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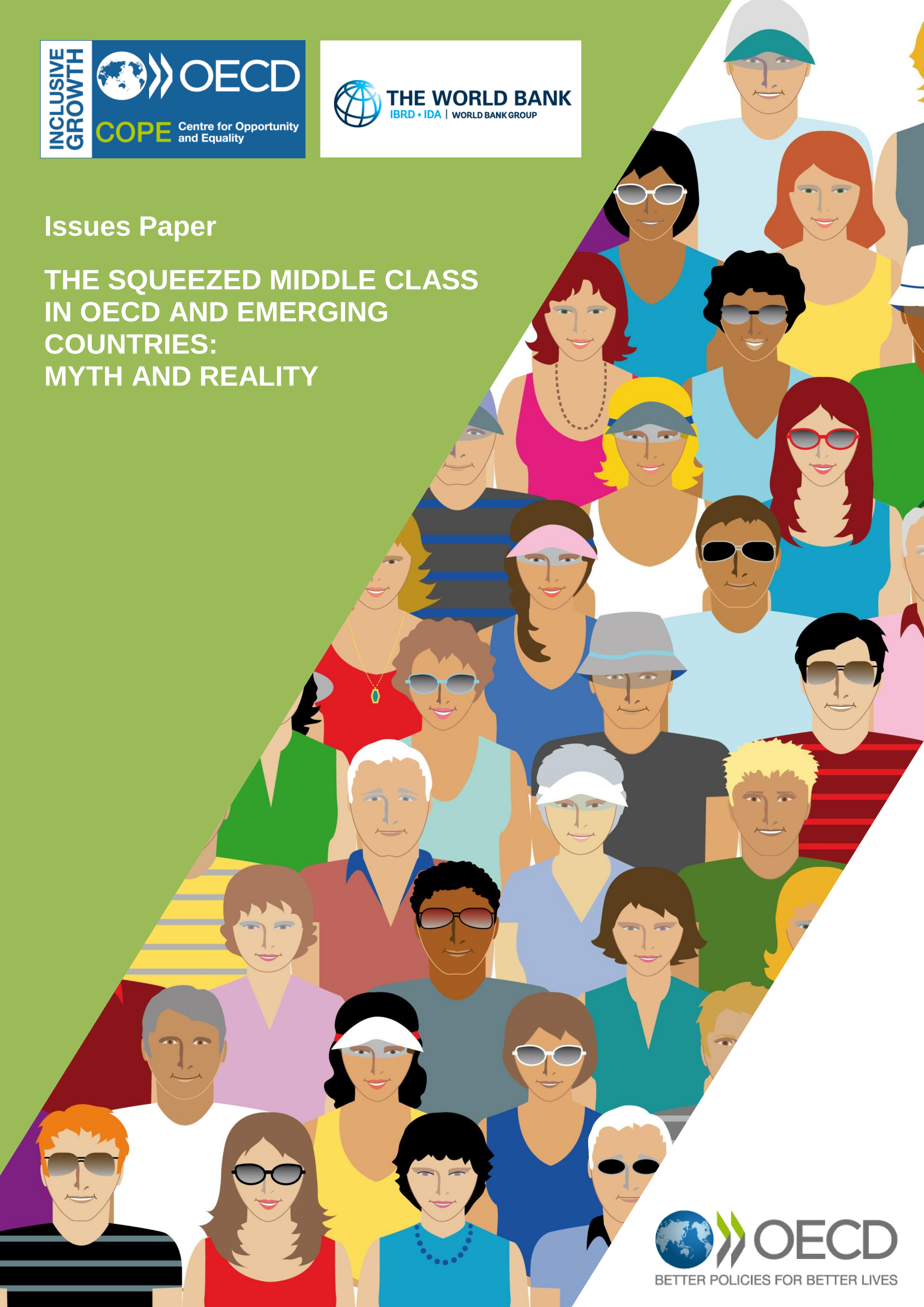

Issues Paper

THE SQUEEZED MIDDLE CLASS IN OECD AND EMERGING COUNTRIES: MYTH AND REALITY

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BETTER POLICIES FOR BETTER LIVES

The squeezed middle class in OECD and emerging countries –myth and reality

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Issues Paper

Session 1: Who is the Middle Class – and is it declining?

