place and should continue for the foreseeable future.
- ***Substantive Educational Reform***. There exists in our society a seeming need for all parents to send all of their children to 4-year colleges, irrespective of the children's skill set, or the needs of society. We now have a serious overhang of college debt which will hamper consumption patterns of many of our youth, due to the fact that they can't find jobs. Bluntly, our society only needs a certain amount of Art Historians (or Economists as far as that's concerned). I have read reports of welders making $150,000 annually in North Dakota. Our educational system needs to take a lesson from Germany, and begin to take notice that apprenticed skills for skilled labor is a valid form of livelihood.
- ***The spaghetti-bowl of tangled tax policies and business regulations.*** This could be streamlined with value-added taxes being substituted for high income-tax rates (this includes Social Security and Medicare taxes which burden the poor in our society). Additionally, federal wealth transfer system actions, while socially well-meaning, are becoming an economic boomerang as many Americans are now opting to stay at home, rather than seeking work, ***due to the fact that they can. The percentage of prime-aged workers who are opting to stay at home is surging, lowering labor production***. This issue made the cover of the current *Barron's* magazine.
- ***Technological optimism***. In the past when technological advancements have replaced needed labor, labor tends to adjust skill levels somewhat rapidly. In other words, when someone's job becomes obsolete due to a technological breakthrough, that worker tends to seek employment elsewhere in another job fairly quickly. This occurs because the worker needs to work. A number of policies have been put in place in Washington which enables the worker to decide *not to work.* Over a period of time, this compounds the problem and makes the unemployed worker *unemployable. These policies need to be revised and rationalized.*
- ***Demographics.*** Due to the retirement of the baby-boom generation it appears there may be a labor shortage which will develop, slowly over the next 10 years or so. This shortage should help restore labor's lost bargaining power with employers. This argument is somewhat offset by the view that baby-boom generation workers are postponing their retirements due to underfunding of retirement pools.

## Final Word

It is my hope that the trilogy which has been written on labor/capital share of national income has been thought provoking. This subject is not "light reading" but is a highly important factor driving global economic trends and capital market results. At the least, I hoped to provide an alternative explanation as to why income disparity has risen since the early 1980s – it has little to do with "greed" or "a broken free-market system" as some would want to say. Rather, in my estimation, this social issue is ***due to the shift from labor income to capital income which has taken place over the last three decades.***

Economic theory and activities alone cannot solve this major social issue.  As you can tell from the “solutions” mentioned above, there are few true “economic” solutions to this problem.  Most “solutions” listed are socially-driven issues, which need to be addressed by a combination of business/labor/political leaders.

But, like any affliction, if the diagnosis of the disease is not fully proper and understood, the cure to the problem will be off target.  ***Our society needs to address the true cause of this problem – and not simply the symptoms.***

We will be back next week.

**William B. Greiner, CFA**
Chief Investment Officer

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