Emerging Concerns about the State of the Middle Class

A Review of the Academic Literature

Final Report

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1. Introduction

During the Great Recession, Canada seemed to fare better than many other countries. Our banking system remained stable, our housing values remained strong and we led the G7 in adding jobs. Many inaccurately seized upon the results of the 2014 Luxembourg Income Study to suggest that Canada has the richest middle class on the planet, buoyed by rising home values, standing in staid and prosperous relief to the still uncertain conditions in the United States.

If all of this were so, Canadians should have spent the past decade feeling confident, even complacent, about their economic prospects. But nothing has been further from the truth. On the contrary, we have observed a startling degree of pessimism felt by Canadians about the economic health and outlook of the middle class.

There are several reasons for this pessimism. Chief among them are lagging growth in middle class incomes, rising levels of household debt and declining personal savings. The reality is, while the knowledge based economy has given Canadians plenty of new gadgets to play with it has largely failed to deliver the sort of stable and prosperous economic circumstances that the middle class have grown accustomed to during the post-World War II era.

While income inequality has been a particularly acute issue in the United States, it is also a reality in Canada. According to a January 2013 analysis by the Conference Board, Canada gets a “C” grade on income equality, with a higher degree of inequality than 11 peer nations.

The dramatic shift in the politics of the United States and the United Kingdom in 2016 demonstrate that a growing public resentment of economic inequality can be channeled and directed to effect dramatic change. The frustration with foreign trade and immigration that fueled the success of Donald Trump’s presidential candidacy and the Brexit ballot measure are symptoms of a deeper unease with respect to personal economic security. Canadian leaders would be remiss to believe that this same blend of resentment, unease and willingness to believe in the promise of easy solutions does not also reside among many in this country.

While there are many ways to interpret the recent, tumultuous political landscape in the United States and Britain, what voters in both countries have ultimately expressed is a loss of faith that the future will be as prosperous as the past.

Without a doubt, this anxiety certainly contributed to the outcome of Canada's 2015 federal election as it did the elections in the U.S. and Britain in 2016. But it would be a mistake to believe that the optimism which characterized Canada's change to a new government has displaced the fundamental anxiety prompting the change in the first place.

Ultimately, the problem may be understood through a troubling syllogism:

- IF a healthy society and a strong economy require a growing, optimistic middle class….
- AND IF the middle class is neither growing nor optimistic…

- THEN societal health and economic progress will be in peril if these negative conditions persist.

Restoring faith in a vision of shared and long-term economic prosperity focused on an economically secure and growing middle class is the critical challenge the new government has before it.

2. What is the Middle Class?

How is it different today? Is the bargain broken? Is it the end of shared prosperity?

If nothing else, the tumultuous events of 2016 show how deeply the concept and concerns of the middle class have moved from the bookshelves of economists, sociologists and policy makers to assume a central and animating place in world affairs. While many have focused on issues of nativism and populism as the factors contributing to Trump's victory, the smart read assigns Trump's success in large measure to growing class tensions. Where the notion of a "middle class crisis" and a coming era of class conflict was once seen as an obsession of policy wonks and fringe political groups, 2016 has seen both ideas pushed to the front and centre of the conversation.

The idea of hierarchical social organization has been a preoccupation of social science and philosophy for some time. The modern concepts of class emanate from the work of Hegel and Marx. The concept of the middle class emerged in the last century and there is a plethora of different conceptual and operational definitions of middle class. Michael Förster of the OECD noted that he was aware of some 138 definitions of middle class (Förster, 2014). Many of these are based on various categorizations of income but some are more structural in nature and some simply rely on self-definition. In his presentation to the Queen's International Conference on the middle class, Förster suggests that the vast majority of citizens define themselves as middle class when asked to which class they belong (Förster, 2014).

In a subsequent presentation at the same conference I noted that this was no longer the case in either Canada or the USA. It is increasingly clear that the USA and Canada are relatively alike in their class outlooks and that the salience of this issue is particularly strong in upper North America.