Key facts

- Almost two-thirds of people live in middle-income households in OECD countries. In Emerging Economies, the equivalent figure is between one-third and one-half.
- The size of middle-income groups has slightly decreased in the last decades, but this happened mostly during the 1980s and 1990s. The rate of decline has slowed recently.
- Today, people in a typical middle-income household are older, more educated and have fewer children than in the past.
- More than two out three people in the OECD consider themselves middle class.
- Middle class self-identification has fallen significantly in recent years, much more than income trends would suggest.

Middle class is an important target group in the public policy debate as it refers to the majority of the population in OECD and (increasingly) in Emerging countries. Of course, different people have different population groups in mind when they refer to "the middle class". The middle class is a fluid and uncertain concept, and has no commonly agreed definition. It can be defined based on a number of perspectives, indicators and approaches. Income is a good proxy of living standards, but there are a number of factors beyond income which can be used to identify the middle class, such as socio-economic status, aspirations, material deprivation or multidimensional approaches. Different definitions of middle class will, naturally, yield different sizes, income shares and characteristics of middle class populations.

One commonly-used measure for “middle-incomes” is household net income between 0.75 and 2 times the median. In most OECD countries, a majority of the population live in such middle-income households (Figure 1). Since the 1980s, this middle income group has, however, decreased slightly, on average across the OECD. In most countries, this decline was stronger in the 1980s and 1990s than in the more recent decade, but there are notable exceptions: in the US, Germany and Luxembourg, the share of middle-income households fell by 5% since 2000. On the other hand, in many emerging economies the focus has been about the *rise* of the new global middle class. With the recent economic slowdown in several of these countries there are growing concerns about their vulnerability and resilience as their income levels are still below the poverty threshold of advanced economies. Furthermore, the potential cushioning effect of public policies and welfare systems is weaker in emerging economies.

The middle-income group of households in OECD countries have changed its composition and characteristics over the past decades. Today’s middle income group is older and more educated. On average, across OECD countries since 1990, the probability of being middle income tends to be higher in working years and lower during childhood and old-age. Single adults and couples without children have seen their chances of being middle income grow, while families and single adults with children have seen theirs decrease.

The decline of the middle class is often associated with job polarisation in skills and earnings. In recent decades many semi-skilled routine jobs have been replaced by new technologies that created new jobs both at the high and low end of education and wage spectrum, at the expense of middle wage-education jobs. Shifts in non-standard employment trends have also affected the middle class – a disproportionately high loss of middle-skill jobs has been accompanied by a rise in non-standard work especially at the lower end of the skill distribution, further contributing to job polarization.

New ways of working and increasing automation and digitalisation are likely to radically change the world of work in the future – providing greater flexibility for workers and employers but at the same time putting at risk job security in middle-class and high-skilled occupations. This constitutes a major challenge for any policy which aims to strengthen the middle class.

The impact of globalisation on the middle class in OECD countries has also been much debated around the apparent dichotomy of middle classes declining in advanced economies while gaining ground in emerging countries – as illustrated in Branko Milanovic's "elephant curve" (which indicates strong income growth at the global middle – mainly emerging economies – as well as at the global top one percent, while income growth at the global 80th percentile – mainly middle-income groups in OECD countries – has stagnated).

