United States Senate
Committee on Health, Education, Labor and Pensions

Hearing on the Endangered Middle Class:
Is the American Dream Slipping Out of Reach for American Families?

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Mr. Chairman and members of the Committee, The jobs and wage crisis of the American middle class began decades before the Great Recession. It was hidden from view by households borrowing against their homes and, before that, by millions of women entering the paid work force to prop up declining male wages. The crisis contributed to the severity of the Great Recession and is a principal reason why America is having such difficulty emerging from it.

If the American dream is to restored, this long-term crisis must be understood, and policies adopted to reverse it.

Let me explain.[1]

THE GREAT PROSPERITY: 1947-1977

How did we go from the Great Depression to thirty years of Great Prosperity? And from there, to thirty years of stagnant incomes and widening inequality, culminating in the Great Recession? And from the Great Recession into such an anemic recovery?

During three decades from 1947 to 1977, the nation implemented what might be called a basic bargain with American workers. Employers paid them enough to buy what they produced. Mass production and mass consumption proved perfect complements. Almost everyone who wanted a job could find one with good wages, or at least wages that were trending upward. During these three decades everyone's wages grew – not just those at or near the top.

Government enforced the basic bargain in several ways. It used Keynesian policy to achieve nearly full employment. It gave ordinary workers more bargaining power. It provided social insurance. And it expanded public investment. Consequently, the portion of total income that went to the middle class grew while the portion going to the top declined. But this was no zero-sum game. As the economy grew almost everyone came out ahead, including those at the top.

The pay of workers in the bottom fifth grew 116 percent over these years – faster than the pay of those in the top fifth (which rose 99 percent), and in the top five percent (86 percent). By the late 1940s, the nation was "more than halfway to perfect equality," as the National Bureau of Economic Research wryly observed.

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[1] Sources for the following can be found in my most recent book, Aftershock: The Next Economy and America's Future (Alfred A. Knopf, 2010, Vintage paperback, 2011).

Productivity also grew quickly, defying the predictions of those who said wide inequality was necessary for rapid growth. Labor productivity – average output per hour worked – doubled. So did median incomes. Expressed in 2007 dollars, the typical family's income rose from about $25,000 to $55,000. The basic bargain was cinched.

The middle class had the means to buy, and their buying created new jobs. As the economy grew, the national debt shrank as a percentage of it. "We're all Keynesians now," Richard Nixon purportedly proclaimed in 1971.[2] By then even Nixon had accepted government's ability to keep people employed when consumers and businesses did not spend enough, by filling the breach.

The Great Prosperity also marked the culmination of a reorganization of work that had begun during the Depression. Employers were required by law to provide extra pay – time-and-a-half – for work stretching beyond forty hours a week. This created an incentive for employers to hire additional workers when demand picked up. Employers also were required to pay a minimum wage, which improved the pay of workers near the bottom as demand picked up. When workers were laid off, usually during an economic downturn, government provided them with unemployment benefits, usually lasting until the economy recovered and they were rehired. Not only did this tide families over but it kept them buying goods and services – an "automatic stabilizer" for the economy in downturns.

Perhaps most significantly, government increased the bargaining leverage of ordinary workers. They were guaranteed the right to join labor unions, with which employers had to bargain in good faith. By the mid 1950s more than a third of all America workers in the private sector were unionized. And the unions demanded and received a fair slice of the American pie. Non-unionized companies, fearing their workers would otherwise want a union, offered similar deals. UAW president Walter Reuther, among others, explicitly invoked the basic bargain: "Unless we get a more realistic distribution of America's wealth, we won't get enough to keep this machinery going." As employers boosted wages, the higher wages did indeed keep the machinery going by giving average workers more money to buy what they produced.

The result was that as corporations did better, so did all their employees. A college sociology textbook of 1956 entitled <u>The American Class Structure</u> noted that "[t]he trend of income distribution has been toward a reduction in inequality. Owners have been receiving a smaller share relative to employees; professionals and clerks have been losing some of their advantages over operatives and laborers." [3] Americans also enjoyed economic security against the risks of economic life – not only unemployment benefits but also, through Social Security, insurance against disability, loss of a major breadwinner, workplace injury, and inability to save enough for retirement. In 1965 came health insurance for the elderly and the poor (Medicare and

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[2] In fact, Nixon didn't actually say this although he is widely credited with it. He said "I am now a Keynesian in economics."

[3] J. Kahl, <u>The American Class Structure</u> (New York: Holt, Rinehart, 1956), pp. 109-110.