Variations on Marxist and earlier Hegelian concepts of class focus on relationships to the economy (in Marx's theories) or the ideas and ideology in Hegel's views. Interestingly Hegel's original 'universal class' was the bureaucracy, which makes the ideas of a society possible, whereas for Marx it was the proletariat, the laboring class that make the material realities of a society possible. More recently, British economist Guy Standing has explored a new social class, the "precariat" which epitomizes neither the ideas or material reality of a society as much as it does a condition of perpetual economic uncertainty (Standing, 2011).

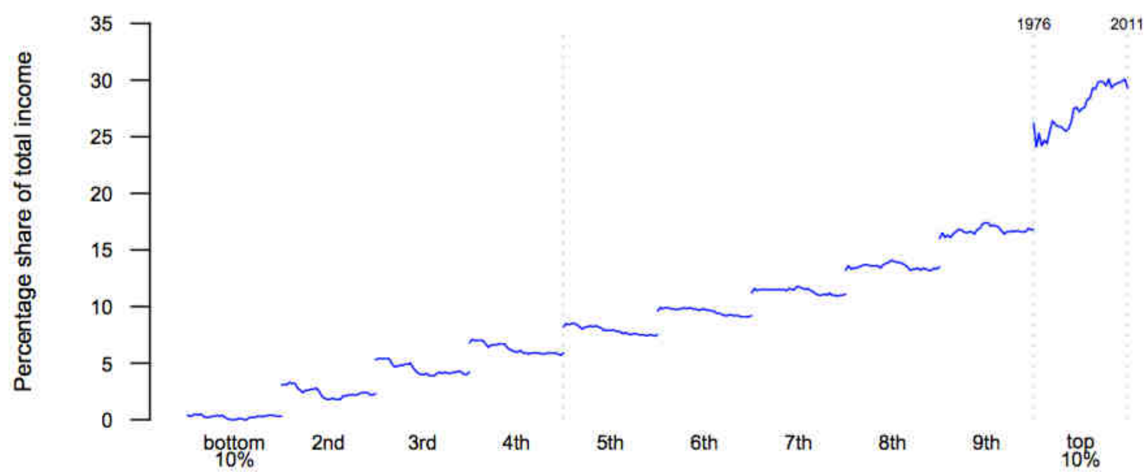
Class theories were largely displaced in North America in the twentieth century with concepts of social stratification and the concept of socio economic status (SES). This was a quantitative product of income, education and occupational prestige. This tradition gave considerable attention to issue of occupational and social mobility (both inter and intra-generational). It covered much of the same concerns of earlier class theorist but with a different methodological approach. It also eschewed issues of class conflict in favour of the search for order. In the latter part of the twentieth century structural functionalism began weakening and was replaced by a new emphasis on what was variously called the "new class' (Alvin Gouldner) and various other theorists who stressed the importance of human capital formation as critical to power and income. In addition to various post-industrial theorists (Bell, Touraine) Robert Reich wrote a seminal piece on the rise of the symbolic analyst class. In an interesting revision of that theory Reich has written more recently that this conception was flawed and that human capital did not displace convention capital. In fact, as Piketty and others have shown, the income and inequality dynamics of the West today now look a lot more like Marx's predictions than those of a post-industrialist era of broad technological and skills-based prosperity (as expressed in Fukayama and Freidman's notions).

While "middle class" has a different meaning in the UK, it is a very similar concept in Canada and the U.S. Given the sheer complexity of the array of income based definitions it may be helpful to simplify with self-defined class membership. Our research shows that there is a very strong correlation between self-defined class and income. Pew has done extensive work on this approach in the USA and other countries. This approach has the advantage of revealing some of the historical shifts in clearer terms although both approaches are necessary.

There is often a sense that Canada is not significantly impacted by these new class and inequality dynamics. This is false. Comparison of the income distribution of the top 1% across the four Anglo Saxon economies over the past century (Piketty, 2014) shows that the overall patterns are more common than unique. Förster's data also shows that income has been increasingly flowing to those at the top of the economic ladder in all OECD countries (Förster, 2014).

