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Why You Should Care About the Threatened Middle Class

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In the last two decades, the income and security of the individual middle class worker has declined and the gap between the middle class and the wealthy has widened. We explain how this is bad for democracy, the economy, and the aggregate health of the nation. We examine the governmental policies and interventions that increased the middle class following the depression and maintained its vigor through the post-World War II period. The impetus for these changes in governmental policies in the 1930s was to end the Great Depression. We pose the question of whether a nation can recover from a depression without invigorating the middle class. We conclude that in order to recover from the current economic and financial crisis, the middle class must be strengthened.

Key words: *middle class, depression, economy, social justice, New Deal*

Since the early 1970s, income distribution in America has become much less equitable (Kawachi & Kennedy, 2002; Krugman, 2007; Piketty & Saez, 2003; Reich, 2007). Both the bottom quintile and the middle quintile of earners have decreased in their share of the nation's aggregated earned income. For the middle class, the proportion of earned income dropped from a 1967 figure of 17.3% to a figure of 14.6% in 2005. For the bottom quintile, the proportion dropped from 4.0% in 1967 to 3.4% in 2005. Who gained? The top quintile rose from 43.8% in 1967 to 50.4% in 2005. Table 1 presents the trends in tabular form, where it is clear that the middle quintile shows the steepest decline.

Table 1: Distribution (in percentages) of all earned income across various quintiles: 1967 to 2005

Income Quintiles	1967	1970	1975	1980	1985	1990	1995	2000	2005
Lowest	4.0	4.1	4.4	4.3	4.0	3.9	3.7	3.6	3.4
Second	10.8	10.8	10.5	10.3	9.7	9.6	9.1	8.9	8.6
Middle	17.3	17.4	17.1	16.9	16.3	15.9	15.2	14.8	14.6
Fourth	24.2	24.5	24.8	24.9	24.6	24.0	23.3	23.0	23.0
Highest	43.8	43.3	43.2	43.7	45.3	46.6	48.7	49.8	50.4

Notes: 2005 average income: $10,655 for lowest quintile, $27,357 for second, $46,301 for middle, $72,825 for fourth, and $159,583 for highest.
Source: U.S. Census Bureau (2005). *Current Population Survey, 1968 to 2006 Annual Social and Economic Supplements*

The reality facing the middle class may be clearer looking at the average income over time (using adjusted dollars). The post-World War II period in America was a prosperous time for the average earner. After World War II, the typical family income doubled from $22,000 in today's prices to $44,000 (Krugman, 2007, p. 55). While household income has risen from 1973 to 2007, more households were represented by two working adults (Palley, 1998, p. 63; Pew Research Center, 2008; Sawhill & Morton, 2007). From 1974 to 2004, for males in their 30s, individual median income declined by 12% (Sawhill & Morton, 2007). From 2000 to 2004, the incomes of college graduates declined by 5% (Krugman, 2006). From 2000 to 2007, wages for full-time, employed men were stagnant and middle class household incomes were lower by $300 in 2007 adjusted dollars (Bernstein, 2008; Pew Research Center, 2008).

While income is a measure of economic prosperity, wealth from property or stocks can also be examined in order to determine how middle class America is doing. The figures here mirror the disparities seen in income levels. From the 1970s to 2007, the nation's richest 1% have more than doubled their share of the nation's wealth (Reich, 2007, p. 114). The richest 1% owns 39% of the nation's total assets, including real estate (Wolff, 1998). The top 1% own 49.5% of all stocks while the top 10% own 83.6% of stocks (Palley, 1998, p. 58). In terms of all investments (stocks, bonds, trusts, business equity, three quarters of home real estate values) the top 10% owns 90% (Wolff, 1998).

In comparing the United States to other Western countries, America exhibits a much less equitable distribution of wealth than other countries (Brandolini & Smeeding, 2007; U.S. Census Bureau, 2005). This is noted on two indices of income distribution: the Gini index and the Decile Ratio. (Specific numbers are presented in Table 2.) Moreover, considering the probability of moving out of poverty in any given year, chances are lower in American than in other Western countries (Kawachi & Kennedy, 2002, p. 166) and the chances of attaining a higher economic standing than one's parents is lower in the United States than in Denmark, Norway, Finland, Canada, Sweden, Germany, and France (Corak, 2006).

