Mind the Gap

What business needs to know about income inequality

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For more than 30 years, there has been a widening gap between the affluent and everyone else in the U.S. During the past decade, however, the less affluent leveraged the increased value of their homes in order to boost spending. Today, that is no longer possible. Going forward, the affluent will likely be able to spend more, and the rest of the population is expected to be seriously constrained. This article will examine the implications of this phenomenon for companies that sell goods and services to consumers.

BACKGROUND

For many decades prior to the 1970s, income distribution in the U.S. was relatively steady. Most households experienced increases in real purchasing power as the economy grew. This coincided with increased educational attainment in the U.S. Yet, starting in the early 1970s, something changed. The share of the adult population with university degrees stopped growing, even though the demand for highly skilled workers continued to rise. The result was that the less educated saw their wages stagnate while the educated experienced sizable income gains. Thus, income distribution became more skewed. Moreover, this was not just an American phenomenon. In the U.K., for example, the wealthiest 1 percent of the population saw its share of total wealth shrink from 70 percent in 1913 to 20 percent in 1980. Yet after the 1980s, the trend toward greater equality in the U.K. went into reverse.

Between 1949 and 1979, the real income of households in the bottom 20 percent of the population increased 116 percent, while from 1979 to 2003 the bottom 20 percent experienced an increase of only 3.5 percent.

In the first decade of the 21st century, as home prices rose precipitously, millions of American households took advantage of the opportunity to borrow against the increased value of their homes. Many Americans dramatically increased their debt, and lower income households increased debt by the largest percentage of any income cohort. This enabled them to expand their consumption even though their real incomes were not rising.

In the aftermath of the global financial crisis, it will likely be a long time before the wealth lost in the housing market is restored. As of this writing, millions of households have mortgage debt in excess of the value of their homes. Hence, the era of using homes as cash machines is over and is not expected to be back for a very long time. In addition, the forces causing the widening of the income gap have not gone away. This means that, except for the relatively affluent, spending power is unlikely to grow very much in the years ahead.

This increasing bifurcation of the consumer market has significant implications, both for companies selling goods and services to consumers and for all companies in need of skilled labor. To simplify, the widening income gap implies that companies will target the affluent or the less affluent through distinct strategies. The former approach will entail focusing on branding, differentiation, customer

experience, lifestyles and consumer aspirations. The latter, on the other hand, will mostly entail a focus on low prices and a strong sense of value. The middle market is increasingly expected to disappear. Companies will have to decide which products and services are targeted at which consumer cohorts and then execute a strategy that fits the needs of their target consumers.

EVIDENCE OF SKEWING

The skewing of income distribution began in the 1970s and is evident from U.S. Census Bureau data on real (inflation-adjusted) income growth by income cohort. For example, between 1949 and 1979, the real income of households in the bottom 20 percent of the population increased 116 percent, while from 1979 to 2003 the bottom 20 percent experienced an increase of only 3.5 percent. The trend for upper income households, however, was quite different. In the period 1949 to 1979, the top 20 percent saw income rise 99 percent. From 1979 to 2003, the top 20 percent experienced an income gain of 45.7 percent (see figures 1 and 2).

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Thus, rapid income growth in the immediate post-war era was experienced by all income cohorts relatively equally. Yet since 1979, most of the gains to income accrued to relatively upper income households.

Other indicators showed a relative decline in the incomes of low and middle income households. From 1967 to 2005, the ratio of the wages of workers in the 95th percentile to wages of workers in the 50th percentile increased from 2.6 to 3.6. Finally, there was a shift in national income away from wages toward remuneration of capital in the form of corporate profits.

WHY DID THIS HAPPEN?

The widening gap between the incomes of upper income households and everyone else coincided with important changes in the structure of the economy. First, globalization in the 1980s and 1990s substantially increased the global availability of low skilled labor at a very low cost. The integration of China into the global economy enabled businesses to tap into a vast supply of low-cost workers. This, in turn, reduced the demand within the U.S. for unskilled workers, especially in manufacturing as well as in lower value-added services.

