The joyless generation: the declining prospects of middle earners

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Summary

When President Obama used his State of the Union speech last week to announce a year of action on inequality he was reflecting a growing political concern in the developed world. That concern increasingly extends beyond the poorest: middle earners in the developed world could be on the verge of a secular stagnation in their real incomes. In many advanced economies the benefits of GDP growth appear to be increasingly concentrated on the providers of capital and the top end of the income spectrum. A prolonged squeeze on the economic prospects of middle earners, who are often decisive in elections, will complicate the politics of recovery and have profound implications for both government policies and business.

In his State of the Union address last week, President Obama declared 2014 will be a year of action on inequality. In the UK, the main political parties are arguing over whether there is a cost of living crisis. In Germany, Chancellor Merkel has grudgingly accepted a national minimum wage as the price of coalition government. The political debate in each country has widened from a narrow focus on the prospects for recovery, to the quality of recovery and, in particular, who benefits. However, there may be an even bigger and more enduring challenge for policymakers to address: a secular decline in the economic prospects of the typical household, at the very middle of the income distribution.

In the US the real income of the median household has decreased in 10 of the previous 13 years, falling by a total of 9% between 2000 and 2012. It is currently no higher than 25 years ago, meaning an entire generation has passed without measurable economic progress (Fig 1). A similar picture emerges when we look at other advanced economies (Fig. 2). Median household incomes stagnated in Germany between 2000 and 2010 and have trailed per capita GDP since 1995. In Japan the picture is even more striking, with median incomes falling by about 1% on average each year between 1995 and 2010. In the UK, the situation has been mixed, with median income growth holding up until 2005 before falling to zero in the period through to 2010.

This adds up to a bleak picture for the typical household in many advanced economies. But before we can consider the implications, we need to understand what is causing this shift and whether we are indeed observing a secular change or a cyclical decline in the fortunes of middle earners.

Four villains

There are at least four possible reasons, which are receiving varying degrees of attention. The first, and currently the most popular villain, is technology. The basic idea is that while technological innovation has hitherto been most disruptive for low-skilled workers performing repetitive tasks, we may now be entering a new phase of innovation affecting middle earners, whose jobs will increasingly be automated and replaced. In future, gains in labour productivity – and real earnings – may become much more concentrated on a small segment of the population with just the right combination of skills and creativity to complement new technologies. This prospect dominated discussions at Davos last month, where Google chairman Eric Schmidt described "the race between computers and people" as one of the defining problems of the next few decades.

The second, and more traditional villain, is trade. There has been a long-standing debate in economics about whether trade or technology is to blame for the decades-long squeeze on the lowest earners. The consensus view is that trade matters, although not quite as much as technology. But two things have changed more recently. First, the volume of trade and the intensity of competition from emerging economies have increased. Second, and perhaps more significantly, the nature of that competition is changing. China, with an 800m workforce, now competes right across value chains, with increasingly educated, skilled and experienced workers producing ever more sophisticated goods and services.

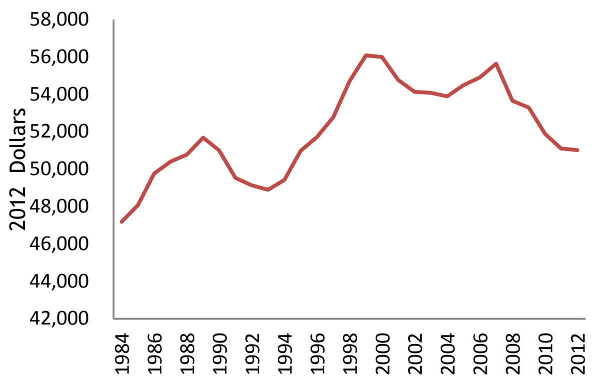

Fig. 1: Median real household income in the US
Source: US Census Bureau

For much of the past twenty years middle earners in advanced economies have benefited from cheap Chinese imports; now they, like low earners before, are beginning to feel the pinch of Chinese competition. In short, the global pool of workers with mid-level skills is bulging, reducing its scarcity value, and providing a drag on incomes for middle earners in advanced economies.

A third, and more contemporary villain, is the rise of the footloose global corporation. The issue here is the way multinationals – particularly those exploiting intangible assets that are hard to account for – are able to reduce their tax bills by shifting profits from one jurisdiction to another. This is forcing countries to cut their corporate tax rates in order to preserve their tax base, in turn shifting the burden of tax from companies to people. Last year, for the first time, UK firms paid more in national insurance (a social charge on employment) than in corporate taxes. This is one possible reason why the labour share of income has been trending downwards and fell sharply in all four countries between 2000 and 2007/8. While the labour share ticked up in 2009, as the crisis hit corporate profitability, this looks like a temporary blip on a declining trend (Fig. 3).