University of Ottawa economist Miles Corak makes several compelling contributions to this debate. He describes two different stories of inequality in the Canadian context: one that presents a view of income inequality as a relatively benign component within a larger story of income growth, relatively high social mobility and middle class needs being largely met; the other, more disturbing story describes an era of rising inequality, flat or stalled income growth outside of the resource-based economies in Saskatchewan, Alberta and Newfoundland, and a stagnant market income that remains far lower than it was in the 1970s (Corak, 2014). Ultimately Corak concludes that while the case can be made for either the benign story of income inequality or the more disturbing one, what ultimately matters most is which of the two resonates most with the middle class. With a stagnating share of total income for every decile apart outside of the top 10%, Corak suggests which story is more likely to correspond with the middle class.

Which Story Will Resonate for Whom? (Corak, 2014)



Another important contribution of Corak's work is the conclusion that rising inequality at the top has reduced not increased upward intergenerational mobility. This corresponds to evidence that social class is become stickier at the top and bottom ends of the spectrum. This may be linked to declining emphasis on 'merit' to the point that Richard Wilkinson made in his now famous Ted Talk that those wanting to live the American Dream should move to Denmark.

The bottom line is that there is something very different about the salience of the middle class and the end of the era of shared prosperity and middle class progress that we saw in the twentieth century.

3. What's happened to the middle class?

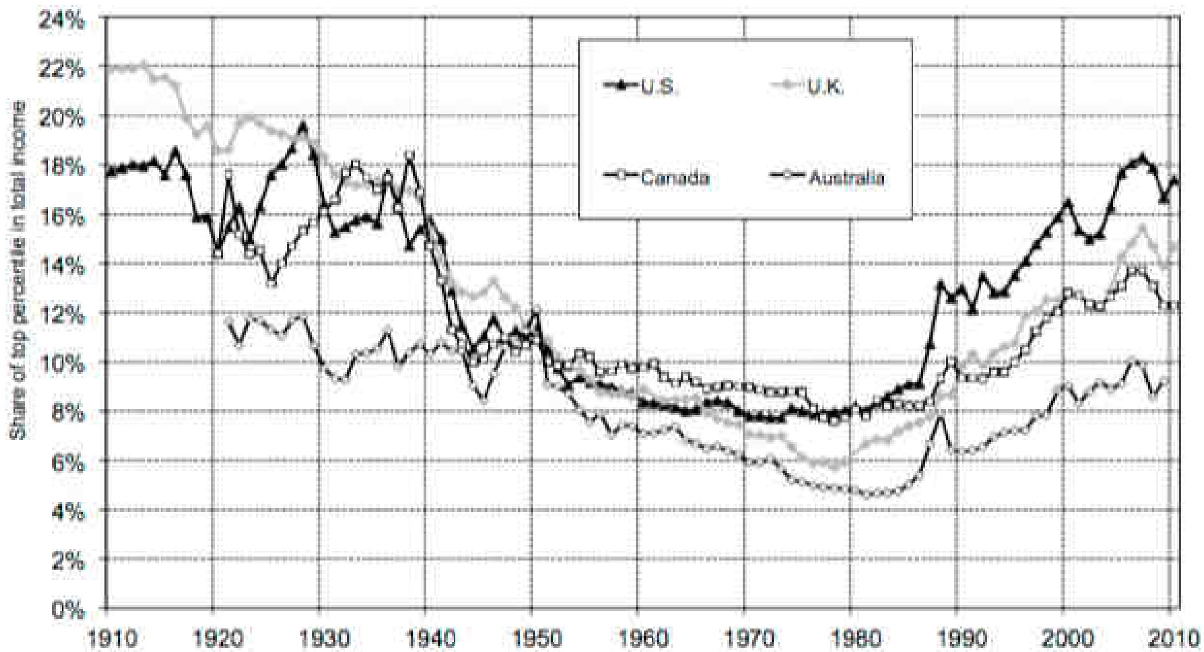
Where Corak points to the malleable nature of economic data and the plausibility of two very different stories about the nature of inequality, others have found to a bleaker and more definitive trend.

In his 2013 book, *Capital in the Twenty-First Century*, the French economist Thomas Picketty provides a historical and international perspective on the evolution of inequality which, crucially, uses as its primary data source and exhaustive compilation of tax records. This is important given that the self-reported data found in census records and survey results typically understates income. Picketty's research operates on the premise that tax records represent a more accurate data set.