Medicaid). Economic security proved the handmaiden of prosperity. In requiring Americans to share the costs of adversity it enabled them to share the benefits of peace of mind. And by offering peace of mind, it freed them to consume the fruits of their labors.

The government sponsored the dreams of American families to own their own home by providing low-cost mortgages and interest deductions on mortgage payments. In many sections of the country government subsidized electricity and water to make such homes habitable. And it built the roads and freeways that connected the homes with major commercial centers. The interstate highway system – 40,000 miles of straight four-lane freeways to replace the old two-lane federal roads that meandered through cities and towns – became the single most ambitious public works program in American history. Begun under Dwight Eisenhower and justified in the halls of Congress as a means of speeding munitions across the nation in the event of war, it did much more than that -- generating sprawling suburbs and shopping malls, boosting auto sales, vastly enlarging the construction industry, creating an entire trucking industry, and radically reducing the cost of transporting and distributing goods across America.

Government also widened access to higher education. The GI Bill paid college costs for those who returned form war. The expansion of public universities – whose tuitions averaged about 4 percent of median family incomes during the Great Prosperity in contrast to the 20 percent then demanded by private universities – made higher education affordable to the American middle class. Consequently, college enrollments surged. By 1970, seventy percent of the nation's four-year students were in public universities and colleges. The federal government, especially the Defense Department, also underwrote a growing portion of university research, especially in the sciences.

Notwithstanding all this, the nation also found the time and money in these years to rebuild Western Europe and Japan – spending billions of dollars to restore foreign factories, roads, railways, and schools. The effort proved an astounding success. The years 1945 to 1970 witnessed the most dramatic and widely shared economic growth in the history of the world, which contributed to America's Great Prosperity. In helping restore the world's leading economies and thus keep communism at bay, the new global system of trade and assistance created vast new opportunities for American corporations – far richer, larger, and more technologically advanced than any other – to expand and prosper.

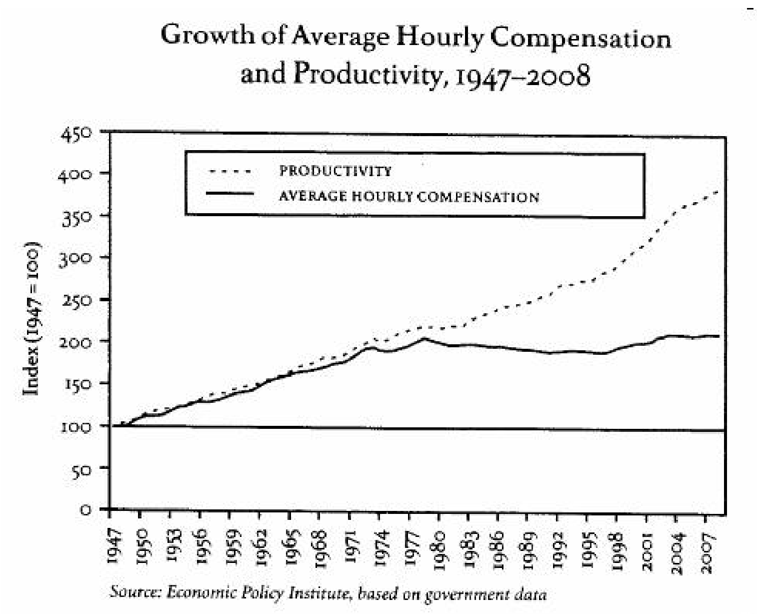
Government paid for all of this with tax revenues from an expanding middle class with rising incomes. Revenues were also boosted by those at the top of the income ladder whose marginal taxes were far higher. The top marginal income tax rate during World War II was over 68 percent. In the 1950s, under Dwight Eisenhower, whom few would call a radical, it rose to 91 percent. In the 1960s and 1970s the highest marginal rate was around 70 percent. Even after exploiting all possible deductions and credits, the typical high-income taxpayer paid a marginal federal tax of over 50 percent. But contrary to what conservative commentators had predicted, the high tax rates did not reduce economic growth. To the contrary, they enabled the nation to expand middle-class prosperity and fuel growth.

Support for the government's new role was founded in the crucible of the Great Depression and World War II, in whose wake Americans shared a larger sense of common purpose. We were all in it together, rising or falling together, connected to one another in ways we had barely noticed before the Depression. None of us could prosper unless prosperity was widely shared. The historian James Truslow Adams coined the phrase "the American dream," and defined it as "a better, richer, and happier life for all our citizens of every rank."