Figure 1: Growth of Real Before-Tax Household Income, 1949-79

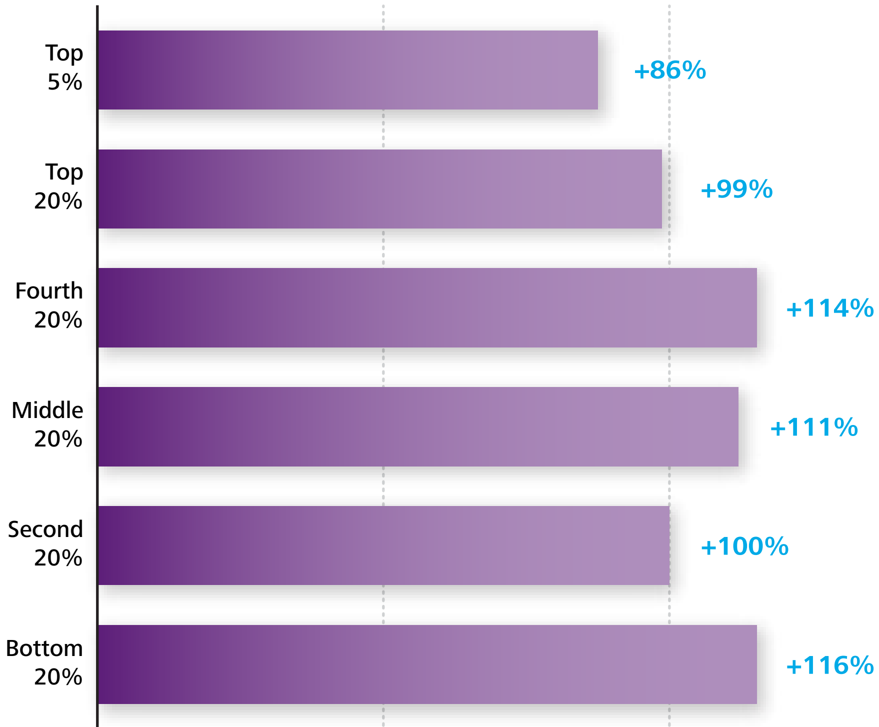
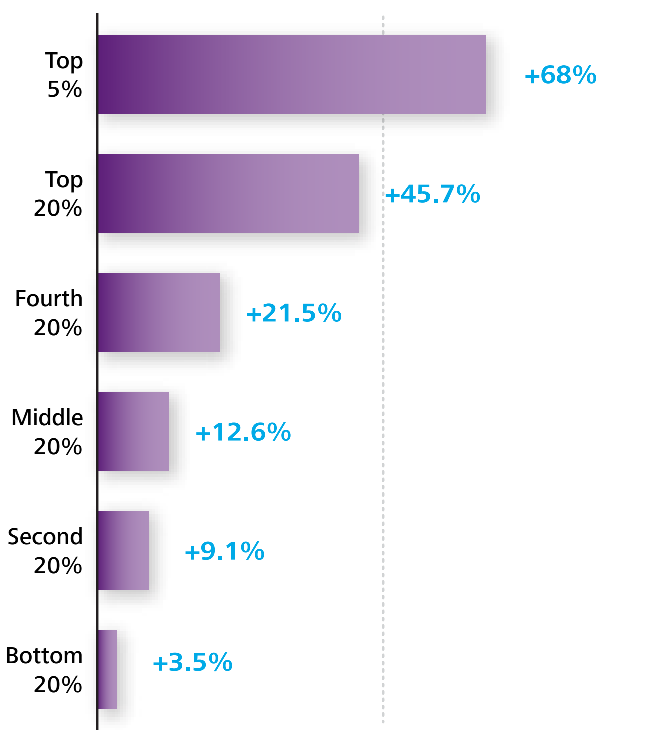


Figure 2: Growth of Real Before-Tax Household Income, 1979-2003



Second, the information technology revolution enabled many lower valued-added tasks to shift from people to machines. This enabled the shedding of low-skill jobs and resulted in reduced demand for lower-skilled labor. In addition, the implementation of information technology boosted the productivity of skilled workers. Yet IT, by its nature, did not boost the productivity of many workers engaged in manual tasks. Thus, the gap in productivity between skilled and unskilled workers increased.

In addition, these various factors enabled many businesses in the U.S. and other affluent countries to shift the mix of functions undertaken at home. More emphasis was placed on functions that require skills and education. These included research, development, engineering, management, finance and marketing. Thus, the demand for skilled labor increased. Naturally, all of this was reflected in increasing compensation for the skilled and stagnant compensation for the unskilled.