Based on this work Piketty describes an endless "inegalitarian spiral" in which the growth of private investment consistently outpaces growth in economic output and wages, resulting in a situation where the old wealth of inheritance and the new wealth of entrepreneurship consistently outpaces the wealth generated by the wages and economic output of labor. Where Milton Friedman saw the free market as the best way to encourage economic growth by providing greater incentives to entrepreneurs, Piketty's analysis concludes that "such immense inequalities of wealth have little to do with the entrepreneurial spirit and are of no use in promoting growth" (Piketty, 2013).

While the U.S. is popularly seen as a sort of poster child for economic inequality, Piketty's work makes clear that the pattern of economic inequality is an international phenomenon, seen particularly clearly in the rapid growth in the income of the top percentile within the four major Anglo-Saxon economies. While it is a truism that Canada is a more egalitarian society than its southern neighbor, Piketty's findings suggest that the basic trend of income inequality applies as well to Canada as it does to the other Anglo-Saxon economies, including the United States.

Income Inequality in Anglo-Saxon Countries, 1910-2010 (Piketty, 2013)



The share of top percentile in total income rose since the 1970s in all Anglo-saxon countries, but with different magnitudes. Sources and series: see piketty.pse.ens.fr/capital21c.

In his 1998 book, *The Crisis of Global Capitalism,* the billionaire philanthropist (and boogey-man of the American right) George Soros characterized the relentless drive towards lassez faire deregulation and lower taxation in the 1970s and 1980s as free-market fundamentalism, characterized by a quasi-religious faith in the power of free markets to act as an invisible hand delivering both economic growth and economic justice with little or no government intervention. Nobel laureate Joseph Stiglitz picked up on the theme in his 2012 book, *The Price of Inequality.* "The power of markets is enormous, but they have no inherent moral character. We have to decide how to manage them," Stiglitz wrote. "It is plain that markets must be tamed and tempered to make sure they work to the benefit of most citizens."

Where Stiglitz sees a moral imperative to tame the free market and ensure economic justice through government intervention, others have identified the failure to do so in larger terms, as leading ultimately to the collapse of nations. In their 2012 book, *Why Nations Fail*, Daren Acemoglu and James Robinson consider the role that political and governmental institutions play in the economic health and viability of nations. Ultimately, they find that "nations fail when they have extractive economic institutions, supported by extractive political institutions that impede and even block growth." In their analysis, extractive economic institutions are ones that sustain and support an economic and political oligarchy, impeding the creative and entrepreneurial drive with by protecting and preserving the economic and political interests of the oligarchy. On the other hand, they point to inclusive economic institutions "that enforce property rights, create a level playing field, and encourage investments in new technologies and skills" as conducive to economic growth and the success of nations.

The political upheavals of 2016 have pushed the problem of inequality to the centre of the conversation, displacing the prevailing narrative of techno-optimism that has held sway since the 1990s. In his book, *The Rise and Fall of American Growth,* the economic historian Robert Gordon pours cold water on the notion that all the many and marvelous technological inventions of the last 20 years or so have fundamentally improved lives or contributed to broad-based economic growth and prosperity in the way that the great innovations of the early Industrial era (i.e., electricity, sanitation, the automobile, mass communications) did. Ultimately, Gordon describes today's economic landscape as one that is characterized by an ever-widening economic inequality fueled, in part, by an information revolution that has failed to deliver the sort of gains in economic productivity and prosperity that the inventions of the past did.

This theme is also explored by Robert Reich in *Saving Capitalism,* where he points to the absurdly enormous pay-offs in the dot com world for innovations that may be very entertaining, but which ultimately do little to improve the standard of living. The poster child for this, in Reich's view, is the $19 billion acquisition of WhatsApp by Facebook. Reich describes the need for "countervailing" power in the form of taxation and regulation to address inequality and the lack of confidence in political systems. "However it is accomplished," Reich concludes, "the rules must be adapted for a more inclusive economy. Absent the means of sharing the increasingly large rewards (of the technological revolution) the middle class will disappear and capitalism as we know it will cease to exist."

4. What does middle-class decline look like?

What does the decline in the middle class look like? According to World Bank economist Branko Milanovic, it looks something like an elephant. Milanovic's "elephant curve" (pictured below) is so named because its shape is reminiscent of the animal. The curve features a large hump of income growth in the 10th through 60th deciles, dropping to a sharply lower rate of growth for the 70th through 95th deciles, before curving sharply upwards again – like an elephant's trunk might – to a 60% real increase in income experienced by those earning the most.

