The American Middle Class, Income Inequality, and the Strength of Our Economy

New Evidence in Economics

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Introduction and summary

To say that the middle class is important to our economy may seem noncontroversial to most Americans. After all, most of us self-identify as middle class, and members of the middle class observe every day how their work contributes to the economy, hear weekly how their spending is a leading indicator for economic prognosticators, and see every month how jobs numbers, which primarily reflect middle-class jobs, are taken as the key measure of how the economy is faring. And as growing income inequality has risen in the nation's consciousness, the plight of the middle class has become a common topic in the press and policy circles.

For most economists, however, the concepts of "middle class" or even inequality have not had a prominent place in our thinking about how an economy grows. This, however, is beginning to change. One reason for the change is that the levels of inequality and the financial stress on the middle class have risen dramatically and have reached levels that motivate a closer investigation. The interaction and concurrence of rising inequality with the financial collapse and the Great Recession have, in particular, raised new issues about whether a weakened middle class and rising inequality should be part of our thinking about the drivers of economic growth.

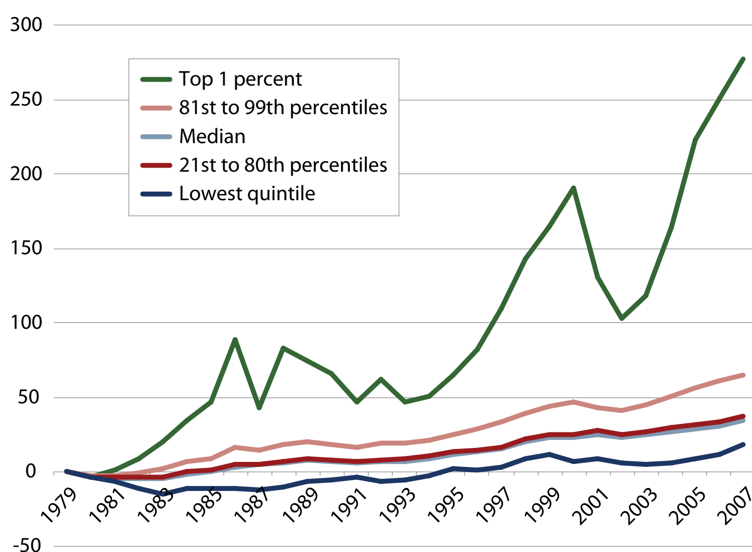
Over the past several decades, the United States has undergone a remarkable transformation, with income growth stalling for the middle class while the incomes of those at the top continued to rise dramatically compared to the rest of the working population. Between 1979 and 2007, the last year before the Great Recession, median family income rose by 35 percent, while incomes for those at the 99th percentile rose by 278 percent. (see Figure 1) Families in the middle class have also pulled away from those at the bottom, but achieved these modest income gains only by working longer hours, increasing their labor supply—particularly among wives and mothers—and increasing household debts to maintain consumption as wages failed to keep pace with inflation.

In 1979 the middle three household income quintiles in the United States—that is, the population between the 21st and 80th percentiles on the income scale—earned 50 percent of all national income. But by 2007 the income share of those in the middle shrank to just 43 percent. Evolution of the Gini coefficient, which measures how much a distribution deviates from complete equality, also shows a similar pattern of rising inequality. Between 1979 and 2007 the Gini coefficient including capital gains, in the United States climbed from 48 to 59, ranking the United States in the top quarter of the most unequal countries in the world.[1]

FIGURE 1

Cumulative growth in average after-tax income, by income group, 1979-2007

Between 1979 and 2007, the last year before the Great Recession, median family income rose by 35 percent, while incomes for those at the 99th percentile rose by 278 percent



Source: Congressional Budget Office, "Trends in the Distribution of Household Income from 1979-2007," (2011).

Theories of economic growth, however, do not typically include models for investigating the implications of changes in the strength of the middle class. If you ask an economist "what makes an economy grow?", they will almost certainly begin their answer by pointing to an economy's level of knowledge about how to produce goods and services (knowledge and technology), the skills of the potential labor force (human capital) and the number of workers, and the stock of physical capital (factories, office buildings, infrastructure). The economy grows when technological improvements or investments in human or physical capital boost productivity, when the labor force increases, or when investment in physical capital adds to the economy's productive stock—and thus total output expands.

