

The Myth of the Declining Middle Class

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Is the American middle class fighting for its life? You would certainly think so if you followed economic stories in the mass media. Lou Dobbs' nightly CNN news program – “The War on the Middle Class” –is the most prominent example of the continuing coverage about growing economic inequality and stagnating middle class incomes. Elizabeth Warren has gone so far as to say that the middle class is “vanishing.”

Robert Kuttner succinctly summarizes the middle class in decline theory: “At least two-thirds [of Americans] are economically stressed... [Over the past three decades] all of the [income] gains went to top 10 percent (most to the top 1 percent), because the right has so relentlessly undermined institutions of opportunity and security long championed by Democrats.” In his recently-released book *The Squandering of America*, he calls the years from 1979 to the present a “silent depression” and writes more recently about a coming downturn that will be worse than anything we have experienced since the 1930s.

New books by Paul Krugman (*The Conscience of a Liberal*) and Robert Reich (*Supercapitalism*) also argue that those in the middle have been maintaining their standard of living only by working more. Earlier, Jeff Faux in *The Global Class War* writes of a “serious erosion [over the last several decades] of the ability of [our] citizens to maintain their living standards.” Finally, Thomas Frank in *What's the Matter with Kansas* intones:

“The country seems more like a panorama of madness and delusion...of sturdy blue-collar patriots reciting the Pledge while they strangle their own life chances; of small farmers proudly voting themselves off the land; of devoted family men

carefully seeing to it that their children will never be able to afford college or proper health care; of working-class guys in Midwestern cities cheering as they deliver up a landslide for a candidate whose policies will end their way of life.”

In a series of books, monographs, and commentaries, a series of specific claims have been made:

“Life was easier with fewer worries in the fifties and sixties when one income was enough.”

“With the decline in manufacturing employment over the past 25 years, most new jobs are low-paid service jobs.”

“With the rise of China and India, service jobs will be lost next.”

“All of the productivity gains of the last several decades went to the richest ten percent of the population.”

“Middle class Americans are working longer just to maintain the same standard of living.”

“The only way that people have kept up is by going deeply into debt.”

“With the disappearance of company pensions and no personal savings, baby boomers are unprepared for retirement.”

“Companies are either abandoning their health insurance benefits or shifting most of the costs to their workers.”

“Because of rising college tuitions, fewer young people from low- to moderate-income families can afford to go to college.”

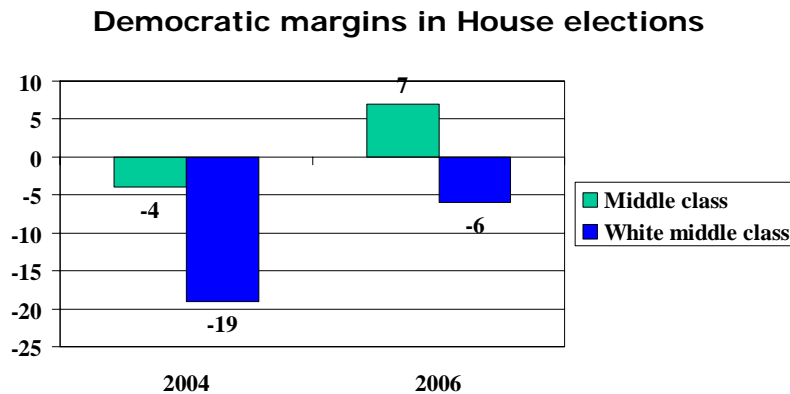
“The government is draining taxes from people and making the economy weaker.”

One might think that all these negative economic trends would translate into votes for Democrats (the party of the people) over the Republicans (the party of big business). However, this is not the case. The Democratic think tank Third Way looked at the voting patterns of White voters in the 2004 and 2006 elections. Arguing that minorities were driven by unique factors, they found that White voters voted for Bush over Kerry by 57

to 38 percent in 2004. This margin persisted among those with low to moderate incomes (incomes of \$30,000 to \$75,000).

In the 2006 election for members of the House of Representatives, there was an across the board revulsion against Bush and the Republican Party. While this translated in majorities in both houses of Congress, White voters, as a whole, and those in the \$30,000 to \$75,000 income range, voted for Republicans over Democrats by eight percentage points (see Figure 1). Obviously this is a great improvement over the previous election, but it is still short of a majority.

Despite Being Party of People, Democrats have not done well with White Middle Class



Middle Class = Family Incomes \$30,-75,000

In rest of this piece, I will present a series of analyses that show that the claims listed above are not supported by the data. Common sense would seem to indicate that there is an obvious disconnect between their story of distress and the ever proliferating suburbs, high home ownership rates, and a thriving market for cars and high-end consumer electronics (e.g., HDTVs, ipods, and multipurpose cell phones and PDAs).

While inequality is certainly up and the bottom 20 percent of the population struggle to get by, the rest of the population has had varying levels of access to the vast output that is available in an economy with \$45,000 of GDP per person.

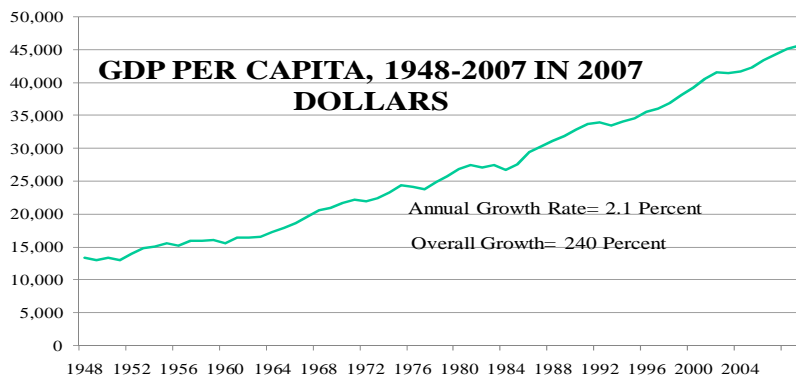
Twenty percent represents over 60 million people and provides the basis for lots of heart-rending stories of suffering and ill treatment. Our country can and should do better. Nonetheless, this number is very different from the claim that 50 to 80 percent of the population have been left behind.

In refuting myths put forward by the current crop of gloom and doomers, I will show that doing socioeconomic analysis requires great care. Because so many things are changing at the same time (e.g., increased labor force participation of women, increased prevalence of single adult households, changing race/ethnic composition, more education, and changing economic structure), it is necessary to avoid making simple comparisons. Also, most data are based on a single year's data, and this adds distortions because of life-cycle effects and volatility.

Some Background on Long-term Economic Trends

Before presenting data on the various claims, it is important to make a few observations about long-run trends. As Figure 2 shows, the economy as measured by real GDP per person has grown fairly steadily at 2.1 percent per year since the end of World War II. Because of compounding, this represents a 240 percent gain: As compared with a current GDP per person of \$45,000, the 1948 level was \$13,300 (in 2007 dollars). Other comparisons reveal that real GDP per person today is 177 percent higher than it was in 1959, 105 percent higher than in 1969, and 66 percent higher than 1979.

Steady Overall Economic Growth



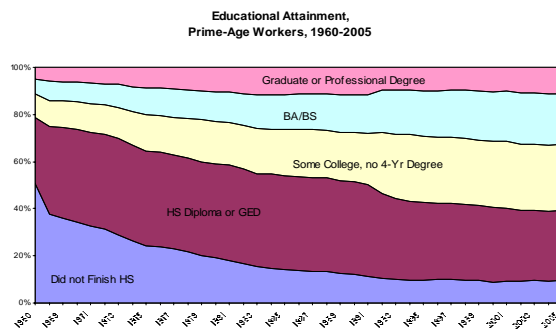
Source: Bureau of Economic Analysis, US Dept. of Commerce

Technological change is one of the main reasons that our economy has grown so much over the decades. Another reason is the vast increase in educational attainment of our work force (see Figure 3). In 1960, just over half of all workers had not finished high school while 11 percent had a four-year degree and another 10 percent had some college but not a bachelor's degree. By 2006, nearly 33 percent of workers had a four-year degree, another 28 percent had some college or two-year degree, and only 10 percent did not have a high school diploma or GED.

There is another disconnect between the images of our economy being dominated by low-skill, low-paid service jobs ("McJobs") and a work force where 60 percent have some post-secondary education. The reason for this is the failure of our categories to truly reflect the current reality. Currently, there is a dichotomous choice between manufacturing and service industries. It is somewhat odd that we have the imagery that manufacturing employment equals good jobs and service employment equals bad jobs because blue collar production work was never a source of much employment of highly-educated workers. The problem here is that service employment is completely

misunderstood. By including stock brokers and sales clerks in an undifferentiated service sector means that it is hard to identify where professional workers are employed.