Milanovic's work speaks to global circumstances, and identifies the sharp rise in income growth experienced in emerging markets like China and India where the breakneck speed of industrialization has brought millions of rural poor to the cities, lifting many into a new emerging middle class. The other big winners in Milanovic's analysis are the super-rich at the top of the scale, at the tip of the elephant's trunk, who enjoyed a 60% growth in income between 1988 and 2008. The losers whose incomes have stagnated or even declined lay between the 75th

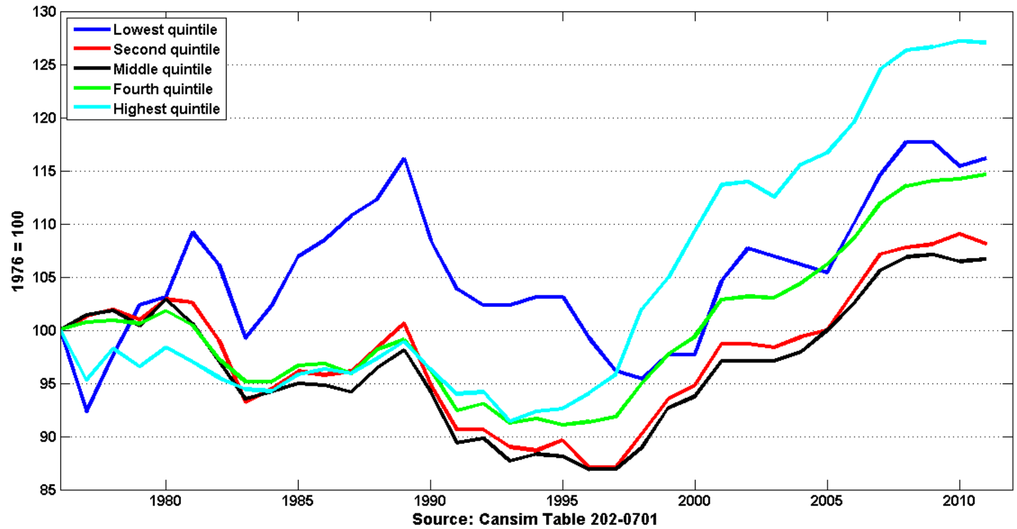
and 90th percentile. In global terms, they are described as the "upper middle class." But, really, the populations falling into this range are the lower middle classes of wealthier North American and European economies.

Change in Real Income Between 1988 and 2008 (Milanovic, 2012)

Note: The vertical axis shows the percentage change in real income, measured in constant international dollars. The horizontal axis shows the percentile position in the global income distribution. The percentile positions run from 5 to 95, in increments of five, while the top 5% are divided into two groups: the top 1%, and those between 95th and 99th percentiles.

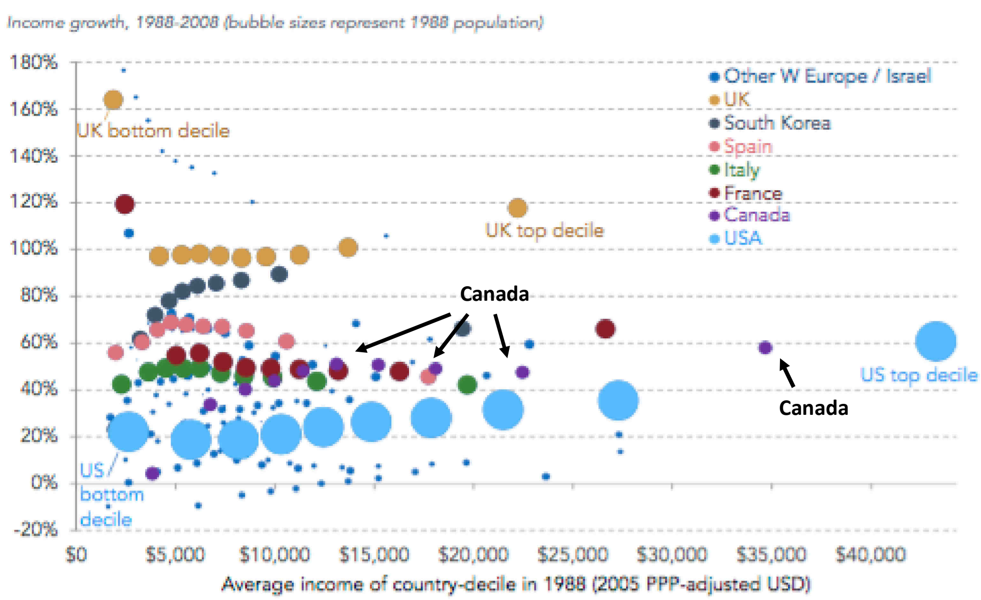
The elephantine shape of Milanovic's curve applies reasonably well to the patterns of income growth in Canada. The chart below provides a different view of income growth between 1976 and 2010, plotting the change in income by quintile over this period. The top earners are represented by the light blue line and show that the pattern of sharp income growth that characterizes the top earners globally also applies to Canada. The lowest quintile also grew, but less sharply, while much lower rates of growth were realized by the middle quintiles.