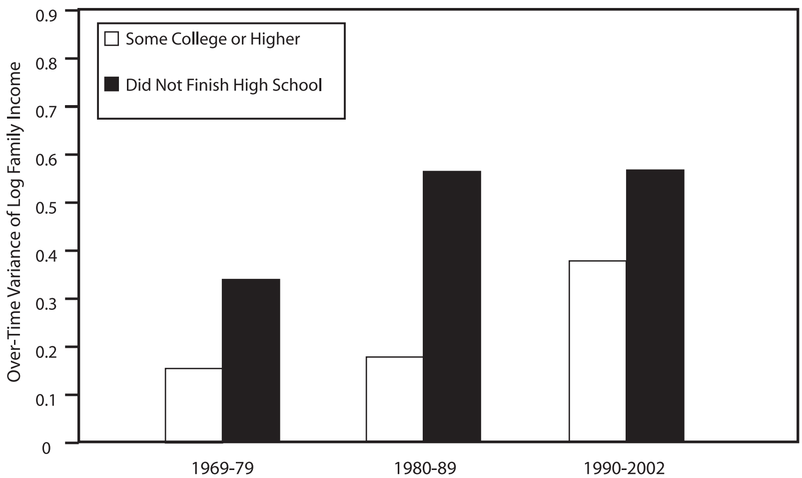
Table 2: Measures of Income Inequality: The U.S. compared to Selected Industrial Countries

Country	Gini Index 2004	Decile Ratio 2000
United States	0.47	5.7
United Kingdom	0.36	4.6
Australia	0.35	4.2
France	0.33	3.4
Germany	0.28	3.4
Sweden	0.25	3.0
Japan	0.25	4.2
Denmark	0.25	2.8

Higher numbers suggest more inequality
Source for Gini Index: United Nations Human Development Report, 2004;
Source for Decile Ratio: Brandolini & Smeeding, 2007, p. 30

Hacker (2006, 2007) has examined the transfer of risk in the society to the average American over the last two decades. Hacker calls this transfer "the great American risk shift." The unemployment rate is increasing, while household debt has increased (Sullivan, Warren, & Westbrook, 2006). The probability of experiencing a decline in income level (called economic instability) increased between 1969 and 2002 for both those without a college degree and those with college educations (Sullivan, Warren, & Westbrook, 2000, p. 117) . In fact, the probability of experiencing a 50% drop in income was 7% in 1970 and rose to 17% in 2002 (Hacker, 2007). Figure 1 represents this pattern.

Figure 1. Income Instability Increased at Both High and Low Educational Levels



Note: These statistics are detailed in Hacker, The Great Risk Shift, supra note 3, at 27-30. The calculations are based on the University of Michigan's Panel Study of Income Dynamics (PSID) and Cornell University's Cross-National Equivalent File (CNEF).

Retirement futures are more insecure as well. In 1980, 83% of firms offered pensions with fixed benefits for life. By 2003, only one third of Americans had guaranteed pensions and more had 401Ks (Hacker, 2007). 401Ks are, of course, very risky because their value fluctuates with the stock market. Ghilarducci (2008) estimates that 50% of retirees will run short of their financial needs in the future, ending up with less than 70% of their pre-retirement income upon retirement.

Manifestations of a Stressed Middle Class

Between 1970 and 2001, bankruptcies quintupled, mortgage foreclosures tripled, and car repossessions doubled (Warren & Tyagi, 2003 p. 78-80). Most people filing for bankruptcy are middle class: they are well educated, own their own homes, and have good jobs. Persons with children are more likely to file for bankruptcy than are households without children. For 90% of those households with children who file for bankruptcy the reasons fall into three categories: job loss, medical expenses, and divorce. Of course, these disasters are more likely today than in the 1950s and l960s. Even before the recent financial meltdown of 2008, involuntary layoffs had increased by 28% since 1970 (Warren & Tyagi, 2003, p. 82). Displaced workers are unlikely to find employment at similar pay (Hacker, 2007). The cost of medical care has escalated. Fewer Americans carry health insurance. Indeed, one-third of non-elderly adults have periods during which they have no medical insurance (Hacker, 2007). Financial pressures place a burden on marriages in a country with an already high divorce rate.

The absence of savings by the American public and the increase in indebtedness of those who are middle class have led to the common assumption that the middle class is spending on luxuries they cannot afford. Fortunately, the government has kept statistics on the spending patterns of American consumers since the l970s. Contrary to what might be believed, spending on most categories has declined over the last two decades. Americans spend 21% less on clothing, 22% less on food, and 44% less on major appliances than they did in the early 1970s. What has increased? Health insurance costs have escalated. With two parents in the workforce, child care is a new expense, as is the necessity of a second car. (Seventy-five percent of three- and four-year-olds attended preschool in 2001 compared to just four percent in 1960.) Moreover, the cost of housing has escalated 26% between 1984 and 2001. Are homes more luxurious today? In fact, 6 out of 10 of families live in older homes; however, the size of new homes has increased by 40% over the last twenty years (Warren & Tyagi, 2003). According to Warren and Tyagi (2003), the major factor driving the increase in the cost of housing is the competition to move into good school districts, although Shiller (2008) argues that cheap interest rates also contributed to inflated housing prices. Comparing houses of similar size and luxury, a five percent jump in standardized test scores of children in one school district versus another adds $4,000 to the cost of the house. School quality is the single most important factor in determining the price of a house (Warren & Tyagi, 2003, pp. 15-54). Thus, contrary to the perception that today's Americans suffer from some form of impaired impulse control (see Whybrow, 2005), the long-term goal of raising children who can become prosperous adults is driving America's current consumption.