Broad Expansion of Educational Attainment



Source: Current Population Surveys and PUMS 60

In order to clarify the misunderstood service sector, I developed a 5 functional approach:

Raw Material Production: all direct work in extracting raw materials from the land and sea in agriculture, mining, fishing, logging, and forestry.

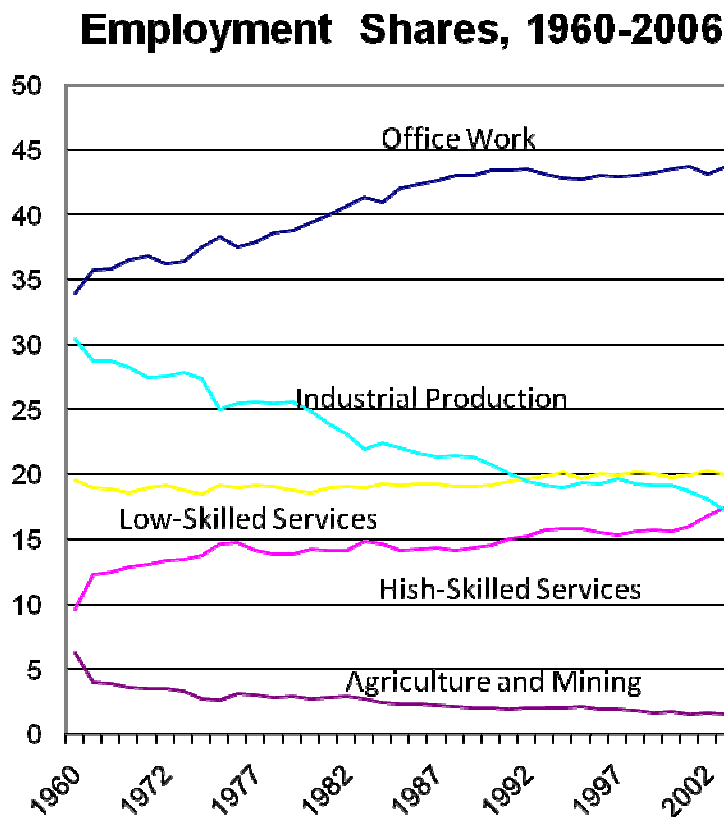
Industrial Production: manual labor in manufacturing, construction, public utilities, and transporting goods to market.

Low-Skilled Services: This category includes all direct contact between consumers and non-specialized service providers—e.g., retail clerks, fast food workers, barbers, and the like.

High-Skilled Services: primarily non-administrative workers in education and health care.

Office and Other Administrative Activities: includes the headquarters activities of consumer service and production firms, public administration, non-profit membership organizations, and business-support activities--e.g., consulting, janitorial service, and all of finance, insurance and real estate.

Using these categories, Figure 4 traces the evolution of employment in these five sectors from 1960 to the present. Not surprisingly, the industrial production and agricultural functions declined dramatically. This decline was offset by rising employment share in office-type activities and high-skilled education and health employment. By contrast, the low-skill service sector varied within a very narrow range over the entire period.



Over time, the educational requirements to get different jobs has changed dramatically. In the 1960s, it was not uncommon for a middle-level manager or insurance agent to just have a HS diploma. Today, virtually all of these jobs are filled by someone with a four-year degree. The largest college major is business, and the majority of men with a bachelor's are employed in the office sector (women are much more likely to be teachers and nurses).

This framework is much more consistent with the rise in educational attainment and continuous economic growth. Office work has mostly ignored in our understanding of economics even though our cities and suburbs are filled with large towers to accommodate these workers.

CONFRONTING FIVE ECONOMIC MYTHS

Myth 1: All of the income gains over the last several decades have gone to the richest ten percent

This is certainly a tempting conclusion when we hear so much about the billions of dollars accumulated by CEOs, entertainers, and top financiers. But one must remember that numbers have to add up, and this is a small slice of the population. As noted above, real GDP per person has grown by 66 percent since 1979. This means that nearly 40 percent of today's income represents the growth that did not exist in 1979 (for the mathematically inclined, this figure is computed by dividing 66 into 166).

Consequently, if all of the growth went to the top ten percent and the top ten percent held 30 percent of the income in 1979, then its share today would be 58 percent (66 plus 30 divided by 166). Combining this value with the share of income received by the second ten percent would lead to the richest twenty percent having 75 percent of all income. This figure is considerably out of the range of any estimate (low to mid fifties) from many data sources.

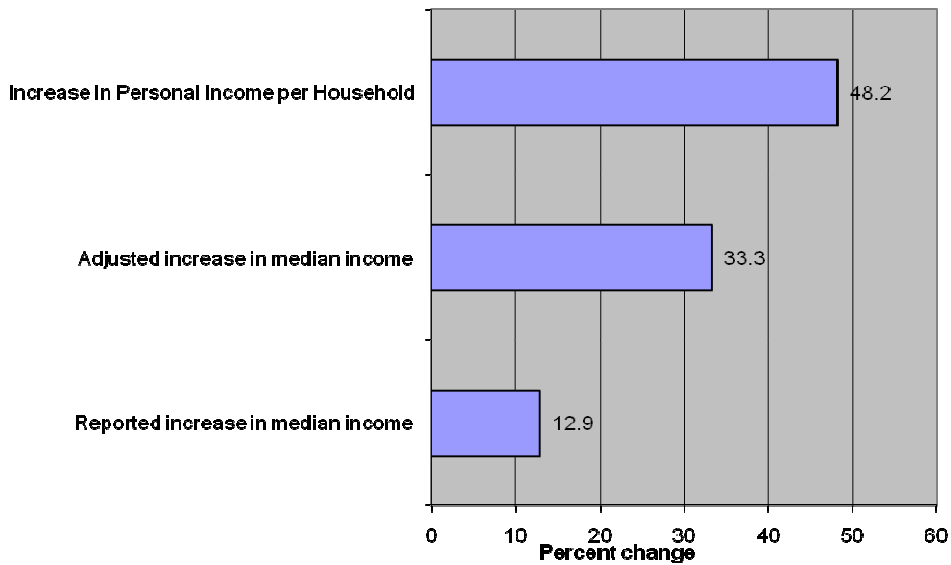
This leaves the question—where did the growth go to? In a paper published by the Information Technology and Innovation Foundation, I address this question and allocate the growth dividend from 1979 to 2005. For those years, real GDP per person was up 63

percent while median household income adjusted for inflation was up 13 percent. This represents a whopping 50 percentage point difference in these two series.

But we have to be careful to compare apples to apples because there were many demographic changes occurring during these years. There was a substantial decline in the number of adults living in husband-wife couples: there was a small rise in the share of single adults with children and a large rise in the number of single adults living alone (primarily in one's twenties and over seventy). Thus, while GDP per capita was up 63 percent personal income per household rose by just 48 percent. Furthermore, the new households that were formed were small and tended to have relatively low incomes.

After adjusting for demographic changes and for rising employee benefits (counted in GDP accounts but not by the Census Bureau), median household incomes rose by 33 percent over these 26 years. While this growth rate is still less than the 48 percent that it might have been if growth had been evenly distributed, it is a long way from stagnation (see Figure 5). This exercise shows that a large part of the income growth was absorbed by forming more single person households.

Gain In Household Incomes, 1979 to 2005



Myth2: The middle class has a tough time making ends meet; they are working longer for basically no increase in their standard of living.

It is often not clear what the alarmists mean when they say that the middle class is “losing ground.” Most researchers shy away from the claim that middle class living standards are lower today than they were several decades ago. Instead, they make the weaker claim that middle class living standards have not grown fast enough. By contrast, the less-scholarly are more likely to talk about absolute declines.

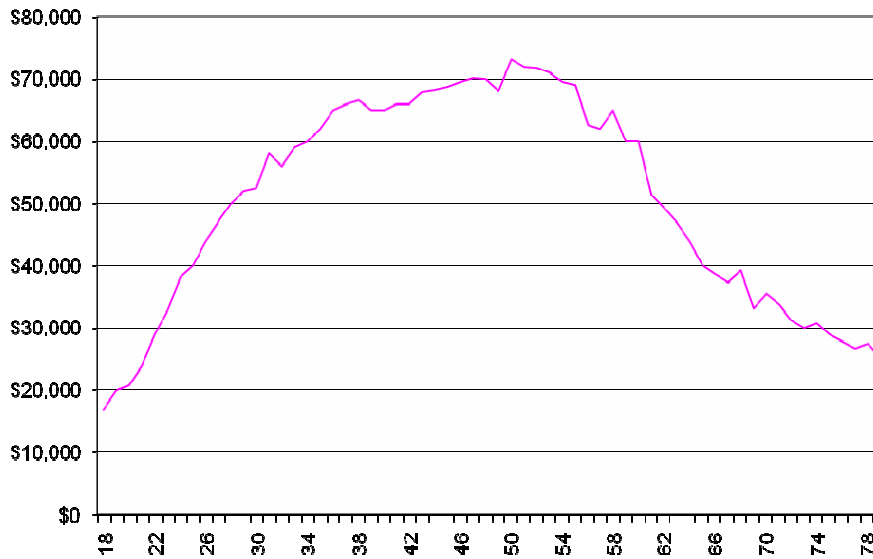
There are a variety of issues that need to be addressed to adequately understand how middle class families are living today. One would think that determining the standard of living of typical Americans would be easy and straightforward. But it is not. In this chapter, various measures of annual median family incomes are presented, ranging from \$48,000 to \$73,000! No wonder people are confused by economic numbers.