But this begs the question: What boosts productivity or creates incentives to invest? Economists differ in their specific answers to these questions, but the different theories point to five primary factors:

- The **level of human capital** and whether talent is encouraged to boost the economy's productivity

- **Cost of and access to financial capital**, which allow firms and entrepreneurs to make real investments that create technological progress to use in the economy

- **Strong and stable demand**, which creates the market for goods and services and allows investors to plan for the future

- The **quality of political and economic institutions**, including the quality of corporate governance as well as political institutions and a legal structure that enforces contracts

- **Investment in public goods, education, health, and infrastructure**, which lays the foundation for private-sector investment[2]

Strong empirical evidence in economics and other social sciences suggests that the strength of the middle class and the level of income inequality have an important role to play for each of these five factors boosting productivity and spurring investment.

The research for this project began with a series of interviews and a national conference with leading U.S. economists to learn their views about the mechanisms through which income inequality and the strength of the middle class affect economic growth and economic stability.[3] This paper summarizes what we have learned from these conversations, alongside our analysis of the economic research in the academic arena. We have identified four areas where literature points to ways that the strength of the middle class and the level of inequality affect economic growth and stability:

- A strong middle class promotes the development of human capital and a well-educated population.
- A strong middle class creates a stable source of demand for goods and services.
- A strong middle class incubates the next generation of entrepreneurs.
- A strong middle class supports inclusive political and economic institutions, which underpin economic growth.

We detail the evidence for these four points in the main pages of our paper, but briefly we encapsulate the economic research here. As we will demonstate, the ways in which a strong middle class is important for economic growth are both interrelated and mutually reinforcing.

A strong middle class promotes the development of human capital and a well-educated population

Economists agree that human capital—knowledge, skills, and the health to put those to work—is a key component of growth. To be most effective, opportunities to build human capital must be broadly available in the population. For the nation to make the most of its human potential, a child from a low- or moderate-income background needs his or her talents and abilities to be nurtured and matched to the most suitable occupation. The evidence is fairly clear that inequality and the strength of the middle class have direct effects on access and use of human capital:

- As the United States has grown more unequal in terms of income, there has been both a decrease in the rate of improvement in educational outcomes and these outcomes have become more unequal.

- The data point to the conclusion that human capital, and the higher incomes that go along with it, are increasingly passed from parents to offspring through social (not biological) channels. This means that individuals are being rewarded for privileges conveyed by their parents' socioeconomic status, not just their productivity characteristics, which will pull U.S. economic growth down.

- The contribution of human capital to growth is not only about access to education: Individuals also must be able to make use of their skills, matching talent to appropriate occupations. If inequality stands in the way of those matches, then it is having a pernicious effect on our nation's growth path.

A strong middle class creates a stable source of demand for goods and services

A strong middle class gives certainty to business investors that they will have a market for their goods and services. Supply-side thinkers argue that light tax and regulatory policies will lead to high investment, employment, and economic growth. But many economists acknowledge that an increase in supply does not automatically lead to an increase in aggregate demand. Rather, economies may have prolonged periods of unemployment and underutilized capital, which can be both the cause and the result of depressed and unstable demand.

If demand matters for economic growth, the question is then, how do high inequality and the strength of the middle class impact demand? Economists have developed a number of theories about how inequality affects demand:

- As more of the nation's economic gains go to those at the top of the income distribution—and if those families have a lower propensity to consume—then this will pull down demand from potentially higher levels given more equitable distribution.

- Heightened inequality and a squeezed middle class leads families to either consume less, lowering demand, or put in place short-term coping strategies, such as borrowing more, which has long-term implications for growth and stability.

A strong middle class incubates the next generation of entrepreneurs

Entrepreneurship is a matter of taking risks, and there are a variety of ways that a strong middle class and less inequality can create the kinds of conditions that reduce the risks of innovators and give them the skills to start up a business:

- Middle-class families can provide entrepreneurs with the financial security and access to credit so they have the time to nurture their ideas and take the risk to start a new business.