America of the era still harbored vast inequalities, of course. But the nation responded to the reality of unequal opportunity with court decisions and legislation designed to overcome racial and gender discrimination, and with public investments in education intended to enable many more of our young to get ahead regardless of circumstance. The Great Prosperity significantly expanded the American middle class. And it proved that widely-shared income gains were not incompatible with widespread economic growth; they were, in fact, essential to it.

THE MIDDLE CLASS SQUEEZE, 1977-2007

During the Great Prosperity of 1947-1977, the basic bargain had ensured that the pay of American workers coincided with their output. In effect, the vast middle class received an increasing share of the benefits of economic growth. But after that point, the two lines began to diverge: Output per hour – a measure of productivity – continued to rise. But real hourly compensation was left in the dust, as you can see below.



It's easy to blame "globalization" for the stagnation of middle incomes, but technological advances has played as much if not a greater role. Factories remaining in the United States have shed workers as they automated. So has the service sector. Remember bank tellers? Telephone operators? The fleets of airline workers behind counters who issued tickets? These and millions of other jobs were lost to automation. Any routine job that requires the same steps to be performed over and over can potentially be done anywhere in the world by someone working for a fraction of an American wage *or* by automated technology. By the late 1970s, all such jobs were on the endangered species list. By now they are nearly extinct.

But contrary to popular mythology, trade and technology have not reduced the overall number of American jobs. Their more profound effect has been on pay. Rather than be out of work, most Americans have quietly settled for lower real wages, or wages that have risen more slowly than the overall growth of the economy per person. Although unemployment following the Great Recession remains high, jobs are slowly returning. But in order to get them, many workers have to accept lower pay than before.

Starting more than three decades ago, trade and technology began driving a wedge between the earnings of people at the top and everyone else. The pay of well-connected graduates of prestigious colleges and MBA programs – the so-called "talent" who reached the pinnacles of power in executives suites and on Wall Street – has soared. But the pay and benefits of most other workers has either flattened or dropped. And the ensuing division has also made most middle-class American families less economically secure.

The real puzzle is why so little was done in response to these forces conferring an increasing share of economic growth on a small group at the top and leaving most other Americans behind. With the gains from that growth, the nation could, for example, have expanded our educational system to encompass early-childhood education and have better equipped our public schools. It could have supported affordable public universities, created more job retraining, and better and more extensive public transportation.

In addition, the nation could have given employees more bargaining power to get higher wages, especially in industries sheltered from global competition and requiring personal service. We could have enlarged safety nets to compensate for increasing anxieties about job loss – unemployment insurance covering part-time work, wage insurance if pay dropped, transition assistance to move to new jobs in new locations, insurance for entire communities that lose a major employer so they can lure other employers. We could have financed Medicare for all. Regulators could have prohibited big, profitable companies from laying off a large number of workers all at once; required them to pay severance – say, a year of wages – to anyone they let go; and train them for new jobs. The minimum wage could have been linked to inflation.

We could have raised taxes on the rich and cut them for poorer Americans – including payroll taxes, capital-gains taxes, and estate taxes. America could have attacked overseas tax havens by threatening loss of U.S. citizenship to anyone who keeps their money abroad in order to escape U.S. taxes. We could have expanded public investments in research and development, and required any corporation that commercialized such investments to create the resulting new jobs in the United States. And we could have insisted that foreign nations we trade with establish a minimum wage that's half their countries' median wage. That way, all citizens could share in gains from trade, setting the stage for the creation of a new middle class that in turn could participate more fully in the global economy.

In these and many other ways, government could have enforced the basic bargain. But it did the opposite. Starting in the late 1970s, and with increasing fervor over the next three decades, it deregulated and privatized. It slashed public goods and investments – whacking school budgets, increasing the cost of public higher education, reducing job training, cutting public transportation, and allowing bridges, ports, and highways to corrode. It shredded safety nets – reducing aid to jobless families with children, tightening eligibility for food stamps, and cutting unemployment insurance so much that by 2007 only 40 percent of the unemployed were covered. It halved the top income tax rate from the range of 70 to 90 percent that prevailed during the Great Prosperity to 28 to 35 percent; allowed many of the nation's rich to treat their income as capital gains subject to no more than 15 percent tax; and shrunk inheritance taxes that affected only the top-most 1.5 percent of earners. Yet at the same time, America boosted sales and payroll taxes, both of which took a bigger chunk out of the pay the middle class and the poor than of the well off.