One of the reasons for the confusion is that it is important to understand what concept we are trying to convey. When most people think of standard of living, they are thinking of something that is persistent over time (researchers call this “permanent income”). If a wealthy businessman has a bad year with an unusual loss, few people would consider this person poor unless this was the beginning of his business going bankrupt. Similarly, graduates students spend many years with very low incomes, but this is clearly not their permanent status.

Figure 6 shows how people’s incomes change over their life cycle: through age 28 they are in households with a median income of under \$50,000. Their incomes continue to rise and reach a median of \$73,000 for 50 year-olds. From age 55 on, people start to cut back on their work and move towards full retirement. Consequently, their reported incomes fall dramatically.

However, the reported income of elderly people does not reflect how well they live. Because of pension income is underreported and because many withdrawals from savings account are not counted as income, elderly households actually have much more money to spend than is reported in Census surveys. Three studies have addressed this issue and found that elderly people have the same amount of disposable income as the non-elderly once adjusted for these factors.

Median Household Incomes by Age, 2006

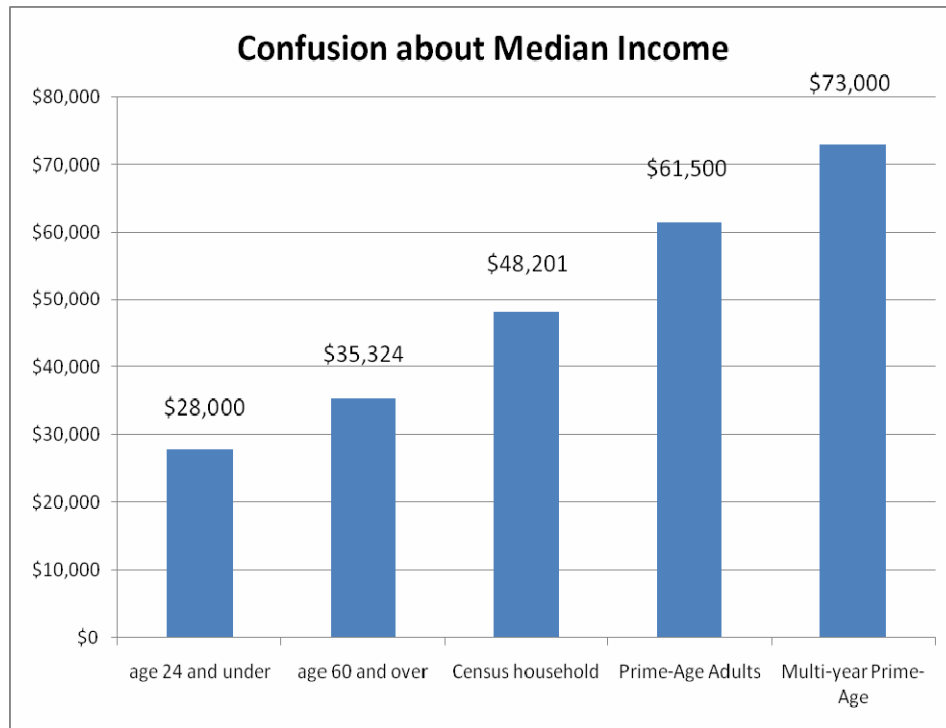


Consequently, the low reported incomes of the elderly are not a proper indicator of their long-run permanent income. At the other end of the age spectrum, young people do not have savings to fall back on but do have parents as a source of financial insurance if they run into tough times. Whatever their situation (some in fact are still in school), their current incomes do not reflect their long-run living standards.

The Census Bureau reports that the median household income in 2006 was \$48,201. There is a quirk in their approach in that they count each household equally even if one has a single person and another is a family of four. Thus, the Census income quintiles do not have the same number of people: the bottom quintile has 15 percent of the population while the top quintile has 25 percent. If we were to make each quintile contain the same number of people, the median would rise to over \$51,000.

If we were to limit the analysis to prime-age people (as an approximation of permanent income), then median income would be \$61,500. Finally Figure 7 uses a different data set to look at the 10-year experiences of prime-age adults. Because people

have a smattering of unusually good and years and because the upswings tend to be bigger than downswings, the 10-year average median income is over \$70,000 a year (over 50 percent of adults had at least one year out of ten in which their household was over \$100,000 of income for at least one of those ten years.).

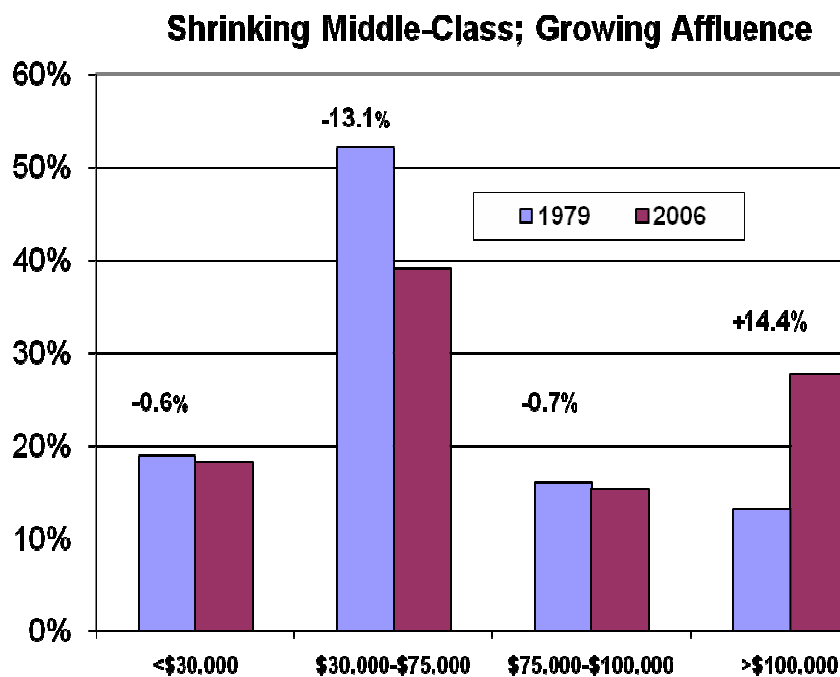


When looking at poverty and standard of living, it is important to recognize the importance of household size. Poverty income thresholds, for example, vary with the number of people in the household. Although there is a debate within the expert community on what formula to use to account for differences in the number of family members, most approaches lead to the finding that a family of four to live requires twice as much income as a single person to live to live at the same standard of living.

As was noted earlier, over time there has been a dramatic shift in the number of households with just a single adult (76 percent of adults were in husband-wife couples in