As the housing bubble grew, along with the rush to buy housing in better school districts, home equity loans and mortgages became much easier to obtain. In 1980, Congress passed the Depository Institutions and Monetary Control Act and then, in 1982, the Alternative Mortgage Transaction Parity Act. This legislation effectively deregulated bank interest rates, allowing higher interest rates from borrowers and permitting higher interest rates to depositors (lenders) (Mansfield, 2000). In the past, down-payments of 20% were required when buying a new home (Warren & Tyagi, 2003, pp. 127-129). In the environment leading up to the collapse of the housing bubble in 2008, down payments were sometimes not required at all. All this led to higher mortgage payments, so the proportion of monthly earnings going to mortgages increased. A new term has been created for those devoting in excess of 40% of monthly income to housing: house poor (Warren & Tyagi, 2003, p. 133). Over the past twenty years the number of middle class households that are "house poor" quadrupled, from 2.8% in 1975 to 13.5% in 2001 (Warren & Tyagi, 2003, p. 231).

Advocates for the poor have sometimes lobbied for easier access to mortgages, in part by requesting smaller down payments and even an absence of down payments. Are borrowers being helped by an absence of down payments? Without a down payment, borrowers are paying higher costs in interest rates, higher points and fees, and are required to carry mandatory credit insurance (Warren & Tyagi, 2003, p. 133). Effectively, they pay more. Tellingly, the percentage of household disposable income spent on debt service—principally mortgage, auto loan, and credit card debt had risen from just over 10% in 1983 to 14.5% in 2006 (Phillips, 2007, p. 99). The median debt-to-annual-income ratio for middle-income adults increased from 0.45 in 1983 to 1.19 in 2004. The median debt-to-asset ratio of middle income adults increased from 0.25 in 1983 to 0.40 in 2004 (Pew Research Center, 2008).

What were banks getting out of deregulation? In the past, the cap on interest rates meant that banks could not offset increased risk with higher profitability attributable to higher interest rates. Banks were reluctant to provide loans that could not be repaid. With deregulation, the allure of high profits (from high interest rates on the loan) lured the banking industry into riskier practices. Before the mass crisis in the banking industry in the fall of 2008, while loan defaults soared, banking profits increased even faster (Warren & Tyagi, 2003, p. 129). Prior to the recent collapse of the housing market, houses were appreciating in value over time. Financial institutions stood to realize an even bigger profit if a foreclosure ensued. Foreclosed properties could be resold at a higher price than the amount of the foreclosed loan (Engel & McCoy, 2002; Warren & Tyagi, 2003, p. 136). Up until the advent of massive foreclosures and the collapse of housing prices, banks had everything to gain by offering big, risky loans.

The shift in how the middle class spends its money has effectively made life more risky. A higher proportion of income is going to fixed monthly payments: mortgage, insurance, daycare, car payments (Warren & Tyagi, 2003, p. 8). Lower proportions of the pay check are going to categories such as food, clothing, and movies, areas where there is flexibility (that is, room to conserve). If a financial disaster occurs (job loss, divorce, unforeseen health problems), there are limits to how much families can cut back. Often people fall into the trap of using their credit cards to make ends meet at the end of the pay period when the money runs out (Ellis, 1998; Warren & Tyagi, 2003, p. 113). (In the last 20 years, savings declined from 11% to negative 1 percent. Credit card debt increased from 4% to 12% of income [Warren & Tyagi, 2003, p. 112].) When families cannot make the augmenting payments on the credit cards, they frequently resort to taking out a home equity loan to pay off the credit card debt (Barr, 2007; Sullivan et al., 2006, p. 251; Warren & Tyagi, 2003, p. 131). However, the new loan adds its own burden of interest payments, so many are forced to file for bankruptcy. At the time of bankruptcy filing, the average family owed 150% of an entire year's income in non-mortgage debt (Warren & Tyagi, 2003, p. 78).

What changes have occurred making all this debt possible? Similar to the expansion of credit in the home equity market, the credit card industry was deregulated and the rules have changed (Ellis, 1998). In 1978, the Supreme Court (in *Marquette National Bank of Minneapolis v. First of Omaha Service Corporation)* ruled that the laws in the state where the credit card company is incorporated prevail over the laws in the state where the debtor resides. Not surprisingly, credit card companies are located in states (South Dakota and Delaware) that do not have usury laws. Effectively, usury laws no longer exist. Credit card companies can raise the interest rates on the amount already borrowed when an individual loses a good credit rating, or when the card company summarily decides to lower the maximum amount that can be borrowed and the debtor is above the new limit. When a person fails to pay the minimum payment on a card, the interest rates (on what is already owed) increase and penalty fees are added. The principal as well as the interest on the debt augments. Monthly minimum payment amounts go up (Fanning & Rummel, 2004).