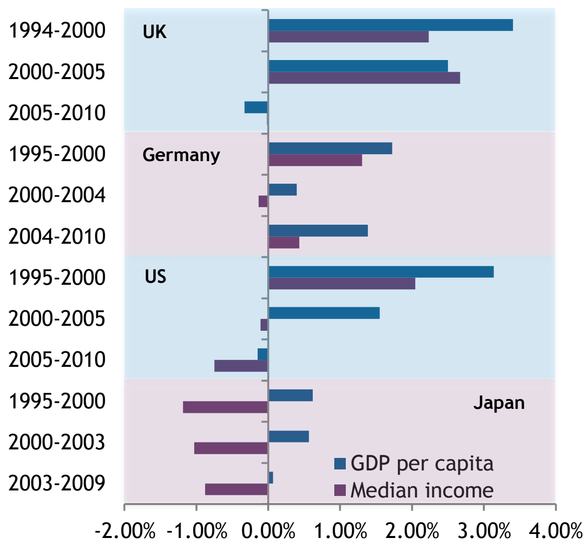

Fig. 2: Annualised growth in real household incomes
Source: OECD Income Distribution and Poverty Database, IMF WEO

The fourth possible villain has received less attention, at least as an explanation for the stagnating prospects of middle earners. This villain is the global savings glut. In the run up to the economic crisis an excess of savings pushed up asset prices and pushed down yields. This meant capital became relatively cheap and substitutable for labour at the margin. In effect this mirrors and magnifies the impact of the first villain, technology, by benefitting high earners with the right skills to complement capital investment, at the expense of others whose labour is substitutable for capital. The savings glut is partly a consequence of demographics, but also policy in China and some other emerging countries, and more recently monetary policy in advanced economies.

Identifying the villains is important, because it tells us something about the durability of the problem, and how policymakers may attempt to tackle it or mitigate its consequences.

What these explanations share in common is that they impact more on the distribution of income than the overall size of the economic pie. In particular they suggest it is the middle – the median household – that is, and will be, especially squeezed. They are also, for the most part, consistent with this being a secular shift. The possible exception is the savings glut, which may eventually be ameliorated by the normalising of monetary policy in advanced economies and the rebalancing of demand in China.

The implications of a squeezed middle

How might policymakers and business respond? First, policymakers may attempt to make tax systems more progressive. This requires more than raising tax thresholds. Introducing a minimum wage, as the German governing coalition intends, misses the middle-income target. The problem with a more fundamental shift in the tax system is that the highest earners are also likely to be the most internationally mobile, capping what can be achieved through income or capital gains taxes. This in turn means policymakers may increasingly focus their attention on immobile assets, for example by raising top-end property taxes.

Second, a fresh approach to education and skills may be required to broaden the pool of talent that complements new technologies. This will almost certainly involve a greater focus on continuing education and training for adults so they can adapt to changing technologies. The skills required will be different, with more emphasis on social skills, critical thinking and creativity. Businesses at the forefront of this transition may want to consider now how to engage with government on this.

Third, the furore over corporate tax bills won't go away quickly. Many governments favour international cooperation. While we are starting to see initiatives through the G8, G20 and OECD any agreement will be difficult to enforce across all jurisdictions. The choice for business may be between living with a tarnished reputation for avoiding taxes or seeking to rebuild trust with customers, perhaps by developing and conforming to new codes of conduct.

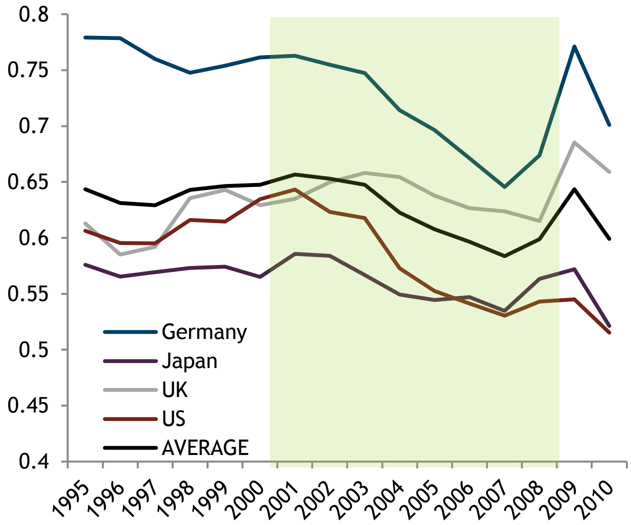

Fig. 3: Labour income share of GDP
Source: OECD Income Distribution and Poverty Database

Fourth, if middle earners begin to feel the direct effects of competition, particularly from China, this may lead policymakers in advanced economies to focus ever more sharply on ensuring a level playing field. This will be the context for negotiations over market access, trade rules, international standards and climate emissions, which will become even more adversarial and increasingly based on the principle of reciprocity. The alternative may be protectionism, with a particularly hostile environment emerging in some EU member states.

Finally, for business, market segmentations will change, with a greater divide between the top end and a bulging middle of price-sensitive consumers. The former will present new opportunities; the latter some political risks, with more scrutiny over market outcomes and particularly whether there is adequate competition. This is an issue that has moved from the margins to the mainstream during the recession; it may be there long after the recovery.

More fundamentally, a squeeze on households in the middle will create a wedge between the interests of the elite and the wider population. The countries best able to cope will be those with the soundest institutions that enable compromises to be found and trade-offs made. The alternative is more populist policies.

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