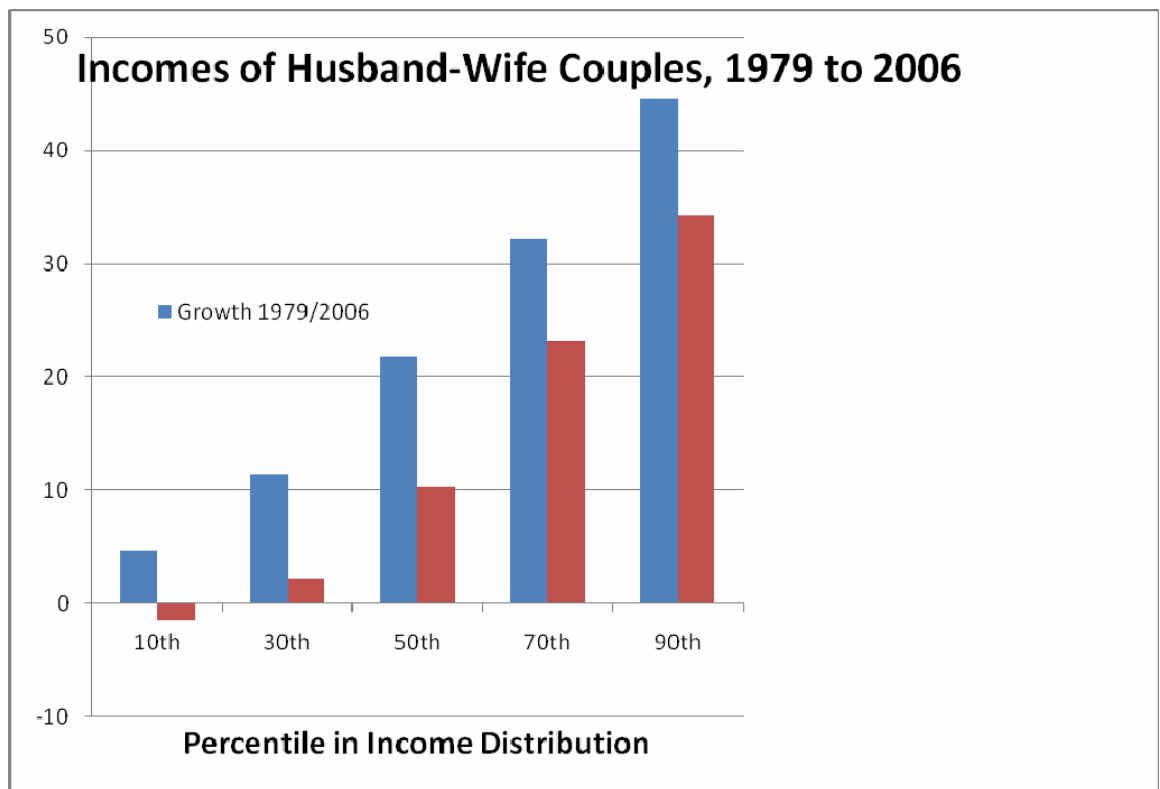
1979 versus less than 68 percent in 2007). Since the current average household size is 2.7 persons, it is possible to convert all incomes into equivalent incomes of a family of three. By this measure, the median income of prime-age adults is not \$61,000 but \$66,000.

Figure 8 shows a comparison of the distribution of incomes in 1979 and 2006 adjusted for size and inflation. The income cut-offs are somewhat arbitrary but reflect the divisions that are often presented in political polls: less than \$30,000= poor and near poor; \$30,-75,000 middle and lower middle class; \$75,-100,000=upper middle class; and greater than \$100,000=upper middle class and well-off. As is evident, the share of adults in the \$30,-\$75,000 range has declined significantly. In fact, all of the income categories have lost ground except that of the group with incomes of greater than \$100,000 which increased from 13 to near 28 percent of the population.



Another element in decline argument is that middle class Americans are working longer for the same standard of living. I've already shown that the standards of living have been rising over time. Is this because people are working more?

The “working more” in this statement is certainly true but is often not correctly described. Men’s working hours have hardly changed over time while all of the increase in working time is limited to women. So, the working-more-for-the-same-income claim only applies to the experiences of husband-wife couples.



As Figure 9 shows, the income gains since 1979 vary considerably by the income level of all prime-age husband-wife couples: from 5 percent for those at the 10 percentile of the income level to 44 percent for those at the 90th percentile. This is another indication of the rising inequality over these years. At the 50th percentile level, incomes

of couples grew in inflation-adjusted dollars by 22 percent (this excludes an extra 5 percentage points if the increase in benefits were included). If the wives had not increased their labor force participation, the gain would have been 10 percent. For those at the 10th and 30th percentile levels, the growth would have disappeared if the wives had not worked longer. Thus, couples are working more and getting higher incomes; for the top two-thirds of the income ladder, incomes would have risen even if the wives' hours had remained at their 1979 levels.

A related claim is that women are being forced to work because their families need the money. While certainly true in some cases, the rise in women's hours in the paid labor force has been an ongoing movement since the early 20th century and has occurred in other advanced industrial countries where male earnings have been rising. Further, the rise in hours has been greatest for women whose husbands have the highest earnings.

Consequently, it seems much more appropriate to argue that women are working more for the extra money and because it gives them much more autonomy over their own lives. Their extra time in the paid labor force has created tensions on how to manage family care needs, and "family friendly" work place policies are a worthy cause to support. But working mothers, even when their children are young, is a fact of modern life here and abroad.

Finally, some researchers argue that the official price deflators underestimate inflation as it applies to moderate-income people. They cite selected cases of higher than average price rises of medical insurance, college tuition, home ownership, and other items. Of course, they neglect to cite the lower than average price inflation of food, clothing, and other items. And they neglect to present a full analysis to back their claims.

In the end, this is the famous Lake Woebegone effect where everyone is above average. If the price indicator for moderate-income families is higher than average, then for whom is it lower the average? Since we also hear claims that the inflation is higher than average for poor people (limited to where they can shop) and for rich people (are price-insensitive), it would appear that inflation is higher than average for everyone.

The CPI is computed by literally hundreds of representatives going to stores around the country and noting specific prices of hundreds of commodities and services. Experts then adjust for any changes in quality to construct separate price indices for each category of good and service. An overall consumer price index is computed by combining the inflation rate of each commodity by its weight in final consumption based on data from the Consumer Expenditure Survey.

So there is an obvious methodology to determine if inflation rates vary by level of income by using product-weighting based on consumption baskets of the different households up and down the income ladder. When researchers at the Bureau of Labor Statistics did this, they found that inflation did not vary by income level.

Myth 3: Middle-class finances are out of whack—they are deeply in debt and unprepared for retirement.

There are a number of specific claims that all are exaggerations: credit card debt is high, total household debt is at unsustainable levels—bankruptcies are at record levels, the savings rate is zero, and baby boomers will have to continue to work and pass up retirement.

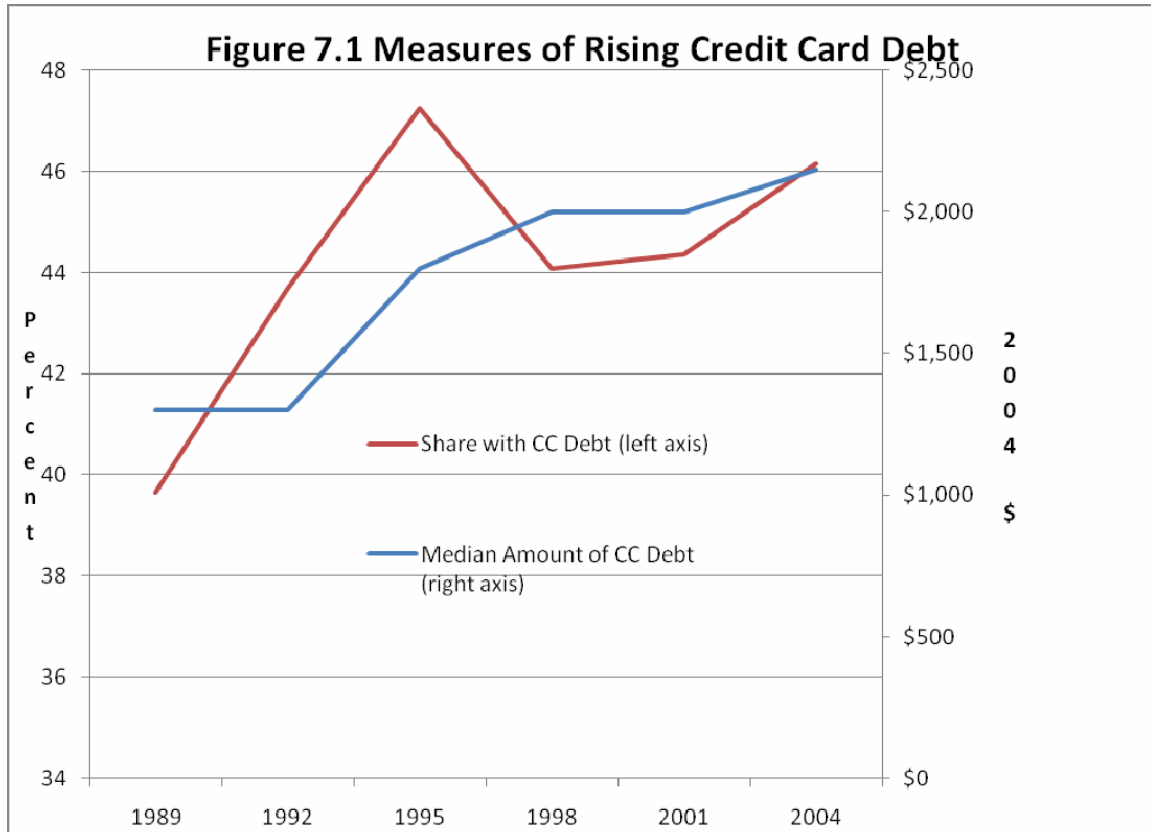
First, according to one commonly-cited report, the typical household has \$9,300 of credit card debt. This is a big number that would cause great pain for most families if it were anywhere near the real number.

According to the 2004 Survey of Consumer Finance (the SCF is conducted every three years and asks detailed questions about assets and debts), 54 percent of households had no credit card debt and the median debt of the 46 percent of households with debt was \$2,150. Counting those with no debt plus those with high debt, the average credit card debt per household was \$2,370. In addition, only 7.7 percent of households had credit card debts above \$9,300 and just over 30 percent of the population had credit card debt over \$1,000.