The wage gap increased. The increased relative return on education should, therefore, have led to an increased demand for education. Instead, this shift in the mix of jobs required by the economy coincided with an opposite shift in the relative supply of labor. Until the 1970s, the average education level of the American workforce was rising rapidly. In the mid 1970s, however, the rate of increase decelerated substantially. As Goldin and Katz (2007) have pointed out, in the first half of the 20th century Americans generally had two more years of education than their parents' generation. Yet those born in 1975 only have 0.74 years more education than their parents' generation. Just when the demand for skills accelerated, the supply decelerated. That, in turn, exacerbated the rising income gap.

Many explanations are offered for this slowdown in educational attainment. These include inadequate government support for tertiary education, rising cost of tertiary education, and poor preparation in secondary school. It has even been suggested that the U.S. has reached a plateau in the ability of its people to achieve education – a questionable explanation given that some other countries continued to increase their average level of education. In any event, it is not the purpose of this article to assign blame. Rather, the goal is to examine the implications.

WHY DID CONSUMER SPENDING AND DEBT INCREASE SO MUCH IN THE PAST DECADE?

In the past decade, many low- and middle-income households, whose real incomes were relatively stagnant, were nevertheless able to increase their living standards by accumulating debt. The housing price bubble increased wealth and the ability to borrow against the rising value of homes. This coincided with historically low borrowing costs, banks that were eager to originate and sell loans, and investors eager to obtain a good return by purchasing assets backed by loans

to low-income households. The result was a huge and unsustainable increase in consumer debt with the largest percentage increase going to the lowest-income households (who, not coincidentally, had the slowest-growing income).

Thus, the widening income gap was temporarily masked by the rise of debt. Moreover, there is academic evidence (see Frank, Levine and Dijk) that increasing income inequality tends to reduce saving and increase expenditure. As Frank et al. point out, when upper income households enjoy strong income growth relative to others, the others reduce their savings in order to boost spending. Their spending decisions are made, in part, in reference to those who are better off. For example, they found that families who live in communities with a relatively high income gap tend to accumulate relatively high levels of debt. Thus, it can be argued that the declining saving and increased debt observed among U.S. consumers in the past few decades is partly explained by increasingly uneven income distribution.

Of course there are other factors that facilitated rising debt levels. These included changes in the behavior and regulation of financial institutions, demographic changes that increased the share of the population in peak-spending years and the illusion of rising wealth due to the housing bubble. The latter enabled households to believe that their notional balance sheet was no worse off by taking on more debt.

WHAT CAN WE EXPECT IN TERMS OF INCOME GROWTH AND SAVING IN THE COMING DECADE?

Regarding the next decade, there are two things that can be said with reasonable certainty. First, the majority of consumers will not be able to take on dramatically more debt. Second, income distribution will probably not get much better and may get worse.

The factors that contributed to rising inequality in the past three decades have not gone away. Globalization and technology investment continue to boost the demand for skills and diminish demand in the U.S. for those with limited skills. In addition, technology will continue to boost the productivity of skills-based workers while having little impact on the productivity of many manual workers. At the same time, even if substantial changes in educational attainment were to take place, it would take many years for this to work its way through to the labor market. Thus, for the time being, the imbalance in the labor market is likely to persist and lead to continuing and/or rising income inequality. It remains likely that lower- and middle-income households will experience limited, if any, increase in real before-tax incomes.

Also, an important legacy of the recent financial crisis is a dramatic shift in the environment for consumer credit. Credit will likely be less freely available, and

many households will spend years unwinding the excessive debts they accumulated in the past decade. In addition, the housing market will not likely be a source of increased consumer spending or debt. There remains considerable excess inventory of homes, house prices continue to fall (as of this writing), and the regulatory environment for mortgage credit is likely to become more restrictive. Thus, in the coming years it is likely that consumer spending will rise more slowly than consumer income as consumers pay off debts and accumulate assets.

WHAT DOES THIS MEAN FOR CONSUMER SPENDING PATTERNS?