Average Incomes in Canada after Taxes and Transfers by Quintile 1970-2011 (Statistics Canada)



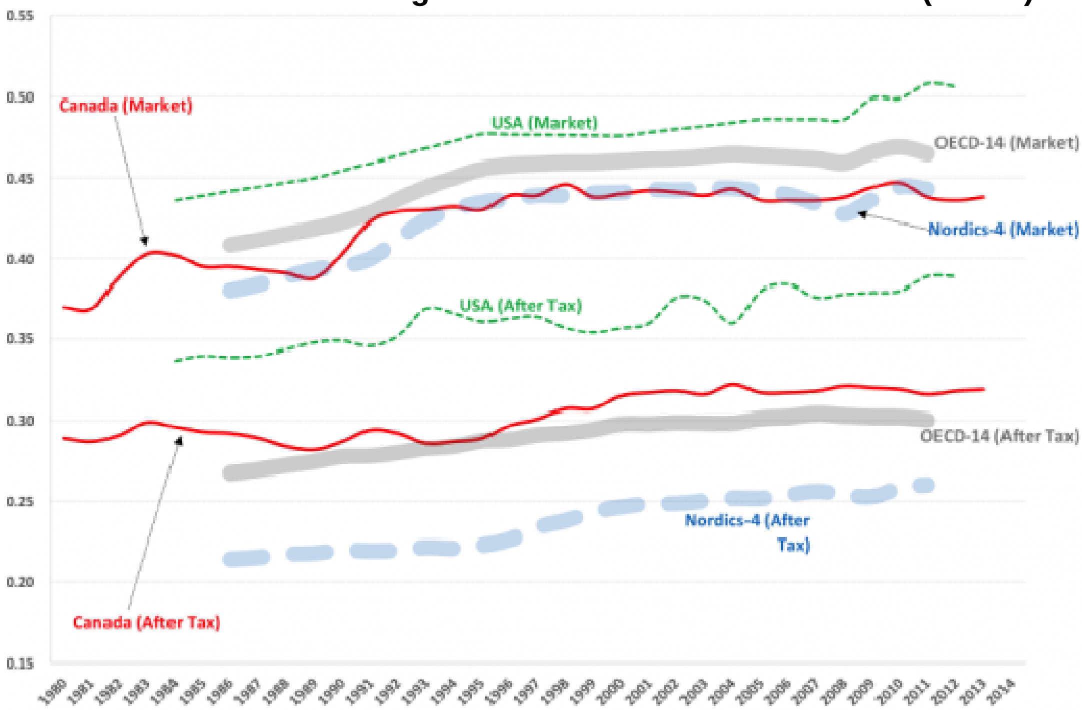
An international perspective on the change in income by decile is pictured in the chart below. The arrows have been added to point out Canada (in purple). The U.S. (in blue) and Canada share a similar pattern in this chart, with much higher incomes in their top decile lying further apart from the lower income deciles and a much higher rate of income growth at the top decile than many of the other countries (with the UK and France as notable exceptions). The important point here is that while Canada does enjoy a relatively more egalitarian reputation, and indeed a higher rate of growth across this period (1988-2008), it shares with its southern neighbor the same basic shape of income inequality.