The real incomes of the middle class have declined over the last twenty years. Their share of America's wealth has declined. Expenses have escalated. With two adults working, a second car usually is a necessity. The cost of borrowing money has increased. With both adults now participating in the workforce, the insurance policy of being able to add a second breadwinner should disaster occur has been lost (Warren & Tyagi, 2003). The middle class is far less secure.

Why Is A Strong Middle Class Important?

"When citizens of different countries have been polled about attitudes toward income inequality, Americans come out near the bottom in their dislike of wide disparities" (Kawachi & Kennedy, 2002, p. 25). In fact, only 28% of Americans polled in a World Values survey responded favorably to policies to reduce inequalities versus 65% in the United Kingdom and 80% in Italy (Kawachi & Kennedy, 2002). Kawachi and Kennedy

(2002) point out that "Strikingly, even the poor in America are less likely to endorse redistributive or egalitarian sentiments than low-income citizens elsewhere" (p. 25). Americans seem to have bought the assumption that income disparity is an inevitable outcome of differentials in productivity that accrue from differences in skills and innate ability (Galbraith, 2008). They make this assumption oblivious to the fact that during the last 20 years increases in wages have failed to keep up with increases in worker productivity (Dew-Becker & Gordon, 2006; Krugman, 2007; Sawhill & Morton, 2007).

A Strong Middle Class Is Required for a Democracy

Aristotle was perhaps the first to recognize that government by the middle class produced the best results. The poor would be captured by a demagogue who would bring tyranny for the promise of income redistribution. The rich would be invested in maintaining their position of privilege. Only the middle class could govern rationally. Aristotle advocated policies that would: (a) generate and maintain a prosperous middle class; (b) provide careers, property, and education for the poor to absorb them into the middle class; and (c) encourage the rich to contribute a portion of their wealth to careers for the poor and to civic projects for the society as a whole. Aristotle's motivation to maintain a strong middle class emanated from his belief that only middle class governance could provide harmony and stability and avert frequent revolutions and blood letting (Glassman, 1995).

Indeed, Aristotle's fears are mirrored in the current loss of civility and bipartisanship since the 1950s and 1960s when more people had attained economic security (Krugman, 2007). Moreover, using country as the unit of analysis finds that those countries with high levels of inequality exhibit high levels of instability of government (Perotti, 1996).

Historical analysis reveals that the emergence of a middle class brought about a shift from governance by the king to governance by the people. Barrington Moore's (1966) classic work on development of modern forms of governments finds that evolution from a feudal society structure was occasioned by the emergence of a middle class in cities. As these middle class individuals grew in numbers, they demanded more representation in assemblies and more constitutional rights. Others have also recognized that during the middle ages, nascent democratic movements were contingent upon a middle class whose wealth emanated from commerce (Glassman, 1995, p. 49, p. 84; North & Thomas, 1973).

While a strong middle class seems to be necessary for a democracy, there are examples of countries with strong middle classes where democratic governance is lacking. Singapore has a large middle class, has business transactions governed by rule of law and courts, but does not elect its leaders. The former Soviet Union is another country with an educated middle class in which leaders were not fairly and democratically elected (Glassman, 1995). Many recognize that Hitler's Germany was a case of the middle class choosing fascism over democracy. Times of uncertainty (either economic recessions or external military threats) seem to increase the possibility that the middle class will move toward fascism (Moore, 1966). We are not claiming that a strong middle class guarantees a democracy, but rather, that democracy will not develop without a middle class.

Political scientists Acemoglu and Robinson (2005) suggest that the presence of a strong middle class is a prerequisite for stable democracy. In their analysis, Acemoglu and Robinson take into consideration the costs to the rich of suppressing a poor majority. They offer detailed calculations to show that when the majority has few, or limited, resources undergirding its demands, the costs of oppression are reduced for the rich. However, a strong middle class has confidence, a sense of entitlement, and resources. (Indeed, all revolutions have been led by the middle-class [Acemoglu & Robinson, 2005, p. 39].) Given a strong middle class, it becomes too costly for would-be oppressors to mount the mechanisms of subjugation. Some form of broad-based participation in decision making becomes a more pragmatic solution. Lipset (1981) reaches similar conclusions.

For the founding Fathers, an equitable distribution of wealth and property was seen as crucial to sustaining a democratic republic (Huston, 1998). On visits to Europe, Ben Franklin, John Adams and Thomas Jefferson were shocked by the disparities in wealth they observed between the aristocracy and common people (Gates & Collins, 2002). After visiting Ireland & Scotland, Ben Franklin wrote:

> In these countries a small part of the society are landlords, great Noblemen and Gentlemen, extreamly (*sic*) opulent, living in the highest affluence and magnificence: The bulk of people Tenants, extreamly (*sic*) poor, living in the most sordid Wretchedness in dirty hovels of mud and straw, and cloathed (*sic*) only in rags. (Willcox, 1975, p. 7)

Later in this same letter Franklin attributed the enormous inequality he observed in Europe to the aristocratic form of government: "And the effect of this kind of Civil Society seems only to be, the depressing multitudes below the Savage State that a few may be rais'd (*sic*) above it" (Willcox, 1975, p. 7).