We allowed companies to break the basic bargain with impunity – slashing jobs and wages, cutting benefits, and shifting risks to employees (from you-can-count-on-it pensions to do-it-yourself 401 (k)s, from good health coverage to soaring premiums and deductibles). Companies were allowed to bust unions and threaten employees who tried to organize (by 2010, fewer than 8 percent of private-sector workers were unionized). And nothing impeded CEO salaries from skyrocketing to 300 times that of the average worker (from 30 times during the Great Prosperity), while the pay of financial executives and traders rose into the stratosphere. We stood by as big American companies became global companies with no more loyalty or connection to the United States than a G.P.S. satellite. Now, firms such as Caterpillar, GE, and Oracle and other so-called "American" firms are selling more outside the United States than in it, and are creating more jobs outside the U.S. as well.

Most telling of all, Washington deregulated Wall Street while insuring it against major losses. In so doing it allowed finance – which until then had been the servant of American industry – to become its master, demanding short-term profits over long-term growth, and raking in an ever-larger portion of the nation's profits. Between 1997 and 2007, finance became the fastest-growing part of the U.S. economy. Two-thirds of the growth in the Gross National Product was attributable to the gains of financial executives, traders, and specialists. By 2007, financial companies accounted for over forty percent of American corporate profits and almost as great a percentage of pay, up from 10 percent during the Great Prosperity. Henry Ford's legacy was a company that no longer made its money off selling cars; in 2007, Ford's financial division accounted for almost half of the company's earnings.

As the financial economy took over the real economy, Treasury and Fed officials grew in importance. The expectations of bond traders dominated public policy. And the stock market became the measure of the economy's success – just as it had before the Great Depression.

We in the Clinton administration tried our best to reverse course. We raised the minimum wage and guaranteed workers time off from their jobs for family or medical emergencies. We tried for universal health care. We offered students from poor families access to college, and expanded a refundable tax credit for low-income workers. We tied executive compensation to company performance. All these were helpful but frustratingly small in light of the larger backward lunge.

Federal Reserve Chief Alan Greenspan insisted that President Clinton cut the federal budget deficit rather than deliver on his more ambitious campaign promises, and Greenspan reciprocated by reducing interest rates. This ushered in a strong recovery. By the late 1990s the economy was growing so fast and unemployment was so low that middle-class wages started to rise a bit for the first time in two decades. But because the rise was propelled mainly by an upturn in the business cycle rather than any enduring change in the structure of the economy, it turned out to be temporary. Once the economy cooled, family incomes were barely higher than where they had been before.

WHY DIDN'T WE ACT?

Why didn't America counteract the market forces that were shrinking the middle class's share of the American pie? Answers to these questions offer clues about when and how the pendulum will swing in the other direction.

Some argue there was simply no need for government intervention. The economy did better on its own, without so much government and with lower taxes on the rich. They point to the great expansion of the 1980s and the long recovery of the 1990s, and to the wildly exuberant bull market of the era. They blame the Great Recession on Alan Greenspan, who by 2002 reduced interest rates so low that too many people got loans who had no business getting them. And, of course, they blame those who did the borrowing.

This argument is bunk. It equates the stock market with the economy, and turns a blind eye to the revocation of the basic bargain – a revocation resulting in stagnating wages, increased insecurity, and widening inequality. The argument refuses to acknowledge the consequences for an economy when the middle class lacks the means to buy what it produces.

Others see the reversal of the pendulum as the inevitable result of declining confidence in government. After all, they say, the era began with the Vietnam War and continued with the Watergate scandal. It culminated in the tax revolts double-digit inflation of the late 1970s – which candidate Ronald Reagan blamed "not on Americans living too well but on government living too well."

Confidence in government did drop, but proponents of this view have cause and effect backwards. The tax revolts that thundered across America starting in the late 1970s were not so much ideological revolts against government – Americans still wanted all the government services they had before, and then some – as against paying more taxes on incomes that had stagnated. Inevitably, government services deteriorated and government deficits exploded, confirming the public's growing cynicism about government's capacity to do anything right.

The real reason for the reversal of the pendulum was political. As income and wealth became more concentrated in fewer hands, politics reverted to what former Federal Reserve Chair Marriner Eccles described in the 1920s when people "with great economic power had an undue influence in making the rules of the economic game." With hefty campaign contributions, and platoons of lobbyists and PR flacks, the rich pushed legal changes that enabled them to accumulate even more income and wealth – including tacit permission to bust unions, slash corporate payrolls, and reduce benefits; lower taxes for themselves; and deregulation of Wall Street. Since so much of their wealth depends on the performance of the stock market, they particularly wanted to free up the Street to put greater pressure on companies to perform. The plan worked. The Dow Jones Industrial Average took off – rising tenfold between 1980 and 2000.