There is a good explanation of why these two numbers differ even though they are both derived from information from the Federal Reserve Board. The SCF number is based on asking people what their most recent credit card balance was after they made their last payment. The \$9,300 debt number comes from the Fed's monthly report on the economy and is derived from the average daily credit card balances as reported by banks.. At first glance, one would think that bank data are more reliable.

The problem is that they are measuring different things. The bank number is based on daily balances and includes the "float" of credit card purchases that will be paid at the month's end. By contrast, the SCF number is based on amount of debt after paying one's last bill. The other factor explaining the discrepancy is that bank reports include credit card balances of the self-employed and some small businesses. An unpublished study by Fed researcher showed how the two numbers were indeed consistent once these two factors were accounted for.

In terms of changes over time, the share with debt jumped from 1989 through 1995 and then stabilized. By contrast, the amount of debt (in 2004 real dollars) climbed from \$1,300 in 1989 to \$2,150 in 2004; most of the rise however occurred by 1998 when median debt levels were at \$2,000 (Figure 10).



Many commentators have cited a figure that shows that overall household debt has outstripped personal income. They make this statement as if it is self-evident that this is a negative omen. But, this is the wrong comparison to make; the usual comparisons are either debt to assets or debt payments to incomes.

In fact, assets have grown faster than debts over the last 20 years, and median net worth is up 35 percent for the entire population from 1989 through 2004. Furthermore,

the fastest wealth accumulation occurs late in life after their children have left home. For those aged 55 to 64, net worth has risen a healthy 73 percent (from \$144,000 in 1989 to \$248,000 in 2004).

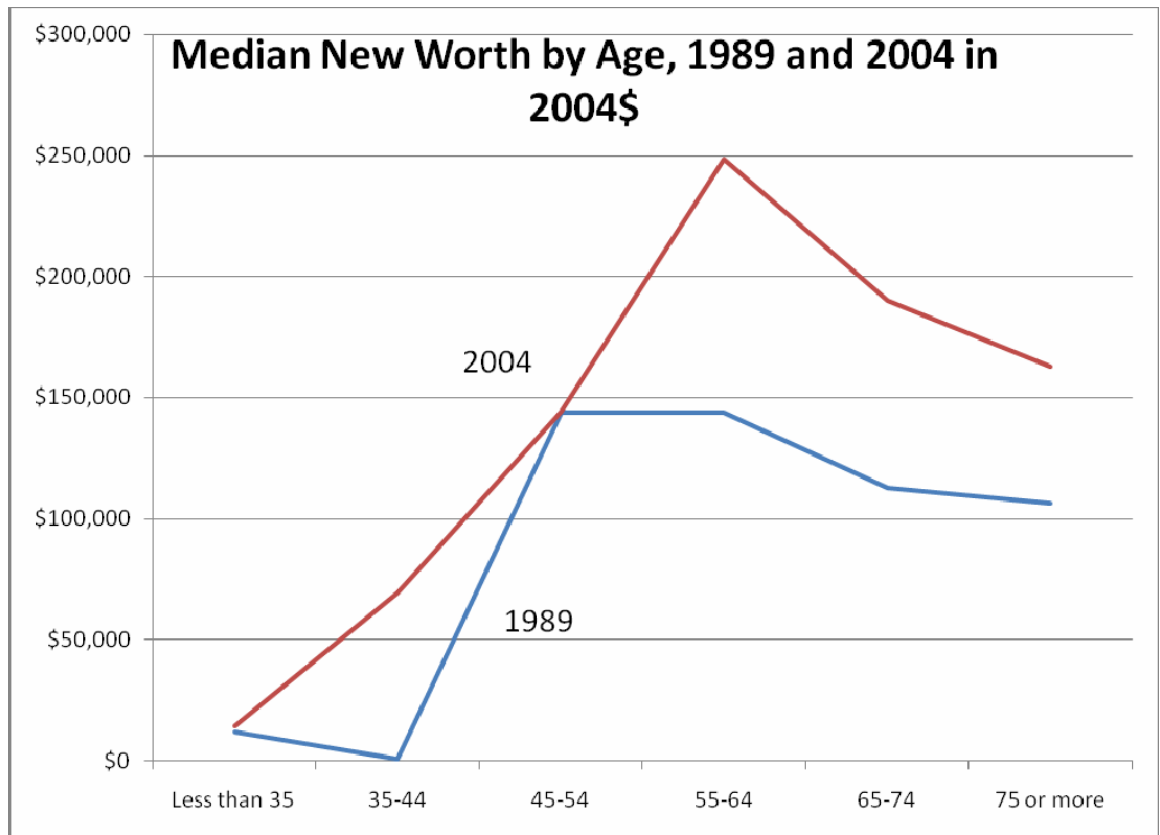
Further, because 79 percent of debt is mortgage debt, this debt is directly backed by a fairly-easily sold asset. Another 12 percent is for goods and services (including auto loans), and 3 percent is for educational loans.

The share of debt out of housing equity has risen leading some to point to this as another negative indicator. But even if housing prices drop 20 percent, the net worth of 55 to 64 year olds would still be 45 percent higher than in 1989. It would appear that as housing prices rose, people have reached their target savings level and cashed in some of the gains by taking out second mortgages and using home-based lines of credit. Of course, this decision may not look that good in retrospect with the pullback in housing prices.

Finally, housing debt is very unequally distributed as high-income people have expensive homes and big mortgages. A number that will surprise many is that *the median household debt from all sources including mortgages was \$22,000 in 2004*. This number is so low because 30 percent of households don't own their homes and another 25 percent of home owners have paid off their mortgages.

On the other side of the equation, there is a lot of confusion about asset accumulation. The connection of net worth with age is even stronger than the one of age and income presented above. As Figure 11 shows, net worth rises sharply through age 64 before declining for retirees. Some have noted that this rise is understated because the value of social security is not included. It is estimated that if one had to buy the income

stream of social security payments, the cost would be about \$250,000 for a median earner. From an economist point of view, this should be included in net worth and would raise the net worth of near retirees to \$500,000.



Another source of negative comments revolves around the preparedness for retirement. In particular, many people have cited the zero personal household savings statistic as proof that boomers are unprepared for retirement.

But this is another case of a number that is completely taken out of context. It is based on our national accounting system that treats retirement payments to current elderly people as deductions from overall savings. A 2006 study from the Center for Retirement Research carefully computed the savings rate of those under 65 over the last several decades. The authors find that private savings of the non-elderly declined slightly from

10 percent in 1980 to 8 percent in 2004. Finally, this savings rate excludes most unrealized capital gains (which are an important source of retirement preparation).

But haven't company pensions disappeared? Yes, there has been a shift from defined benefit (traditional pensions) to defined contribution 401K style plans. Two things should be noted however. First, companies have not walked away from their obligations to their workers as evidenced by the fact that the share of payrolls that companies contribute to employee pensions has remained constant over the last 25 years.

Second, traditional pensions were great for those who received them. Unfortunately, relatively few workers qualified for generous payouts because they required many years of employment with the same company. Because 80 percent of the benefits went to 20 percent of the workers under the old system, University of Michigan wealth researcher James Poterba and colleagues have shown that more people are better off under 401-K plans than they would be if everyone was in a company with just a traditional plan.

The result of these different trends in pensions, asset accumulation, and savings is that a variety of studies about the conditions of coming retirees predict that their incomes will be higher than those of current retirees. The reason for this is simple—upcoming retirees made more than previous retirees and many more women worked.

Whether this income will be “adequate” is a different matter. Some researchers describe adequacy in terms of being able to replace a high share of previous income and find that many young baby boomers may be in trouble down the line. However, by this measure, having \$30,000 a year in retirement is defined as adequate if one's pre-

retirement income was \$40,000, while having \$90,000 of retirement income is not adequate if your pre-retirement income was over \$150,000.

Other researchers use different approaches and find the vast majority of those approaching retirement to be well prepared (one study estimated that 81 percent of the near-elderly had enough savings). Under all circumstance, the data show that few people over 65 will face near poverty conditions in retirement or be forced to continue to work to maintain their incomes.