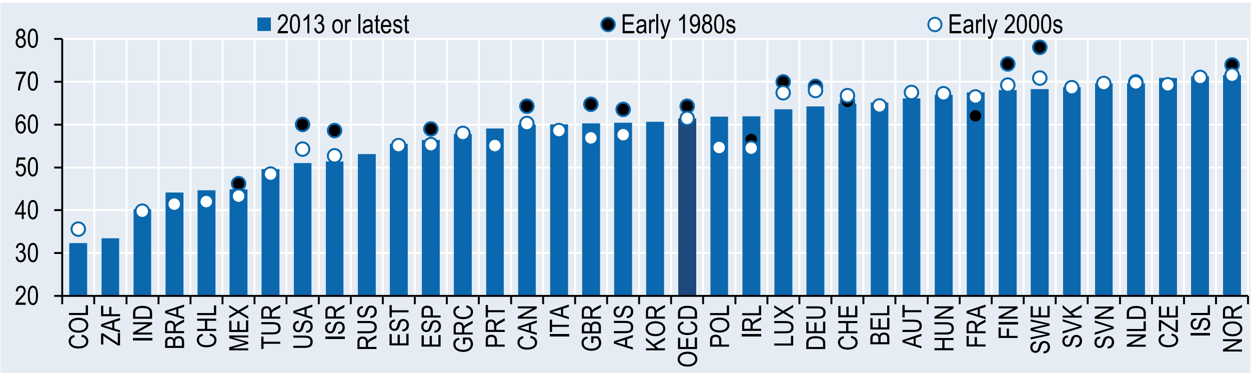
In most OECD countries the majority of the population – around 70% on average – self-identifies as belonging to the "middle class". While the proportions of the population with "middle incomes" and "subjective middle class" are correlated, there are distinctive country clusters (Figure 2). While in Northern and Continental European countries, as well as Italy and Turkey, the proportion of population self-identified with the "middle class" is higher than income data would suggest, the opposite holds for Canada, Portugal and the United Kingdom.

The share of the population that considers itself as belonging to the middle class has fallen significantly in recent years. Over the last ten years, in the United States and Canada it fell from two-thirds to one half (Figure 3). The fall in middle class perceptions may reflect rising economic insecurity following the financial crisis, accompanied by a lack of confidence in future labour market and economic prospects. Higher job insecurity and income volatility may have pushed middle-class self-identification down as people feel less certain about maintaining their socioeconomic status in the future.

Questions for discussion

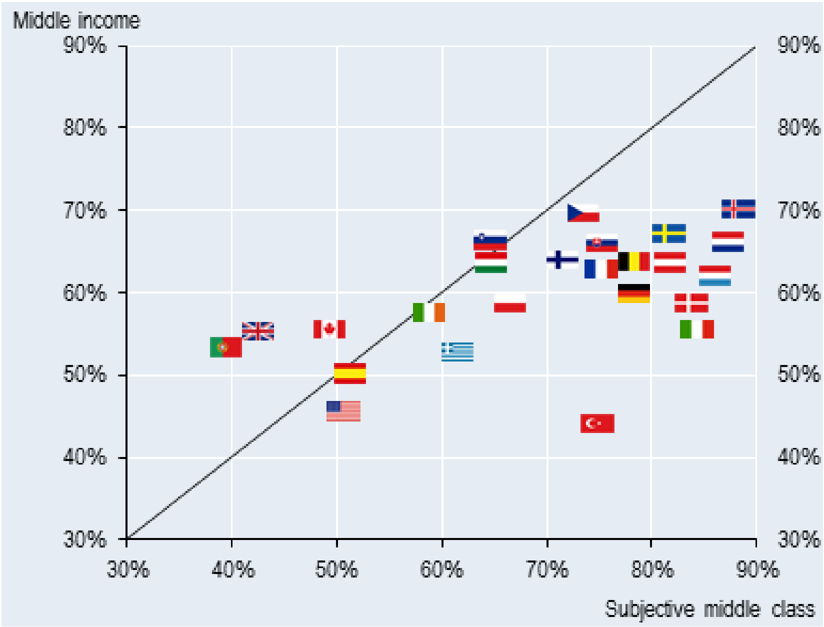
- Who is the "middle class"?
- How could we connect different perspectives, indicators and approaches for measuring middle class? Could big data help creating these connections?
- How do globalisation, digitalization and the future of work affect middle class incomes?
- What explains differences between "middle income" and perceived "subjective middle class" sizes and trends?