The rich and powerful also had substantial influence "in conditioning the attitude taken by people as a whole toward [the] rules," as Eccles described the pre-Depression years. They generously financed think-tanks, books, media, and ads designed to persuade Americans that free markets always know best. Ronald Reagan, Margaret Thatcher, Alan Greenspan, Milton Friedman, and other apostles of free-market dogma reiterated a simple story: The choice was between a free market and big government. Government was the problem. Free markets were the solution.

But how could the public have been so gullible as to accept this story? After all, America had gone through a Great Depression and suffered the consequences of an unfettered market and unconstrained greed. Even Marriner Eccles, chairman of the Federal Reserve Board, saw that left to its own devices markets concentrate wealth and income – which is disastrous to an economy as well as to a society. Americans had also experienced the Great Prosperity, which depended so obviously on public goods, safety nets, and public investment. Now that the basic bargain was coming apart once again, the need for them was even greater.

One way to understand the paradox is loss of generational memory. While the trauma of the Great Depression echoed in the memories of people who came to adulthood in the 1930s (and who carried its lessons into the forties and fifties), their children <u>became</u> adults during the Great Prosperity. And their grandchildren, born <u>during</u> the Great Prosperity, had no actual, palpable memory of their grandparents' experience. So when this last generation became adults (from around the end of 1970s onwards), all they recalled was the failure of government and the apparent success of the market. This made them particularly susceptible to the seductive rants of the free-marketeers who wanted to blame government for the economy's failings. They had no clear memory of a society whose members were all in it together. They witnessed instead an economy in which, increasingly, each of us was on his own.

HOW AMERICANS KEPT BUYING ANYWAY: THE THREE COPING MECHANISMS

Americans also accepted the backward swing of the pendulum because they mitigated its effects. Starting in the late 1970s, the American middle class honed three coping mechanisms, allowing it to behave as though it was still taking home the same share of total income as it had during the Great Prosperity, and to spend as if nothing substantially had changed. Not until these coping mechanisms became exhausted in the Great Recession would the underlying reality be exposed.

<u>Coping mechanism # 1: Women move into paid work</u>. Starting in the late 1970s, and escalating in the 1980s and 1990s, women went into paid work in greater and greater numbers. For the relatively small sliver of women with four-year college degrees, this was the natural consequence of wider educational opportunities and new laws against gender discrimination that opened professions to well-educated women. But the vast majority of women who migrated into paid work did so in order to prop up family incomes, as households were hit by the stagnant or declining wages of male workers.

This transition of women into paid work has been one of the most important social and economic changes to occur over the last four decades. It has reshaped American families and challenged traditional patterns of child-rearing and child care. Its magnitude has been extraordinary. In 1966, twenty percent of mothers with young children worked outside the home. By the late 1990s, the proportion had risen to sixty percent. For married women with children under the age of six, the transformation has been even more dramatic – from twelve percent in the 1960s to fifty-five percent by the late 1990s.

Families seem to have reached the limit, however – a point of diminishing returns where the costs of hiring others to see to the running of a household or to take care of the children, or both, exceeds the apparent benefits of the additional income.

<u>Coping mechanism # 2: Everyone works longer hours</u>. By the mid 2000s it was not uncommon for men to work more than sixty hours a week, and women to work more than fifty. Professionals put in more “billable” hours. Hourly workers relied on overtime. A growing number of people took on two or three jobs, each demanding twenty or more hours. All told, by the 2000s, the typical American worker worked more than 2,200 hours a year – 350 hours more than the average European worked, more hours even than the typically industrious Japanese put in. It was many more hours than the typical American middle-class family had worked in 1979 – five hundred hours longer, a full twelve weeks more.

Here too, though, Americans seemed to have reached a limit. Even if they can find the work, they can’t find any more time.

<u>Coping mechanism #3: Draw down savings and borrow to the hilt</u>. After exhausting the first two coping mechanisms, the only way Americans could keep consuming as before was to

save less and go deeper into debt. During the Great Prosperity the American middle class saved about 9 percent of their after-tax incomes each year. By the late 1980s and early 1990s, that portion had been whittled down to about 7 percent. The savings rate then dropped to 6 percent in 1994, and on down to 3 percent in 1999. By 2008, Americans saved nothing. Meanwhile, household debt exploded. During the Great Prosperity debt had averaged around 50 to 55 percent of after-tax income. That included what people owed on their mortgages. But starting in 1980 debt took off. In 2001, Americans owed as much as their entire after-tax income that year. But the borrowing didn't even stop there, especially after the Federal Reserve Board lowered interest rates and made borrowing easier. By 2007, the typical American owed 138 percent of their after-tax income.