Income Growth by Decile in Mature Economies - 1988-2008 (Corletta, 2016)



Looking at change in income by deciles or quintiles allows us to see the change in income per each category, from the lowest to the highest income levels. The Gini coefficient, which calculates inequality on an aggregate basis, is the most commonly referenced measure on income inequality. The chart below shows the change in the Gini coefficient between 1980 and 2012 based on both market (or gross) income and income after taxes and distributions. The data compare Canada (red), the U.S. (green), the 14 largest OECD economies (grey) and the four Nordic markets (blue).

Before and After Tax Change in Gini Coefficient - 1980-2012 (OECD)



As an aggregate measure, change in the Gini coefficient is more gradual, and less revealing, than are changes in income within deciles or quintiles. Nevertheless, in looking at the chart above you can identify a distinct upward trend in the inequality of market incomes in all four regions (the U.S., the OECD-14, Canada and the Nordic-4). Looking at the Gini coefficient after taxes and distributions shows the redistributive effects that tax and social transfers have. While the trend towards greater inequality remains in the after-tax numbers, it is a far lower level of inequality and the slope towards greater inequality is not as steep. While the growth of income inequality in Canada is slower than the OECD-14 average in terms of market income, it has been faster than the OECD-14 when looking at income after taxes and transfers.

5. Easy Money and the Generational Shift

The 2015 film, *The Big Short,* gives the Hollywood treatment to the 2008 housing crisis. Along the way, the film explains the complicated history of the crisis by starting with the creation of mortgage-backed securities in the 1970s, changing the traditionally staid and predictable mortgage market into a very profitable and heavily traded financial instrument. The film shows how the new and exciting market for mortgage-backed securities combined loose and easy credit to homebuyers culminated in a perfect storm, cueing up the U.S. housing bubble and ensuing global financial crisis and recession.

In the early days of the crisis, the former chief of the U.S. Federal Reserve, Paul Volcker, described an environment of skyrocketing consumer spending and household debt, disappearing savings and huge trade deficits, all aided and abetted by the foreign purchase of U.S. debt. "It all seemed so comfortable. There was no pressure for change, not in Washington which was spending money and keeping taxes low, not on Wall Street which was wallowing in money, not on Main Street with individuals enjoying easy credit and rising house prices, not in China or elsewhere dependent on booming exports and content to build huge financial reserves" (Ibid.).

Essentially, what Volcker and others (e.g., Paul Krugman, Edward Glaeser) have identified is a dramatic shift in the underpinnings of the U.S. economy from a wage-driven model of personal wealth accumulation to one driven by asset ownership (The Economist, 2009). Where the traditional model of wealth accumulation involved a slow and steady accumulation over years and decades as people saved money and paid their mortgages off, the new model, focused on asset ownership, meant a far more rapid accumulation of wealth through the transfer of ownership and the embrace of capital risks.

While it may be popular to think of this dynamic as a U.S. problem, particularly given the relative stability of Canada's financial markets and economy during the housing crisis, the data show otherwise. A 2013 analysis from Rob Carrick in *The Globe and Mail* found that over the previous 17-year period Canadian incomes rose by 2.6 per cent per year on average, while house prices grew by 5.4 per cent (Carrick, 2013). Put another way, while average house prices moved from the mid-$150,000 range in 1997 to nearly $400,000 in 2012, income growth remains in the mid-$100,000 range ($48,497 in the 2013 analysis).

The shift from a wage to an asset-based model of growth has had profound effects on Millennials. In both the United States and Canada the Millennials have moved away from ownership in a number of categories, but particularly housing (Rampell, 2016). This trend among Canadian youth is well illustrated in a Census analysis that shows the dramatic increase of youth 20-24 years of age and 25-29 years of age living in their paternal home (Statistics Canada, 2015).

The spill-over impact of a housing market fueled by asset driven wealth has had the impact of making home ownership less accessible to young buyers, and has coincided (and probably exacerbated) other changes in typically middle-class behaviors: delaying marriage, delaying children, delaying or avoiding the purchase of a vehicle. The combination of low wage growth with the financial uncertainties of the Great Recession have had a profound impact on the future of the middle class as it will be lived by Millennials.