Figure 1. Most people are in the middle income group in OECD countries, but share has fallen in many countries



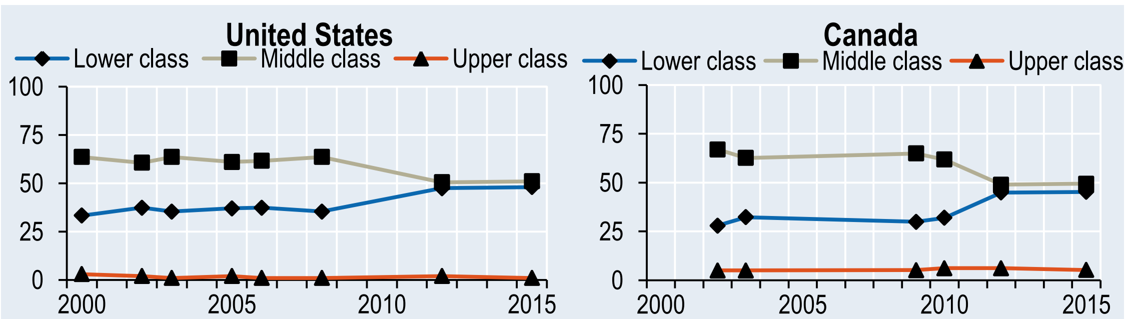
Note: Incomes groups are defined by population share with equivalised household disposable income of below 50% of the median (Lower), 50-75% of the median (Lower middle), 75-200% of the median (Middle), 200-300% of the median (Upper middle), and above 300% of the median (Upper). *Source*: OECD Secretariat's calculations.

Figure 2. More than two out three people in the OECD consider themselves middle class.



Note: The "middle income" group is defined by population share with equivalised household disposable between 75% and 200% of the median. Subjective middle class group comprises the population that self-identifies as lower middle, middle, and upper middle class.
Source: OECD Secretariat's calculations

Figure 3. Decline in middle class self-identification, 2000 to 2015



Note: Based on self-identification. Middle class comprises upper middle and middle class in the United States, and middle class only in Canada. Lower class encompasses working class and lower class (United States) or working class and poor (Canada).
Source: OECD Secretariat calculations based on data from Gallup (USA), EKOS (Canada).

Session 2: The middle class: economic growth, trust and political stability

Key facts

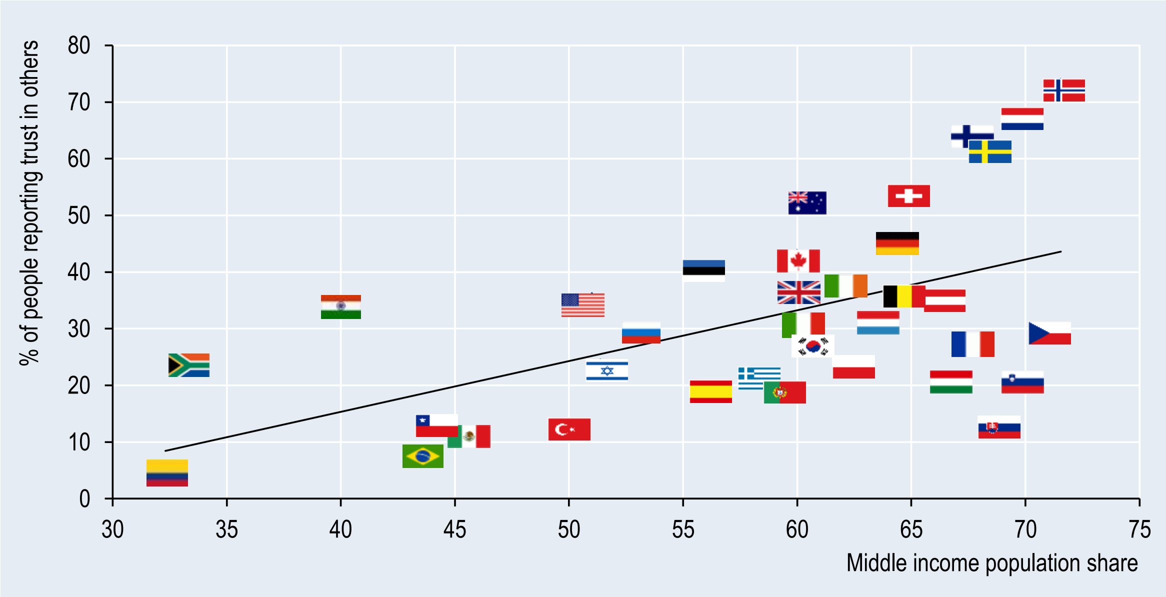
- A strong middle class contributes to higher levels of trust.
- Middle-class decline fuels social and political instability.
- A shrinking middle class can be a threat to economic growth.