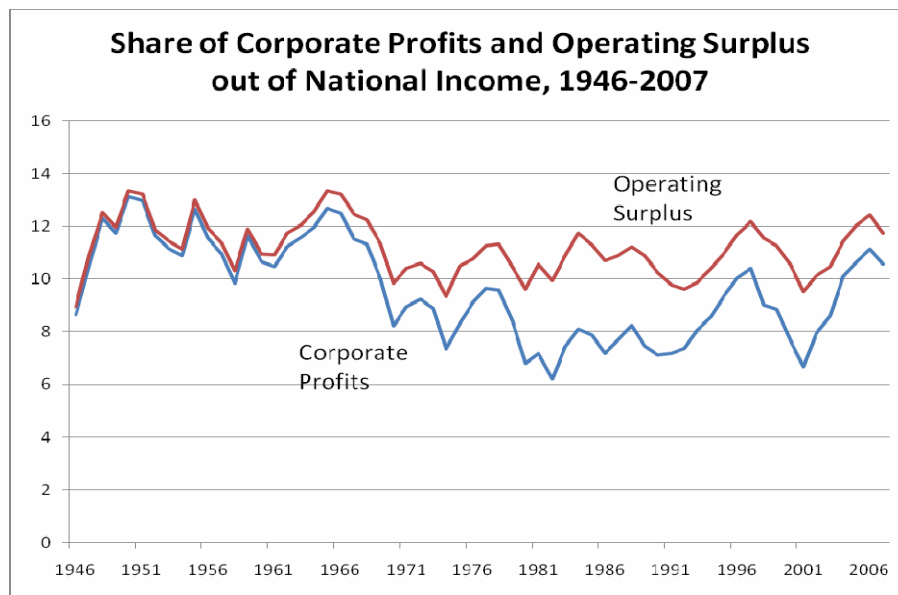
All of these numbers were based on conditions before the decline in home prices and meltdown in the subprime mortgage market. Even though wealth aggregates may show large growth, it is possible that a substantial chunk of the population has become overextended. Certainly the rise in bankruptcies can be seen as the foreshadowing of more problems to come.

But this is a case of a big rise starting from a very small base. According to the SCF, only 11 percent of 50 year-olds had ever declared bankruptcy. In terms of other indicators of financial distress—the percentage paying more than 40 percent of their income for debts and the percentage with at least one late payment over 60 days past due, the share of people facing these hardships has just inched up one or two percentage point since 1989. How the current housing slump will affect these numbers will be discussed briefly in the conclusion.

Myth 4: Corporations are making out like bandits: their profits are at record levels as they have walked away from their retirement and health obligations.

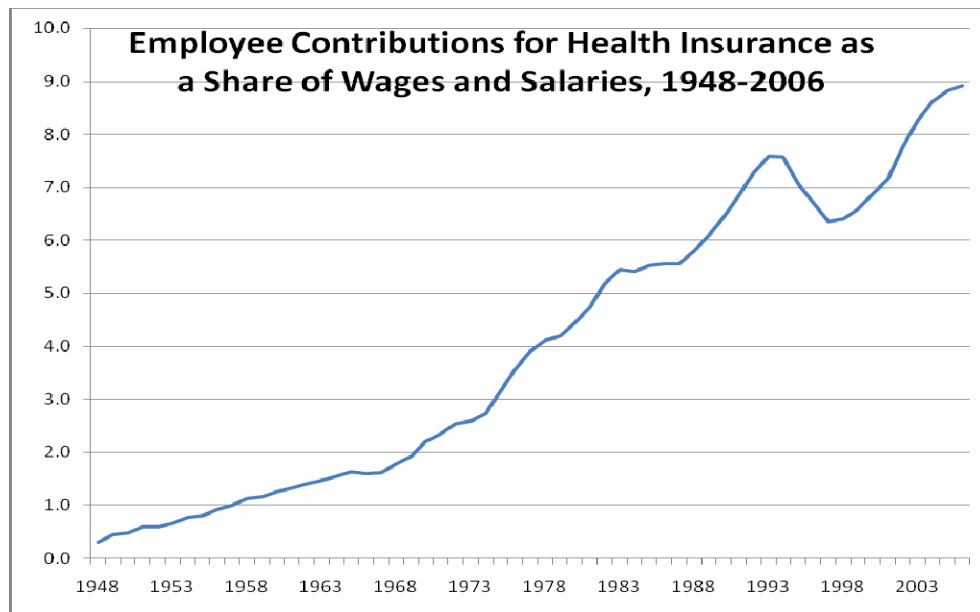
Any good story requires a good villain. For the gloom and doomers, it is the avarice of large corporations and CEOs with runaway compensation packages that are the cause of middle class declines. The impression that is given is that corporate profits have been rising consistently over the last several decades.

As Figure 11 shows, this is not the case. Instead corporate profits are mainly cyclical rising in the boom part of business cycle and declining during the bust. In 2005 and 2006, corporate profits were at a level that had not been reached in 40 years. But in 2001, the share of corporate profits was at one of its lowest points in the whole post-World War II period.



The other line on Figure 12 is operating surplus, which includes corporate profits and net interest. Companies have a choice of raising capital through selling stock or going into debt. Consequently, the operating surplus is a better indicator of the share of corporate output that is going to capital because it is not sensitive to the amount of debt-financing (which was used heavily in the 1980s). Although its movements mirror those of profits alone, the share of operating surplus is a bit less volatile.

In terms of benefits, companies are paying a higher share than ever before. While their contributions for retirement have remained mostly fixed as a share of wages and salaries, their contributions for health insurance have sky rocketed (Figure 13). It was not until 1957, that employers were contribution one percent of wages to health insurance. Even in 1969, the share was under 2 percent. Is it any wonder that companies were lax in offering health benefits such as promises for retiree benefits in place of wage increases?



Today, health insurance is much more expensive and represents nearly 9 percent of wages. These increased costs have direct effects on workers, and the notion that companies can just eat the extra expenses is just ridiculous. Companies are indeed requiring more copays and higher deductibles resulting in rising costs for workers. But, because health care costs have grown so much, this represents sharing the increased cost. Even with these extra worker expenses, company payments have risen to levels that affect how much cash that they have available for wages and salaries.

In fact, a Department of Health and Human Services study shows that the share of total national health care spending that consumers pay is down significantly while the

share that companies pay has remained constant. Taking up the slack is an increasing public share.

As has often been repeated, we are the only country that has this linkage of health insurance coverage to employment. But, as Jacob Hacker shows in *The Divided Welfare*, our many checks and balances end up being a large number of road blocks that make change difficult. Furthermore, since the majority of workers have reasonable health care insurance today, there is a natural reluctance to support a major overhaul that may leave them with worse coverage.

Consequently, we have created a system that has many holes. When health care costs were relatively small as a share of an economy, it was possible to have a lot of uncompensated care being subsidized by higher prices charged to paying customers. As costs have risen, companies and government have been much more aggressive in negotiating their fees and in some cases ending health insurance benefit.

But, the decline in worker coverage has been concentrated in small firms and the self-employed; the share of large companies (those with more than 200 employees) offering insurance to their workers has remained constant at 98-99 percent. In addition, the share of premiums that companies pay has remained constant over the last 15 years.

Myth 5: Increasing globalization has led to job losses and lower wages. We've lost our manufacturing base and with the rise of China and India, as many as one-third of all jobs are subject to outsourcing.

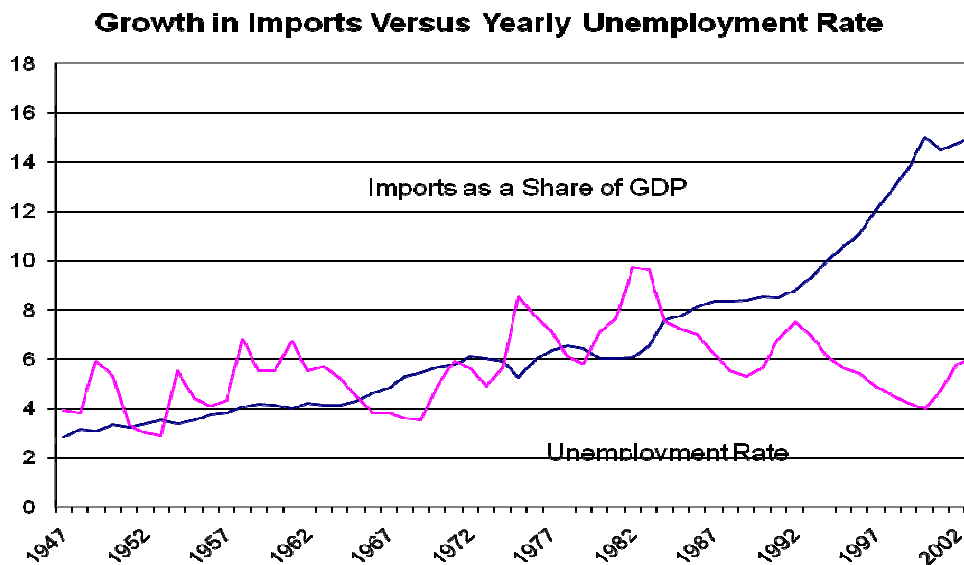
This is a big issue that has generated a lot of heat over the last 25 years. In general, economists have taken the view that an open economy is good and that trade

should be as open as possible. This has changed over the last years as a number of very prominent economists have begun to talk about the need for new approaches given the size of India and China.