The trends discussed imply that, in the coming years, most of the increase in consumer spending in the U.S. will likely come from relatively upper-income households. On average, lower- to middle-income households are not likely to have the means to significantly increase their spending. Thus, their behavior is likely to change. They are likely to become more price sensitive, more prone to shop for bargains, and less prone to purchase big-ticket items. Moreover, as they are likely to be less active in the housing market, fewer of their purchases will be related to housing market activity. Such purchases include furniture, appliances, electronics and home improvement products and services.

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Yet the absence of income gains for lower- and middle-income households will not necessarily erase the fact that people often conduct their spending in reference to those with more. Thus, a significant degree of frustration could develop. The spending implication is that people are likely to demand products and services that help to satisfy the desire for minor luxuries while not breaking the bank. This could entail luxury brands sold in discount venues, the development of value-oriented sub-brands by luxury purveyors, small-ticket branded purchases for the home, and the return of layaways and other forms of long-term payment that don't result in increased debt. The ability of retailers and suppliers to tap into this need could become a key success factor.

As for upper-income households, not much change is expected. They will probably continue to experience income gains, even if tax rates go up. Thus, their

spending will likely be less price-oriented and more oriented toward quality of products and services and the superiority of the customer experience. Brands that convey these attributes will probably gain in popularity. The share of total spending attributable to upper-income cohorts will likely rise, and the brands that appeal to them are expected to grow more rapidly than the overall market.

This bifurcation of the market has actually been under way for some time. Yet the ability of consumers to accumulate debt in the past decade slowed the process of consumer market bifurcation. The end of the era of debt suggests that bifurcation will now return with a vengeance.

WHAT STRATEGIES SHOULD CONSUMER-ORIENTED COMPANIES FOLLOW?

Retailers and consumer product manufacturers must prepare for a business environment very different from the one they experienced in the past decade. Given the expectation of essentially two different types of consumers (affluent consumers with rising income versus low- and middle-income consumers with stagnant incomes), companies can either choose to target only one consumer group or undertake to segment the market and target each group separately. Targeting all consumers uniformly—that is, selling all things to all people—will likely be less effective.

Another strategy that may be problematic would be to target the middle market. The trend of a widening income gap suggests that the middle continues to decline, if not disappear. A more effective approach would be for retailers and suppliers targeting the lower- to middle-income groups to focus on price competition, given the likely price sensitivity of such consumers. Those targeting upper-income households will likely have to focus on nonprice factors such as quality, convenience, differentiation and customer experience.

Finally, stagnation of incomes, combined with limited ability of consumers to take on debt, means that overall consumer spending in the U.S. is likely to grow far more slowly in the next decade than in the past decade. For consumer-oriented companies, this means that the business environment will likely be more of a market share battle. It means that companies will grow by taking share from competitors. This suggests a more intensely competitive environment. Companies may either struggle to cut costs and offer the lowest prices or struggle to find differentiating factors that boost brand equity and, therefore, market share.

An important implication of slow growth is that U.S.-based consumer-oriented companies will increasingly look overseas for growth. Emerging markets are likely to attract an increased share of the investments of such companies. Indeed, this is already happening.

IS INCOME INEQUALITY GROWING GLOBALLY?

The trend toward income inequality appears to be a worldwide phenomenon. The forces of globalization and investment in information technology are boosting the demand for skills in affluent countries while causing the shedding of jobs requiring fewer skills. Thus, the return on education is increasing. Yet the slippage in educational attainment that is characteristic of the U.S. has not been repeated everywhere. Acquisition of skills has continued to increase in many affluent countries at a rate faster than that of the U.S. Thus, the rise of income inequality in many countries has not been as pronounced.

In poorer countries, there has been a general move toward income inequality that is not atypical of what happens in rapidly growing economies. The one major exception has been Brazil, where government policy has shifted resources toward lower-income households.

In any event, the global trend toward income inequality is likely to reinforce some of the business implications discussed above. Indeed it is no surprise that the global luxury market is growing rapidly. Nor is it any surprise that one of the fastest-growing retail formats in the world is the discount store, a type of retailer that appeals to a price-sensitive consumer.

INCOME INEQUALITY TO THE FORE

The issue of income inequality was in abeyance for the past decade as rising consumer debt concealed the true nature of income growth. In the coming decade, the implications of rising income inequality will likely be far more apparent and are expected to have a significant impact on business strategy for companies focused on the consumer market. The issue will very likely also play a role in political debate and in the setting of economic policy. Businesses ignore this issue at their peril. DR

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