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Hollowing Out

The U.S. middle class is shrinking as households climb into higher, or slip into lower, income brackets.

Ali Alichi
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Rating

9

9 Importance
8 Innovation
9 Style

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Take-Aways

- The middle class in the United States is quietly disappearing, as more of its citizens fail to achieve the American Dream.
- The middle class's proportion of total national income has plunged from 47% in 1970 to 35% in 2014. Higher income households have taken up most of the slack, while statistics for lower income households have barely budged.
- Between 1999 and 2013, the contracting middle class cost the US economy an estimated 1.75 percentage points in consumption growth, or roughly six months' worth.
- Possible explanations for this "income polarization" include recessions, immigration and tax policies, new technologies, and the decline of unions.
- Income polarization has been even more notable in Canada and Germany, while it has decelerated or fallen in the United Kingdom, France and Italy.

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Review

The American Dream seems to be fading, as the US middle class struggles to maintain a foothold. Between 1970 and 2014, middle-income households shrank from 58% to 47% of all US households. Until 2000, moving into the ranks of upper-income households accounted for most of the attrition. But since then, the number of middle-income households that slipped into lower income status has outpaced those rising to higher income levels. This "hollowing out" eats away at consumption, a major driver of economic growth in the United States. This powerful article by economist Ali Alichi provides a thoughtful look at the consequences of a dwindling middle class. *getAbstract* recommends it to policy makers and economists.

Summary

The middle class in the United States is quietly disappearing, as more of its citizens fail to achieve the American Dream. The middle class is critical to keeping consumption going, because high-income households spend only a comparatively small share of their incomes, while those with lower incomes have relatively little to spend.

"In the United States, the middle class not only accounts for most of the economy's consumption, it also provides most of its human capital and owns most of its physical capital, such as houses and cars. So a shrinking middle class hurts the economy."

The difference between those who have moved down the economic ladder since 2000, rather than ascending it, is striking: Only 0.25% of households have climbed to higher ground, versus the 3.25% that have fallen out of the ranks of the middle class. The middle class's proportion of total national income has also plunged, from 47% in 1970 to 35% in 2014. Higher income households have taken up most of the slack, while statistics for lower income households have barely budged.

"Falling into a lower-income bracket takes a toll on households, especially at a time when average real incomes have been broadly stagnating."

Although economists have devoted ample research to the distinctions between those at the highest and lowest income levels – by measuring income inequality – they have examined the shrinking of the middle class, or "income polarization," far less. Yet since 1970, polarization has proceeded at a much faster clip, and the trend could have far greater negative implications for the economy than inequality. Between 1999 and 2013, the contracting middle class cost the economy an estimated 1.75 percentage points in consumption growth, or roughly six months' worth. The picture darkens even further, because overall consumption has not kept pace with rising incomes. Tighter purse strings have sacrificed another six months' worth of consumption growth.

"A strong economy needs strong consumption and investment to function well."

Possible explanations for income polarization include recessions, immigration and tax policies, new technologies, and the decline of unions. By grasping the causes, politicians might be better equipped to work toward mitigating income polarization's adverse consequences. The trend has been even more notable in Canada and Germany. On the other hand, it has decelerated or fallen in the United Kingdom, France and Italy. Among emerging markets, one study found that polarization increased between the mid-1990s and mid-2000s in eight of nine Asian countries; it decreased in Thailand but grew the most in China.

About the Author

Ali Alichi is a senior economist at the International Monetary Fund.