It should be noted that this is not the first time that commentators have claimed that our economy would not generate enough jobs in the future. In the 1960s, there was great concern that automation would lead to a permanent class of unemployed. The refrain then was: “who would buy the products if firms could make more with fewer workers?” In late 1980s, it was common to prophesize the coming end to the American economic dominance. For example, Harvard economist Benjamin Friedman predicted a *Day of Reckoning* because of our large trade and capital deficits. In addition, there were a slew of books marveling at the dynamism of Japan and predicting that it would be the world economic leader in the near future. MIT economist Lester Thurow wrote in *The Future of Capitalism* that a combined Europe would be eating America’s lunch economically by the first decade of the new century. And, in the 1992 election, Ross Perot made the vivid claim of the great sucking sound of jobs leaving the country if NAFTA passed.

The economic history in this country and in every advanced industrial country has shown employment rising in the face of technological change and rising international trade. Instead of job losses, the years of the Clinton presidency were characterized by large employment gains even though NAFTA passed in 1993. Further, there have been a number of examples of the successful incorporation of a large influx of new workers into the labor force—e.g., the increasing labor force participation of women, successive waves of immigrants, and returning veterans of foreign wars.

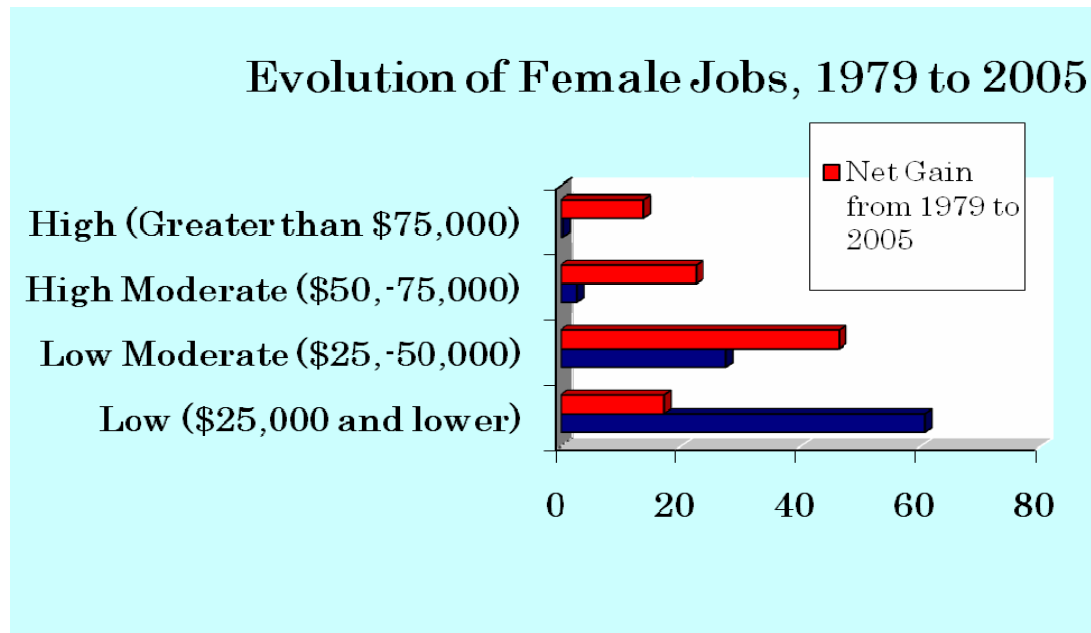
As Figure 13 shows, rising trade has not been associated with rising unemployment. Even if one tried to use lags or change the approach to changes in employment versus changes in imports or changes in the trade deficit, one cannot find that trade has had a negative effect on total employment in America over the last 30 years.



If total employment is not affected by trade, a more plausible claim is that wages are driven down by added contact with low-wage countries. In the past, most of our imports were from other industrialized countries or consisted of raw materials, especially petroleum. Consequently, the effect of American wages could not be that large.

One way to check to see how trade has affected earnings is to look at the new 50 million jobs that were created during the recent era of rising imports since 1979. The distribution of earnings of new jobs can be compared with the earnings of the 80 million jobs that existed 1979. Figures 13 and 14 use a simple division of employment in terms

of four categories of yearly earnings: low earnings (less than \$25,000), low-moderate earnings (\$25,-50,000), moderate-high (\$50,-75,000), high (greater than \$75,000).

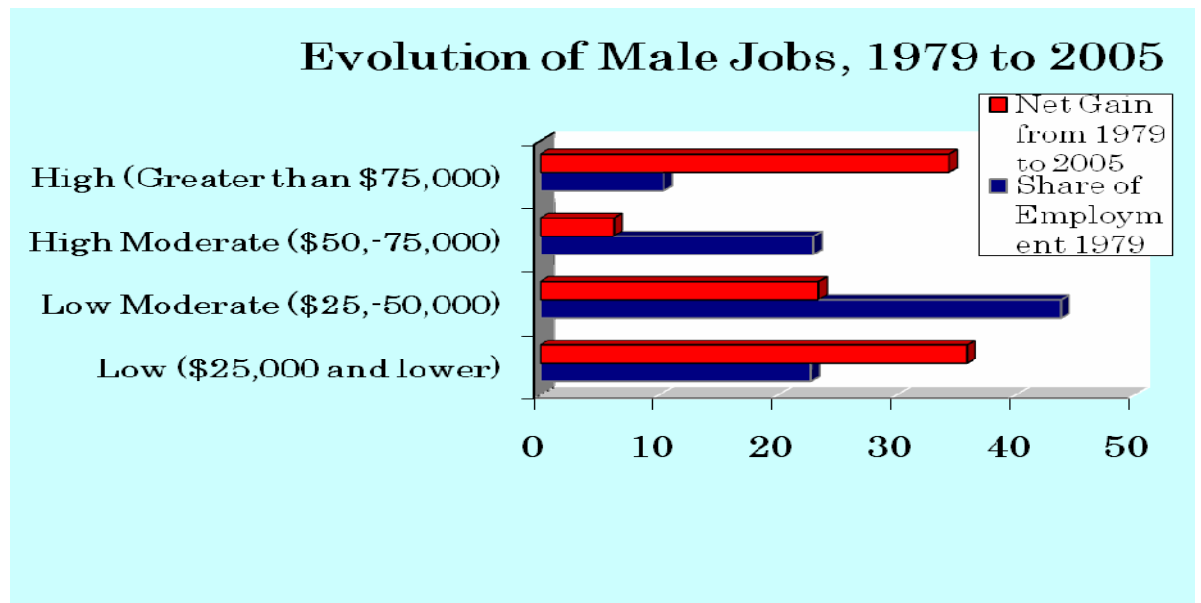


During these years, women experienced a sharp increase in middle-class employment during this period. There was an across the board improvement for all women workers, and the median pay adjusted for inflation rose by 54 percent. As recently as 28 years ago, more than 60 percent of women workers were in the lowest pay category, and only 3 percent earned more than \$50,000 a year. By contrast, today more than 36 percent of new jobs for women pay more than \$50,000. This represents an economic and social shift of historic proportions, though it must be noted that American women still lag their male counterparts in pay for comparable work.

The men's experiences were much different. The growth of the share of high-pay jobs is particularly large: only 10 percent of 1979 male workers earned more than \$75,000, but 34 percent of net new jobs fall in that category. At the bottom end of the

labor force, 23 percent of the jobs were in the lowest pay category versus 36 percent of the net new jobs created. By contrast, moderate-paying jobs (between \$25,000 and \$75,000) represented 67 percent of male employment in 1979 but only 30 percent of the new jobs created since 1979.

So during the period when trade was growing, there were two positive labor market shifts and one negative one. For women, the story is one of increasing pay for traditionally female-held jobs and an opening up of high-paying managerial and professional jobs that had previously been denied to them. College-educated men also benefited from the increasing pool of managerial and professional jobs, but for those with just a high school diploma or less, high paying blue collar jobs dried up and they were forced into lower paying positions.



Thus, it is certainly true that individual workers and communities have been hard hit by economic dislocations over the past several decades. However, state-wide data on employment and per capita income tell a different story. In every state since the passage of NAFTA, including all those in the mid-west, employment grew by at least 14% and

per capita incomes grew by 15 percent. These figures were only slightly lower than the comparable national growth rates of 20 and 21 percent. So even at the state level, there are no examples of trade stopping economic growth.

This is a mixed but more positive than negative picture. At a minimum, these numbers do not support the claim that trade led to a worsening of job prospects for most American workers. Whatever negative effects trade has had, they are more than outweighed by changes elsewhere in the economy. In fact, most economists who have tried to look at the causes of rising male income inequality have estimated that trade is only responsible for 10 to 20 percent of the change. While trade certainly played some role in the loss of good jobs for high school educated men in the US, the economy created a steady stream of new jobs, many of which were higher paying than the ones lost to trade.

