The great income stagnation

By Laura Tyson and Anu Madgavkar
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Nowadays, the inequality debate often focuses on the disproportionate accumulation of income and wealth by a very small share of households in the United States and other advanced economies. Less noticed – but just as corrosive – is the trend of falling or stagnating incomes for the majority of households.

For much of the post-World War II period, until the 2000s, strong GDP and employment growth in the advanced economies meant that almost all households experienced rising incomes, both before and after taxes and transfers. As a result, generation after generation grew up expecting to be better off than their parents. But, according to new research from the McKinsey Global Institute, that expectation may no longer be warranted.

During the last decade, income growth came to an abrupt halt for most households in the developed countries, with those headed by single women or comprising young, less educated workers among the hardest hit. Real income from wages and capital for households in the same part of the income distribution was lower in 2014 than in 2005 for about two-thirds of households in 25 advanced economies – more than 500 million people. From 1993 to 2005, by contrast, less than 2% of households in these economies had flat or falling incomes.

Increases in government transfers and lower tax rates reduced the effect of stagnating or falling market incomes on disposable incomes. Nonetheless, 20-25% of households faced flat or falling disposable incomes from 2005 to 2014, compared to less than 2% in the preceding 12 years.

A major culprit behind this reversal is the deep recession and slow recovery following the 2008 economic crisis in the advanced economies. From 1993 to 2005, GDP growth contributed about 18 percentage points to annual median household income growth, on average, in the US and Europe; that figure plunged to just four percentage points from 2005 to 2014.

But the post-crisis drop in growth is far from the only problem. (If it were, the last decade could be just an anomaly.) Longer-term factors like weak investment, decelerating labor-force growth, and a sharp slowdown in productivity growth have reduced income growth for the median household in most advanced countries relative to the 1993-2005 period.

Demographic shifts – including changing family structure, low fertility rates, and population aging – have led to reductions both in the overall size of households and in the number of working-age earners per household. And labor-market shifts – driven by technological change, the globalization of low- and medium-skill jobs, and the growing prevalence of part-time, temporary employment – have caused the wage share of national income to decline and the distribution of that income among households to become increasingly uneven. None of these trends is going to be reversed anytime soon. On the contrary, some are likely to strengthen.

McKinsey's research confirms the role of such long-term factors in undermining incomes for the majority of households. It shows that most households' real market incomes remained flat or fell, even though aggregate growth remained positive in the 2005-2014 period.

In the US, in particular, the ability of labor to protect its share of national income, and of lower- and middle-income households to protect their share of the wage pool, eroded substantially. As a result, real growth in median disposable income slowed by nine percentage points from 1993 to 2005, and by another seven percentage points from 2005 to 2014.

Sweden, where median households received a larger share of the gains from output growth in the 2005-2014 period, has bucked this negative trend. In response to the growth slowdown of the last decade, Sweden's government worked with employers and unions to reduce working hours and preserve jobs. Thanks to these interventions, market incomes fell or were flat for only 20% of households. And generous net transfers meant that disposable incomes increased for almost all households.

To be sure, the US also intervened after the crisis, implementing a fiscal stimulus package in 2009 that, along with other transfers, raised median disposable income growth by the equivalent of five percentage points. A four-point decline in median market income thus became a one-percentage-point gain in median disposable income. But that did not change the fact that, from 2005 to the end of 2013, market incomes declined for 81% of US households.

Similarly, recent research by Berkeley's Emmanuel Saez shows that real market income for the bottom 99% in the US grew in both 2014 and 2015 at rates not seen since 1999. Nonetheless, by the end of 2015, real market incomes for that group had recovered only about two-thirds of the losses borne during the 2007-2009 recession. In other words, the US intervention was far less effective than its Swedish counterpart at enabling workers to recapture their past income levels.

The consequences of such failures are far-reaching. Stagnating or falling real incomes do not just act as a brake on consumption demand and GDP growth; they also fuel social and political discontent, as citizens lose confidence in existing economic structures.

MGI surveys in France, the United Kingdom, and the US have found that people whose incomes are not growing, and who do not anticipate an improvement, tend to view trade and immigration much more negatively than those who are experiencing or foresee gains. The Brexit vote in the UK and bipartisan opposition to trade agreements in the US are clear signs of this.

Recent debate about income inequality in the US and other developed countries has focused on the rapid surge in incomes for the few. But stagnating or falling incomes for the many add a different dimension to the debate – and demand different types of solutions that emphasize wage growth for the majority of the income distribution. With most households continuing to face stagnating or falling incomes – and with younger generations thus on track to be poorer than their parents – such solutions are urgently needed.

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