John Adams agreed with the 17th century political philosopher James Harrington, who believed that power in society was determined by those who owned property (Adams, 1854). According to John Adams:

> …the balance of power in society, accompanies the balance of property in land. The only possible way, then, of preserving the balance of power on the side of equal liberty and public virtue, is to make the acquisition of land easy to every member of society; to make a division of the land into small quantities, so that the multitude may be possessed of landed estates. If the multitude is possessed of the balance of real estate, the multitude will have the balance of power, and in that case the multitude will take care of the liberty, virtue, and interest of the multitude, in all acts of government. (Adams, 1854, pp. 376-377)

In agrarian Colonial America wealth was largely determined by ownership of land.

Of course, one strong reason for opposing concentrated wealth is the undue influence afforded to the rich. Woodrow Wilson stated in 1913 (p. 286), "If there are men in this country big enough to own the government of the United States, they are going to own it." Studies of small communities, such as the classic Middletown study (Lynd & Lynd, 1937), bear out that those with more resources can buy advertising and manipulate what the public hears. Concomitant with the concentration of wealth in the U.S., we have witnessed the rise of lobbying in Congress and growing concerns over corruption. Campaign contributions *do* buy access to legislators (Stratmann, 2005). Congressmen who succeed in passing legislation for particular industries are rewarded, after leaving office, with high salary jobs as spokespersons for the industries. Financial resources *do* influence election results (Repetti, 2001). Reich (2007, p. 166) argues that super-capitalism (referring to the current state of America with the rich capturing a greater proportion of aggregate income) has diverted the attention of Congress from guarding and promoting the interests of citizens to regulating disputes between corporate interests. In the wars between the powerful, the interests of citizens have been forgotten. For example, in 1963, Congress passed six bills out of ten to reduce economic inequality; again in 1979, it passed four bills out of seven to that same end; whereas in 1991, it passed only two out of seven aimed at reducing inequality.

Beyond the threat to good government posed by the concentration of wealth is the issue of equality of opportunity. The founding fathers were concerned with having a society of equal opportunity. However, Krugman (2007, p. 249) reflects, "A society with highly unequal results is, more or less inevitably, a society with highly unequal opportunity, too." The wealthy will be better able to invest in the education of their children. Their children have more time to devote to their education. A superior education implies that the children of the wealthy will emerge with better skills. Of course, societal investment in public schools and libraries could offset some of the factors militating against equality of opportunity. However, only through clearly progressive taxing, that is, a further shift of the tax burden onto the wealthy, with less allowance for ingenious opting out of taxation, will there be sufficient revenue to support these institutions.

Inequality is Bad for the Health of Persons at All Levels of Income

The Whitehall studies have shown us that with each decrease in level of socioeconomic status, various indicators (mortality, morbidity, risk for heart disease) mark a deterioration in health (Marmot, 2004; Salpolsky, 2005). Childhood economic status also affects adult health. Both the risk of infectious disease and heart disease is higher in persons whose parents had low incomes when they were growing up, regardless of adult socioeconomic status (SES) (Cohen, Doyle, Turner, Alper, & Skoner, 2003; Kivirmäki et al., 2004; Lehman, Taylor, Kiefe, & Seeman, 2005). The findings of the SES gradient in health are found in nations with universal health care, so unequal access is not a likely explanation. Moreover, the findings hold after controlling for diet, exercise, and smoking (Lantz et al., 1998; Steptoe & Marmot, 2002, p. 44).

What is most surprising in the health research is the comparisons of countries with narrow gaps between the top earners and the bottom (e.g., Greece and Japan) to countries with wide disparities (e.g., the United States). At all levels of income, the health status of persons from the more egalitarian countries is better (Babones, 2008; Marmot, 2004, p. 65; Wilkinson, 2005, pp. 100-143). According to Wilkinson (1992, p. 49) the degree of income inequality in a society explains about three quarters of the variation in life expectancy across countries; per capita Gross National Product explains about 10% of the variance. Studies in which states are the unit of an analysis have produced similar findings (Kaplan, Pamuk, Lynch, Cohen, & Balfour, 1996; Kennedy, Kawachi, & Prothrow-Stith, 1996) as has a study in which the unit of analysis was U.S. metropolitan areas (Lynch et al., 1998). However, at the neighborhood level, poor individuals usually enjoy better health in a mixed income neighborhood than in neighborhoods with concentrated poverty (Stafford & Marmot, 2003). Also, the association between regional income inequality and life expectancy does not hold up in Canada, where across provinces there is not much variation in income distribution (Ross & Wolfson, 1999).