- An individual in a middle-class family is more likely than someone from a low-income background to have access to the kind of education that provides the training and skills necessary to start a business.

- As described in above, less inequality is associated with greater macroeconomic stability, which allows entrepreneurs to make informed investment decisions with greater confidence about economic conditions and the risks of starting a business.

A strong middle class supports inclusive political and economic institutions, which underpin economic growth

This dynamic of a strong middle class boosts efficient and honest governance of an economy's enterprises. In the U.S. context, less inequality and a stronger middle

class support more inclusive political institutions and steer politics away from only responding to an economically powerful elite. This provides the foundation for more inclusive economic institutions, which, in turn, promote growth. This includes encouraging effective governance that supports broad-based economic growth through establishing secure property rights; investing in public goods and quasi-public goods, such as education, health, and infrastructure; and a level playing field, including transparent and accountable legal and regulatory structures. A strong middle class prevents the concentration and exploitation of power that led to entrenched privilege in aristocracies—the antithesis of dynamic societies throughout human history.

The evidence of the role of the middle class in economic growth

To be clear, we do not assert that the middle class is the only factor affecting economic growth. The price of capital, taxes, resource endowments, luck, chance, and other causes all have important roles to play. But after surveying the available theories and evidence, it is difficult to point to anything else so central to so many causes of economic growth as a strong middle class. This paper explains the most current, empirically grounded economic evidence showing how income distribution affects the efficient functioning and growth potential of our economy.

In this paper the concepts of "inequality" and "middle class" are broadly construed. When we say "middle class," we mean more than just families who are, broadly, in the middle of the income distribution. By middle class, we do not mean rich, but we do mean families with enough financial security to make ends meet, provide investments in the next generation's success, and have a little margin of safety to boot. A middle-class family has some economic security, be that a good job with health insurance and a retirement plan, or some savings in the bank to tide them over in an emergency, send a child to college, or even float a loan to a family member who wants to start up a business. This is consistent with individuals' perceptions: Surveys show that most Americans believe they are in the middle class, from those generally in the 20th or 30th percentile of the income distribution to the 80th and even above.[4] Our conception of inequality is tied mostly to income, although there is a high degree of overlap between individuals with very high incomes and individuals with high net worth.[5]

Throughout the paper we examine the ways that either category affects economic growth. There are distinct ways in which each can relate to the growth potential for

an economy. The security that a middle-class family provides goes beyond wages to include a sense of a longer time horizon for economic decision making than a family hovering on the edge of poverty, or the way that a middle-class child may be able to pursue a field of study suited to their interests. Nevertheless, given the interrelationship and overlap between the two, it makes sense to include both in our thinking as we discuss causal relationships with macroeconomic performance.

Finally, we wish to make a note on our approach to the subject of the relationship of inequality and the strength of the middle class and U.S. economic growth. There is, of course, a rich literature on the relationship between inequality and growth. (see box on next page) Although there are many conflicting views, there is ample evidence that inequality can, in fact, hurt growth under many circumstances. But this literature focuses mostly on the experience of developing countries, and its applicability to the challenges currently facing the United States is not entirely clear.

The United States is a developed economy at the edge of the technological frontier, with the highest levels of income inequality it has ever seen. Panel data studies analyzing how inequality affects growth across a range of countries are unlikely to tell us much about this unique situation. Thus, we have taken a different approach in this investigation. Instead of looking broadly at analyses of inequality and growth in other countries, we have looked at the evidence regarding the specific ways in which inequality and the strength of the middle class might affect economic growth in the U.S. context. If, in fact, there are specific ways that growth is affected, then it is reasonable to assume that there is a relationship overall.

At the end of the day, the conclusions that economists come to about what makes an economy grow are important for how we understand the complexities of an economic system. Economists are often seen as the arbiters of credibility about what is good for the economy. Thus, sifting through how disparate pieces of the economic evidence fit together to tell a cohesive story about how inequality and the middle class affect economic growth is a critical and timely task. We turn now to examining in detail the leading channels through which the middle class impacts economic growth.

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