6. Income inequality: the superstar economy and the new gilded age

There are any number of ways to understand the decline in the middle class, whether the inability of wages to keep pace with the cost of living, the rise in the number of hours worked per year, declining union membership or skyrocketing levels of household debt. Ultimately, however, there is a consensus emerging that the widening gap between the wealthiest 1% (and .1%) and everyone else is to blame.

Robert Reich nostalgically points back to the years immediately following World War II as a far more egalitarian era, when the CEOs of large corporations earned 20 times the amount of the typical worker. Today, Reich points out, they earn "substantially over two hundred times" the amount of the rank-and-file worker (Reich, 2015).

The outsized rewards to be had for, in Reich's words, the "superstars" in the economy have the ironic effect of blunting economic innovations that ultimately contribute to increased productivity and growth. In Piketty's analysis, the "hypermeritocratic" and inegalitarian nature of the superstar economy defies common sense. The relationship of marginal productivity typically applied to labor output is unsuited to evaluate the salaries of superstars. While Piketty acknowledges the important role that education plays in the widening gap in the income of those who have a secondary education and those who don't, this component fails to explain the problem: "The over-performance of the top centile explains most (nearly three-quarters) of the increase in the top decile's share of U.S. national income since 1970" (Piketty). It's important to note here that Piketty bases his analysis on tax records, where as many of the data reported for Canada, particularly, are based either on self-reported income or incomplete information that underestimates the full extent of individual wealth.

Ultimately, Piketty concludes that the easier burden of capital taxation has resulted in a kind of profligacy amongst the investing class, or an ability to accept greater losses on investments and therefore make more bad ones. In Piketty's view, increasing the tax on capital investments would have the effect of forcing bad investments out of the market. In other words, in Piketty's view raising taxes on capital would have the effect of blunting investor enthusiasm for innovations that do not enhance productivity or, ultimately, contribute to economic growth (such as Facebook's $19.5 billion investment in WhatsApp, which Reich points out).

Where Piketty dwells on taxation as the solution to both address inequality and to fix the flawed incentive system within capitalism, Acemoglu points to the need to inclusive rather than extractive institutions. *Why Nations Fail* is rife with examples of prosperity and failure based on whether the inclusive institutions adequately fostered incentives or if the institutions became, ultimately, extractive in the service of the economic elite. In her book, *Plutocrats,* Canada's Minister of International Trade, Chrystia Freeland summarizes this analysis as follows: "Inclusive states give everyone a say in how their society is ruled and access to economic opportunity. Inclusive societies often benefit from a virtuous circle in which greater inclusiveness creates more prosperity, which creates an incentive for greater inclusiveness." The sharply curtailed fortunes of the middle class in Canada and across many other developed economies calls into question whether our system can still be viewed as inclusive.

7. Conclusions

- The evidence shows clearly that growth has slowed and inequality has risen in most of the mature economies over the past 35 years. This is particularly true of the USA and Canada

- The rise in inequality, which has occurred in virtually every OECD country, is very much concentrated in the top of the income spectrum. Canada has experienced this and is middle of the pack in the OECD countries

- The notion that Canada is somehow not experiencing these patterns doesn't not correspond with the longer-term comparative and historical trends charted by Piketty and more recent work on the Elephant Curve. Canada is most likely more similar to the US than other mature economies.

- Middle class membership has hollowed and the middle class is doing much more poorly than the upper class in terms of income growth. This is true across a range of different operational definitions

- There are, however, two very different stories of the decline of the middle class. Depending on which indicators and start points one selects we can say that the problem is either benign or nonexistent or that the problem is acute. The longer-term story favours the acute version which also corresponds to the way the public are seeing and experiencing this.

- Upward intergenerational mobility is declining, particularly in those countries seeing the fastest rise in inequality concentration at the top.

- The literature seems to suggest that the decline of the middle class is rooted in a failure of the incentive systems to reward skill and effort in the way that it did in the past. This may be signaling a shift from inclusive to extractive institutions which is linked to why nations fail (in Asmoglu's analysis).

- These shifts are the critical drivers of some of the huge and surprising changes occurring in Western politics, most strikingly, the Brexit and Trump results.

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