Researchers have yet to identify the mechanisms through which large income disparities impact the health of all persons in the society. However, particular variables such as social capital (measuring whether people view others as trustworthy and participate in voluntary organizations) have been shown to impact health (Kawachi & Kennedy, 2002). Comparing countries with narrower gaps between the top earners and the bottom finds that the citizens of countries with narrower gaps are more trusting of others and report higher levels of satisfaction (Ellison, 1999; Kawachi & Kennedy, 2002, pp. 102, 110). Essentially, social cohesion is more likely to develop among individuals who are of similar social status. Perhaps the greater social cohesion affords health benefits for everyone.

A Strong Middle Class is Required for a Market Economy with High Productivity and Growth

A large middle class is vital to a capitalist economy because the middle class spends on consumer goods. The middle class is the market. Economists have long known that middle class individuals spend proportionately more of their income (have a marginal propensity to consume), whereas wealthy individuals have a marginal propensity to save (Mankiw, 2003, p. 54). Henry Ford recognized this fundamental truth when he raised the wages of the workers so that they could afford to buy the automobiles they were mass producing. Presently, between 62-70% of current Gross Domestic Product (defined as the money that changes hands in America) is constituted of consumer spending (Krugman & Obstfeld, 2006, p. 283; Mankiw, 2003, p. 27). Without the expectation of selling the goods that get produced, no one will build a factory or employ workers. If consumer spending declines, there is no incentive to invest in new companies and industries. Job creation stagnates.

The emphasis on consumer demand as the impetus for economic growth is referred to as "demand led growth theory." "Supply side" theory emphasizes investment's role in economic growth. It is true that there must be some money to invest. To generate investment dollars, some of the difference between the selling price of a product and the cost of production must go into investment (as opposed to workers' wages). Those individuals in the society with the highest marginal propensity to save (the wealthy) must be left with some after-tax dollars to invest. But, will those with excess money use their savings to increase factory resources and/or open new businesses and create new jobs, without an expectation that a sufficient number of consumers will be able to buy their products?

During the Reagan years in the 1980s, when there was much deregulation of financial institutions, we witnessed alternatives for the use of investment dollars beyond creating new companies and new jobs. In the era of "hostile takeovers and leveraged buyouts," persons with money to invest bought up companies, closed sectors of the company where unionized workers had negotiated high-wage contracts, and effectively eliminated many jobs (Uchitelle, 2007). Profits can be used to invest in overseas production, as well as being used to buy up company stocks to raise stock values (Madrick, 2007). Managers of hedge funds specialize in making money through speculation. The realization that companies can use profits in other ways, besides buying new equipment that could enhance production and employ more people, may explain a recent paradox. Between 2001 and 2006, profits had risen to approximately 15% of Gross Domestic Product (GDP), but capital investment fell as a share of GDP by 2 percentage points from the high in 1999 (Madrick, 2007, p. 3). Until the recent downturn, the availability of funds for investment was not a problem. Ira Glass (2008) reports that since 2002, investment funds have doubled. The frenzy to invest prompted the sub-prime housing loans which ended in the recent banking crisis.

So when will investment dollars be used to create new companies? Adam Smith, who recognized that when goods (e.g., pins) are mass produced, unit prices decline owing to an economy of scale, also cautioned, "the benefits of such enhanced potential productivity are only realized if the market is large enough to absorb the new supply of pins" (Smith, 1776/1936). It is well to remember that when the causes of devastating African diseases are discovered, drug companies are not goaded into finding a cure, because there is no market (Sattaur, 1990). Drug companies fail to develop drugs for malaria, which infects the third world, because without consumers who can pay, there is no incentive (Thurow, 2003, p. 179). James Watt, an investor in the mass production of the steam engine, is quoted as saying, "it is not worth my while to manufacture in three countries only; but I can find it very worthwhile to make it for the whole world" (Mokyr, 1992, p. 245). Moreover, economists have credited the growth of the American economy to America's enormous, continent-wide population (Madrick, 2007, p. 12), whereas others credit the industrial revolution to the market expansion occasioned by world trade (Cameron & Neal, 2003). Rather than technological innovations leading to growth in the world economy, Madrick (2002, pp. 2-12) concludes that an increase in world markets stimulated the growth in the world economy of modern times.

If demand is required for investment and high wages increase demand, then localities with higher wages should realize more economic growth. Researchers have examined how increases in worker wages covary with economic growth. Naastepad and Strom (2006-2007) analyzed data for eight economies (France, Germany, Italy, Japan, Netherlands, Spain, Britain, and the U.S.) for two periods: 1960-1980 and 1980-2001. They found that when wages were high, there was less unemployment and a greater rise in GDP. Alternatively, when wages declined, although corporate profits increased, these periods were associated with greater unemployment and with less growth in a country's GDP.

There are also data on the relationship between the level of income inequality (which will increase with lower wages) and economic growth. Comparisons of countries differing on the degree of equality of income distribution have concluded that there is an inverse correlation between inequality and economic growth (Aghion, Caroli, & García-Peñalosa, 1999; Alesina & Rodrick, 1994; Persson, & Tabellini, 1994), although Persson and Tabellini (1994) found that the inverse relationship between high inequality and economic growth was limited to democracies. Furthermore, in the Persson and Tabellini data, a larger middle class was associated with greater investment within a country. Similarly, Repetti (2001) reviewed studies in which economic units were observed over a 25 year period. Repetti concluded that concentration of wealth is associated with less economic growth over the long run, while the correlation is less clear over shorter time intervals (Repetti, 2001).