Others argue that the rise of the internet (which makes distance and communication less of a barrier) and the size of China and India represent unique challenges that will be harder to surmount. Predicting the future is always a dicey proposition because change is so unpredictable. But how much evidence do we need to debunk the trade-unemployment theory?

Conceptually, the reason that the effect of trade is misunderstood is because the full context of international transactions is seldom discussed. While trade in goods and services can be out of balance, the flow of dollars in and out of country cannot. Our trade deficit is offset by the inflow of foreign investments in the form of building plants and subsidies here (e.g., Japanese auto plants in the US), portfolio investments in stocks and bonds, or purchases of US government bonds. This reverse monetary flow generates

economic activity and employment directly (when foreign subsidiaries open here) and indirectly (by flowing through our financial system and ultimately providing loans and capital for new investment).

Ultimately the size of our national economy is determined by the skills of our work force, the technology that firms use, and open product and capital markets. While history has shown that tight monetary policy can destabilize an economy, central banks have learned this lesson and provide enough liquidity to ensure high levels of employment. It is no accident that business cycles in America have changed dramatically. From 1854 to 1919, the economy was in the contraction stage of the cycle over 40 percent of the time. By contrast, recent contractions have been short while expansions have persisted for many years.

International trade is unlikely to change this experience because it is an exchange of goods for dollars and dollars for financial instruments. China and India are underdeveloped countries that have relatively small numbers of skilled workers who are often used to run the government and to meet domestic needs. After a scare story appeared that radiological services being outsourced to India, two researchers from MIT investigated the issue and could find only 15 Indian radiologists who had ever read American scans. After carefully analyzing the industry, they concluded that there was little chance that this service could be outsourced.

If China can produce everything to meet worldwide demands for lots of products, what is the world going to give China in return? And why would they continue to pay their workers so little to produce cheap goods for others? China produces relatively low-

end products because that is their comparative advantage and that is the development model that they have chosen.

Furthermore, the label “made in China” can be a bit deceptive: between one-third to one-half of the price of these foreign goods go to American companies and workers. The retailers, wholesalers, designers, insurers, and delivery companies are all predominately American.

Finally, Robert Lawrence of the Kennedy School at Harvard has done a careful analysis of changing earnings over the last ten years and found that the earnings of low-skilled workers did not change much relative to that of other workers. He hypothesized that trade may have already run its course in affecting American wages. The current rise in trade with China seems to be associated with displacing our trade with other less developed countries rather than increasing the share of imports in the economy.

The Challenges Ahead

The common wisdom among many pundits is that the people’s tough economic position is reflected in public opinion polling about the economy. The problem here is that there are so many polls that the answers are all over the place. The relevant answers can be grouped into three findings: a majority of Americans think that “economy is headed in the wrong direction;” a reasonable high percent have general worries/a smaller percent have specific worries (e.g., being laid off, or not being able to pay off credit card debt); and large majority of people have very positive feelings about their own conditions.

Figure . presents data from a recent Pew that asked people a series of questions about how satisfied they are about different aspects of their life. Remarkably, the answers do not vary with age, indicating that there are no specific generational effects (the purpose of the survey was to see if young people were more negative than older generations).

Results from Pew Poll January 2007

	18-25	26-40	41-60	61+
Quality of life	%	%	%	%
Excellent/Good	84	81	83	82
Only fair/Poor	14	18	17	16
<i>How are things in your life?</i>				
Very happy	30	34	36	40
Pretty happy	63	52	51	42
Not too happy	6	13	11	16
<i>Percent satisfied with.</i>				
Family life	93	93	90	88
Housing	82	87	88	93
Free time	81	79	78	78
Standard of living	78	80	75	83
Job	82	87	87	
Income	66	71	69	74

Republicans made inroads with white working class Americans (“Reagan Democrats”) by pillorying Democrats for being “liberal elitists.” Listen to any of the conservative talk show hosts on radio and television and you will hear this theme repeated over and over again. Yet, to this day, many liberals have not understood how their efforts to stand up for economic justice can be seen as “elitism.”

Paradoxically, liberals’ continuing story of widespread economic plight may have unintended consequences. Reagan Democrats seemed to have decided that liberals care more about the poor (especially the poor of color) than they do about them. While other “middle class” concerns about gay rights, abortion, gun control, and the environment

widen the cultural gap, many moderate income Whites worry about rising taxes and don't think that governmental regulations and policies benefit them a lot. And for many the story about economic plight is directly connected to doing something about it –i.e., new regulations, more public spending, and higher taxes.

To say that the middle class is not vanishing or declining is not to say that we have no problems. The Bush administration policies of rewarding the super-rich have yielded very mediocre results. The claim that his tax cuts have led to our current “prosperity” rings very hollow given that living standards have stagnated for most Americans during the first five years of this recovery. The current economic expansion is, in fact, less robust than the typical post-World War II expansion.

It is no secret what key issues need to be addressed. First, we have a health care system that is very expensive, does not cover everyone, and often refuses to pay for medical procedures for those who are covered. Because of its expense and lack of portability, this system is forcing businesses and individuals to make decisions solely on the basis of health care expenses.

Second, the real losers in the last several decades have been the bottom twenty percent of the population. While people express willingness to pay higher taxes to help the poor, the high concentration of non-whites among those with persistent low incomes is more tolerated because many people consider these people to be “undeserving victims.” Another reason for the lack of political will to help the poor is people's lack of confidence that government programs really work.

Third, we live in an era of rapid change. Although the overall employment rate remains high, there is a high level of churning even among relative experienced

employees. Many workers understand that there are new rules and expect to change careers over their lifetimes. Public policies can play a bigger role in aiding workers through these often difficult transitions. Further, public policy has a major role to play in helping young people develop skills and attend post-secondary education.

Fourth, there are many family responsibilities that don't go away because both spouses are working. In a paper the Institute for Women's Policy Research, I showed that half of prime-age women interrupted their careers for at least one year over a 15 years period to deal with family responsibilities. This is part of a self-reinforcing pattern in which: employees pay women less because they fear that they will quit; couples lose less income if the wife rather than the husband takes time off; and distinct women's jobs are created that are suited to periodic absences. As a result, the long-run gender gap is much greater than the commonly cited number that women earn just over three-quarters of the salaries of their male counterparts (based on surveys of full-time, full-year workers in a single year).

Fifth, we are wasting a lot of public resources on wars, unproductive earmarks and unnecessary weapons programs. These big ticket items have fewer positive spill-over effects than if we invested in infrastructure, research, and development of new technologies. Given the size of government spending, we have a public industrial policy; it would be better if we used our dollars more wisely. Instead of a bridge to nowhere in Alaska, we could be spending more in infrastructure repairs to avoid tragedies like the Minnesota bridge collapse.

The final question to address is whether the current housing slump and probable recession changes this story. If the experiences of the last 25 years are any guide, this

recession will be relatively short (2-3 quarters), have unemployment not climb above 6.5 percent, and have a GDP decline of less than 2 percent. An experience like this will have few long term effects.

Even during economic prosperity, our economy is very fluid and one-third of households have lower incomes over the course of a year and about 12 percent of workers will experience at least some time unemployed. During recessions, the share with lower incomes climbs to about 45 percent and the share experiencing unemployment rises to 18 percent.

The trouble in the housing market affects few people directly and a lot of people indirectly. The share of home owners had fluctuating in a narrow range between 63 and 65 from 1975 to 1995. At the urging of the Clinton administration, financial institutions developed new products to help marginally-qualified buyers get a mortgage. By 2005, the ownership rate stood at 69 percent. There will be a lot of foreclosures, but it is very unlikely that the home ownership rate will be below 66 percent by 2009.

Since few people sell their homes during the course of a year, the decline in home prices only has an indirect effect on current behavior. Economists have estimate that the consumers decrease the spending by about 2-5 cents for each dollar of decline in net worth (“the wealth effect”). So, people will talk a lot about the diminished value of their homes, but the immediate effects will be small.

Consequently, unless there is a radical break with past economic patterns, the strengths of world economy will likely see us through a brief downturn and lead to returned growth by 2009. The pessimists who are predicting much worse times ahead are likely to be proven wrong again.

Politicians who talk about the strong fundamentals of the American economy are likely to receive a poor reception. The public wants someone who will project empathy and a commitment for positive action. But politicians who are seen as permanently expanding the social safety net by a lot of money (Kuttner has talked about a \$1 trillion expansion) are likely to get a negative reaction because of the worry of higher taxes. Surprisingly, there is little support for raising taxes on the rich by a significant amount; and there is less support for raising taxes for these with comfortable but not high incomes.

The bottom line is that moderation is the preferred path. This is true because the middle class has not been in a free fall and believe that the benefits of “big government” are smaller than the costs.