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The Limping Middle Class

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THE 5 percent of Americans with the highest incomes now account for 37 percent of all consumer purchases, according to the latest research from Moody's Analytics. That should come as no surprise. Our society has become more and more unequal.

When so much income goes to the top, the middle class doesn't have enough purchasing power to keep the economy going without sinking ever more deeply into debt — which, as we've seen, ends badly. An economy so dependent on the spending of a few is also prone to great booms and busts. The rich splurge and speculate when their savings are doing well. But when the values of their assets tumble, they pull back. That can lead to wild gyrations. Sound familiar?

The economy won't really bounce back until America's surge toward inequality is reversed. Even if by some miracle President Obama gets support for a second big stimulus while Ben S. Bernanke's Fed keeps interest rates near zero, neither will do the trick without a middle class capable of spending. Pump-priming works only when a well contains enough water.

Look back over the last hundred years and you'll see the pattern. During periods when the very rich took home a much smaller proportion of total income — as in the Great Prosperity between 1947 and 1977 — the nation as a whole grew faster and median wages surged. We created a virtuous cycle in which an ever growing middle class had the ability to consume more goods and services, which created more and better jobs, thereby stoking demand. The rising tide did in fact lift all boats.

During periods when the very rich took home a larger proportion — as between 1918 and 1933, and in the Great Regression from 1981 to the present day — growth slowed, median wages stagnated and we suffered giant downturns. It's no mere coincidence that over the last century the top earners' share of the nation's total income peaked in 1928 and 2007 — the two years just preceding the biggest downturns.

Starting in the late 1970s, the middle class began to weaken. Although productivity continued to grow and the economy continued to expand, wages began flattening in the 1970s because new technologies — container ships, satellite communications, eventually computers and the Internet — started to undermine any American job that could be automated or done more cheaply abroad. The same technologies bestowed ever larger rewards on people who could use them to innovate and solve problems. Some were product entrepreneurs; a growing number were financial entrepreneurs. The pay of graduates of prestigious colleges and M.B.A. programs — the "talent" who reached the pinnacles of power in executive suites and on Wall Street — soared.

The middle class nonetheless continued to spend, at first enabled by the flow of women into the work force. (In the 1960s only 12 percent of married women with young children were working for pay; by the late 1990s, 55 percent were.) When that way of life stopped generating enough income, Americans went deeper into debt. From the late 1990s to 2007, the typical household debt grew by a third. As long as housing values continued to rise it seemed a painless way to get additional money.

Eventually, of course, the bubble burst. That ended the middle class's remarkable ability to keep spending in the face of near stagnant wages. The puzzle is why so little has been done in the last 40 years to help deal with the subversion of the economic power of the middle class. With the continued gains from economic growth, the nation could have enabled more people to become problem solvers and innovators — through early childhood education, better public schools, expanded access to higher education and more efficient public transportation.

We might have enlarged safety nets — by having unemployment insurance cover part-time work, by giving transition assistance to move to new jobs in new locations, by creating insurance for communities that lost a major employer. And we could have made Medicare available to anyone.

Big companies could have been required to pay severance to American workers they let go and train them for new jobs. The minimum wage could have been pegged at half the median wage, and we could have insisted that the foreign nations we trade with do the same, so that all citizens could share in gains from trade.

We could have raised taxes on the rich and cut them for poorer Americans.

But starting in the late 1970s, and with increasing fervor over the next three decades, government did just the opposite. It deregulated and privatized. It cut spending on infrastructure as a percentage of the national economy and shifted more of the costs of public higher education to families. It shredded safety nets. (Only 27 percent of the unemployed are covered by unemployment insurance.) And it allowed companies to bust unions and threaten employees who tried to organize. Fewer than 8 percent of private-sector workers are unionized.

More generally, it stood by as big American companies became global companies with no more loyalty to the United States than a GPS satellite. Meanwhile, the top income tax rate was halved to 35 percent and many of the nation's richest were allowed to treat their income as capital gains subject to no more than 15 percent tax. Inheritance taxes that affected only the topmost 1.5 percent of earners were sliced. Yet at the same time sales and payroll taxes — both taking a bigger chunk out of modest paychecks — were increased.

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. By 2007, financial companies accounted for over 40 percent of American corporate profits and almost as great a percentage of pay, up from 10 percent during the Great Prosperity.

Some say the regressive lurch occurred because Americans lost confidence in government. But this argument has cause and effect backward. 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 doing anything right.

Some say we couldn't have reversed the consequences of globalization and technological change. Yet the experiences of other nations, like Germany, suggest otherwise. Germany has grown faster than the United States for the last 15 years, and the gains have been more widely spread. While Americans' average hourly pay has risen only 6 percent since 1985, adjusted for inflation, German workers' pay has risen almost 30 percent. At the same time, the top 1 percent of German households now take home about 11 percent of all income — about the same as in 1970. And although in the last months Germany has been hit by the debt crisis of its neighbors, its unemployment is still below where it was when the financial crisis started in 2007.

How has Germany done it? Mainly by focusing like a laser on education (German math scores continue to extend their lead over American), and by maintaining strong labor unions.

THE real reason for America's Great Regression was political. As income and wealth became more concentrated in fewer hands, American politics reverted to what Marriner S. Eccles, a former chairman of the Federal Reserve, 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 public relations spinners, America's executive class has gained lower tax rates while resisting reforms that would spread the gains from growth.

Yet the rich are now being bitten by their own success. Those at the top would be better off with a smaller share of a rapidly growing economy than a large share of one that's almost dead in the water.

The economy cannot possibly get out of its current doldrums without a strategy to revive the purchasing power of America's vast middle class. The spending of the richest 5 percent alone will not lead to a virtuous cycle of more jobs and higher living standards. Nor can we rely on exports to fill the gap. It is impossible for every large economy, including the United States, to become a net exporter.

Reviving the middle class requires that we reverse the nation's decades-long trend toward widening inequality. This is possible notwithstanding the political power of the executive class. So many people are now being hit by job losses, sagging incomes and declining home values that Americans could be mobilized.

Moreover, an economy is not a zero-sum game. Even the executive class has an enlightened self-interest in reversing the trend; just as a rising tide lifts all boats, the ebbing tide is now threatening to beach many of the yachts. The question is whether, and when, we will summon the political will. We have summoned it before in even bleaker times.

As the historian James Truslow Adams defined the American Dream when he coined the term at the depths of the Great Depression, what we seek is "a land in which life should be better and richer and fuller for everyone."

That dream is still within our grasp.