The Case for Progressive Taxation

Mechanisms are available for ensuring a healthy middle class: higher wages and progressive income taxation. Those who emphasize the supply side of economic growth object to increasing wages and increasing taxes on the wealthy. If business people have their profits taxed at, for example, 91% (the level during the 1950s) rather than at 35% (the current level), it is argued that they will be less inclined to make investments with their accumulated profits (Krugman, 2007, p. 47). Without new companies and expanded capacity of production, then economies of scale and increased productivity (amount produced by worker and machine) will not be achieved. The data, however, suggest that such fears are groundless.

Data are available allowing examination of the relationship between high taxes and economic growth. During the period in this country when we had the highest taxes on the rich and the top 1% of the economic hierarchy controlled less of the nation's wealth, viz. 1950-1972, we witnessed better economic growth than in other times. The Multifactor productivity for the years 1929-1996 were as follows: 1928-1950, 1.90%; 1950-1964, 2.35%; 1964-1972, 2.07%; 1972-1979, 1.12%; 1979-1988, 0.90%; 1988-1996, 0.67% (Gordon, 1999).

Others have compared countries to determine how taxation relates to a country's level of economic growth. Using country as the unit of analysis, several researchers have found that high tax rates are associated with more, rather than less, economic growth (Lindert, 2004; Perotti, 1996; Slemrod, Gale, & Easterly, 1995), although these authors recognize that the many confounds of level of taxation with other variables (e.g., the amount of GDP in a country which emanates from agricultural production) make it difficult to draw firm conclusions about causation (Slemrod et al., 1995). However, examining their data, Easterly and Rebelo (1993) conclude that Wagner's law is essentially correct. Wagner's law states that government taxes and government spending will increase with increasing wealth of the country.

There are a couple of arguments to be made about the fairness of a progressive tax system. One such argument is called Engel's law (about.com: Economics, 2009), named after the statistician Ernst Engel. Engel's law states that as a consumer's income increases, the proportion of income spent on food declines. More generally, people with low incomes are forced to spend the bulk of their income on essentials just to survive. For the poor, any tax is likely to be a tax on essentials. For the wealthy, the taxes are on discretionary income. There is a related economics law, the law of marginal utility, which holds that the more one has of a given commodity, the less the owner values any single unit of it (Cameron & Neal, 2003, p. 15). Thus, if fairness means equal discomfort for all under taxation, you would want to take larger amounts of money from the person who possesses more of it.

Finally, it might be well to remember that those who have accumulated wealth in this country have not achieved their wealth exclusively on their own. Government-sponsored research at universities, which fill our academic journals and end up undergirding everything from pharmaceutical patents to new forms of plastic, are often implicated in new developments in the marketplace. There is also our precious heritage of an open society, where news travels with lightning speed, and promotes the expeditious interchanges that characterize our financial marketplace. More generally, our American institutions (including the financial markets themselves, the educational system, our physical infrastructure, civil courts, the patent office, etc.) enable the accumulation of wealth. Thus, the society as a whole has a claim on the return on its investment (Gates & Collins, 2002, pp. 110-135).

Should We be Particularly Worried Now by the Insecure Middle Class?

Economists have argued that the cause of the Great Depression was insufficient consumer demand (Krugman, 1997). Thurow (2003, p. 72) recognizes that the rest of the world relies on America to create demand, that is, to be the big market of spending consumers. Presently, world production capacity exceeds expected consumption by at least one third in almost every industry, suggesting that a deficit in demand is a world problem (Thurow, 2003, p. 248). Palley's book, *Plenty of Nothing*, was written in 1998, prior to the 2008 collapse of the housing market and the country's financial sector. Palley offered four reasons why the present diminution in middle class wages makes us vulnerable to a depression again:

1. As the disproportionately large cohort of baby boomers ages, the bulk of the population will be older. It is established that older people spend

less than younger people. Thus, the aging of the population will contribute to the decline in demand.

2. In the manufacturing sector, the practice of paying over-time hours (as opposed to hiring additional workers) has increased. During a recession, these hours will be easy to cut.
3. The economy has fewer automatic stabilizers than in the past. For example, rather than increasing wages, workers have been compensated with bonuses tied to company profits. When profits decrease in a recession, compensation to workers also decreases.
4. Over the past several decades, Americans have maintained their standard of living by offsetting declining wages with increased borrowing and debt.

Given present levels of indebtedness, another economic downturn with job losses will make it impossible to borrow further. Rather, more Americans will default on loans and go into bankruptcy. The picture is one of a contractionary spiral, "with wage deflation feeding collapse in spending, and collapsing spending feeding further wage deflation" (Palley, 1998, p. 204). Palley's concerns seem particularly cogent now, as we consider falling prices, job layoffs, and falling retail consumption in the last year.