Mortgage debt exploded. As housing values continued to rise, homes doubled as ATMs. Consumers refinanced their homes with even larger mortgages and used their homes as collateral for additional loans. As long as housing prices continued to rise, it seemed a painless way to get additional money (in 1980 the average home sold for $62,000; by 2006 it went for $245,000). Between 2002 and 2007, American households extracted $2.3 trillion from their houses, putting themselves ever more deeply into the hole.

Eventually, of course, the debt bubble burst. With it, the last coping mechanism ended.

It has been easy to place blame ever since. Some observers blame consumers for borrowing too much. Others fault banks for lending so carelessly. Others blame foreign lenders – especially the Chinese – who were happy to send so much money our way. Or they blame the Federal Reserve, which made borrowing too easy by lowering interest rates too much. Or they blame regulators who didn't adequately oversee the banks that did the lending.

All of this misses the point. The huge amount of debt that middle-class consumers took on was the last of a series of coping mechanisms, undertaken because median wages had stopped growing and the proportion of total income going to the middle continued to shrink. The only way most Americans could keep consuming <u>as if</u> wages hadn't stalled was for women to move into paid work, for everyone to put in more hours and, finally, for households to take on more debt. But each of these mechanisms reached its inevitable limit. And when the debt bubble burst, most Americans woke up to a startling reality: They could no longer afford to live as they <u>had</u> been living; nor as they thought they <u>should</u> be living, given the growth in the economy; nor as they <u>expected</u> to be living, given how their pay used to grow when the economy grew; nor as they assumed they <u>could</u> be living, given the lavish lifestyles of people at the top of the income ladder.

THE FUTURE WITHOUT COPING MECHANISMS

The fundamental economic challenge ahead is to restore the vast American middle class. That requires resurrecting the basic bargain linking wages to overall gains, and providing the middle class a share of economic gains sufficient to allow them to purchase more of what the economy can produce.

It is both an economic challenge and a moral challenge. The nation cannot achieve nearly full employment, a higher median income, and faster growth without a reorganization of the economy on a scale similar to that which occurred during and after the Great Depression.

The Great Recession accelerated the structural change in the economy that began in the late 1970s. More companies have found ways to cut their payrolls for good – discovering new ways to use software and computer technologies to substitute for employees. The spread of such technologies around the world has simultaneously made many more workers in Asia and Latin America almost as productive as Americans, and the Internet has allowed more work to be efficiently outsourced to them. Consequently, large numbers of Americans will not be rehired unless they are willing to settle for lower wages and benefits.

The official unemployment numbers hide the extent to which Americans are already on this path. Among those with jobs, a growing percent have accepted lower pay as a condition for keeping them. Or they have lost higher-paying jobs and are now in a new ones paying less. Eventually jobs will return, but if the trend continues more people will be working for pay they consider inadequate, more working families will be at or near poverty, and inequality will have widened.

Nor will households be able to borrow as before. Banks and other lenders that got burned will be far more careful in the future. Furthermore, lending standards have tightened, and bank regulators and new regulations will require prudence. Housing values will not regain their speculative peak for a long time – which means homeowners cannot use their homes as sources of easy money through home equity loans and refinancing deals. A large number of Americans are paying off, paying down, or walking away from trillions of dollars of outstanding loans – in a vast "deleveraging" of household finances that is likely to continue for years. At the same time, tens of millions of boomers are approaching retirement with nest eggs that have shrunk to the size of peanuts, and must save in earnest.

Where will demand come from without a buoyant American middle class? Absent their spending, companies have little incentive to buy new equipment or software, new commercial buildings or factories; entrepreneurs have little incentive to embark on new research and develop new products and services. Government can fill the gap for a time, but government cannot continue indefinitely to stimulate the economy with deficit spending or by printing money. Nor can we rely on exports to fill the shortfall. Exports will remain a relatively small proportion of our economy. Other economies – even the Chinese – are relying on net exports to maintain their employment. It is impossible for every large economy, including the United States, to become a net exporter.

Hence our challenge. As we should have learned from the Great Prosperity – the thirty years after World War II when America grew because most Americans shared in the nation's prosperity – we cannot have a growing and vibrant economy without a growing and vibrant middle class.