How Stimulating Recovery from the Great Depression Inadvertently Created the Middle Class

We have thus far argued that a strong middle class is required for maintaining democracy, the health of all citizens, and a vibrant economy. We have argued that in the past 20 years, the vitality of the middle class has been vitiated. But, what created the large middle class which remained robust through the 1950 and 1960s? While there was a modest middle class in America prior to the Great Depression, the middle class gained in strength and numbers following the New Deal and World War II. Goldin and Margo (1992) report that wage inequality began to decrease with the passage of the First New Deal legislation in 1933, but the "Great Compression" continued throughout the 1940s. Economists believe that the "Great Compression" was effectively created by governmental policies: high marginal rates of taxation, the wage and price controls in effect during World War II, and then policies bolstering labor extant during the 1950s (Krugman, 2007; Levy & Temlin, 2007; Murolo & Chitty, 2001; Piven, 2006). These policies were critical components of Roosevelt's "New Deal." Another component of the New Deal, the Federal Housing Administration (FHA), was created in 1934. It provided mortgages to middle class Americans and was followed by more loans for returning veterans through the Veterans Administration. The GI Bill educated the masses and created a more productive workforce. All of these policies increased the size and vibrancy of the middle class.

The New Deal was intended to bring recovery from the Great Depression of the 1930s. In fact, the early years of the New Deal did initiate some marginal recovery from stagnation of the Great Depression. Some believe that the New Deal might have brought the nation out of depression; indeed, by August of 1937, unemployment had dropped from a high of 24.9% to 12.3% and production was up to 1929 levels (McElvaine, 1993, p. 297; Shlaes, 2007, p. 267; Smiley, 2002, p. 106). However, in 1937, when taxes were increased in the form of payroll deductions for the newly initiated Social Security System, Roosevelt cut back on governmental spending, and money supply through the Federal Reserve was cut, a second recession occurred (Borosage & Lotke, 2009; Kuttner, 2009; McElvaine, 1993, p. 297). (The next big government stimulus package, World War II, effectively ended unemployment in America.) While the New Deal was initiated to bring an end to unemployment (i.e., end the depression), concomitantly, it also initiated the Great Compression, the narrowing of the gap between the rich and the poor. Could Roosevelt have ended unemployment and ended price deflation without increasing the size and security of the middle class? We do not have a case-study addressing the issue of whether economic recovery is possible without strengthening the economic security of the bulk of Americans.

In responding to the 2008 financial system debacle and recession, the Bush Administration was ready to infuse money into the banking system in order to ensure that American businesses could secure loans to keep their businesses running. While everyone agrees the liquidity is vital, some members of

Congress were unwilling to ensure good wages for workers in the failing auto-industry or to intervene to prevent foreclosures on those who could not make their mortgage payments. Defining recovery from economic depression as restoring price stability and restoring full employment of the factors of production, we suggest that recovery from an economic depression may not be possible without an increase in the economic security of the bulk of the population.

The housing market offers a case in point. Rationales for renegotiating loans to prevent foreclosures extend beyond compassion for the distressed. With the rash of foreclosures, vacant houses have offered a haven for drug dealers and criminals, increasing the cost of law enforcement (Mummolo & Brubaker, 2008). Additionally, given a glut of houses on the market, property values have collapsed, with prices falling by six percent during 2007 (Barr, 2008). Since more foreclosures are anticipated, shoppers for new homes will not buy because they are waiting for prices to fall to their lowest possible level. Consumer demand, necessary for stabilizing the price of homes, is lacking.

Similar problems in the housing market occurred during the Great Depression. The newly created FHA purchased troubled mortgages from banks. The owner was then asked to repay the outstanding amount on the then current value of the home, rather than the amount of the original loan (Barr, 2008; Mansfield, 2000; Seidman & Jakabovics, 2008). Identifying which particular policies re-stabilized the housing market after the depression is difficult; many governmental initiatives were occurring under the New Deal. However, in line with our arguments about why a middle class is required for an economy, we proffer the hypothesis that bringing an end to the current world recession/depression and stabilizing markets will require bolstering the middle class. Interventions to save corporations will not work unless workers' wages are also saved.

Conclusions

Presently we are confronting another worldwide depression as we did in the 1930s (Meyerson, 2009). In 1930, the government instituted the New Deal to bring the country out of the

Great Depression. The New Deal policies initiated the "Great Compression," widening the middle class and narrowing the gap between the rich and the poor. Presently, the government is going to intervene to improve the economy. In sculpting interventions to end the current depression/recession, the government should look to the example of the New Deal and realize that interventions must revitalize the middle class. Recovery from depression may not be possible without strengthening the middle class. Certainly, a prosperous, harmonious, healthy society is not possible without a vibrant middle class. If the middle class is insecure, the outcomes of everyone are compromised. In this time of innovation, hopefully we will get it right.

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