A declining middle class poses a threat to both economic and political stability. The middle class plays an essential role in economic growth as well as in the social and political stability (Thurow, 1984), and improves the strength and quality of democracy and its institutions (Barro, 1999; Fukuyama, 2011; Lipset, 1959).

A strong middle class drives higher growth and per capita income (Easterly, 2001). Given its purchasing power and propensity to consume and invest in education, the middle class promotes economic growth by stimulating aggregate demand and increasing human capital and productivity (Brown and Hunter, 2004; Pressman, 2007). Middle class strength is also associated with higher levels of social trust, which shrinks business transaction costs, increases innovation, minimizes the principal-agent problem (Figure 4) and has been linked to economic growth and development (Gould and Hijzen, 2016).

Political instability and failing public policies are also potential symptoms of middle class decline. Larger middle classes are associated with improvements in health and education policies, democratic participation and governance, and their impact on such outcomes seems stronger than those produced by lower poverty and inequality or higher GDP capita (Loayza et al., 2012). A powerful middle class also helps to combat political polarization and promote greater compromise within government (Madland, 2015). Furthermore, political instability itself is an important channel through which income inequality decreases economic investment and growth (Alesina and Perotti, 1996). Recent work in the United States suggests that middle class' ability in influencing public policy has diminished as policy makers are more responsive to the opinions of affluent constituents (Bartels, 2009), whose preferences differ considerably from the majority (Page et al., 2013). Anti-immigration and anti-globalization sentiments can arise as a shrinking middle class creates disillusionment and damages political engagement, or turns voters towards anti-establishment and protectionist policies (Bettiza, 2010; Stiglitz, 2012).

Figure 4. Social trust is lower in countries with a squeezed middle class



Source: OECD Secretariat's calculations

Questions for discussion

- How can the virtuous cycle between middle class strength and economic growth be reinforced?
- How comparable are the vulnerabilities and feelings of insecurity of the middle class in OECD countries and Emerging Economies?
- How can government policy reforms cope with fading support from the declining middle class?

Session 3: What policies for the middle class?

Key facts

- The middle class plays a significant role in shaping the welfare state.
- The economic influence of middle-income groups compared to upper-income groups has been declining.
- The cost of typical middle class goods, services and assets are rising faster than median incomes and driving some middle income households into debt.

In OECD countries, where the middle class comprises the majority of the population, a welfare state consensus is largely dependent upon the policy preferences of middle-income groups. The middle class plays an essential role supporting *and* benefiting from the welfare state. OECD's *In It Together* (2015) shows that during the financial crisis the tax-benefit system succeeded in cushioning the middle class from further falls in their disposable incomes. On the other hand, middle incomes have not been immune to recent fiscal consolidation measures in many OECD countries (see Figure 5a).

Middle incomes have been rising at a significant slower pace than those at the top. As a result, the economic influence of the middle class has been declining with respect to the upper class since the 1980s. In the United States, the share of the country's income earned by middle-income households has fallen by 21% in the last three decades, while it increased by 75% among top incomes. On average in the OECD, the middle-income group (those with incomes between 0.75 and 2 times the median) collectively had incomes six times the level of the collective incomes of the top income group (i.e. those with incomes that exceeded twice the level of median income) in the 1980s. This ratio fell to 5 to 1 in the 1990s and to 4 to 1 since the 2000s. It may well be that this fall in the relative economic importance of the middle classes has contributed to a fall in their political influence, enabling a more 'pro rich' policy environment to take shape in areas such as attitudes toward top tax rates, and regulation of economic rents. Recent work in the United States suggests that middle class' ability in influencing public policy has diminished as policy makers are more responsive to the opinions of affluent constituents whose preferences may differ considerably from the majority.

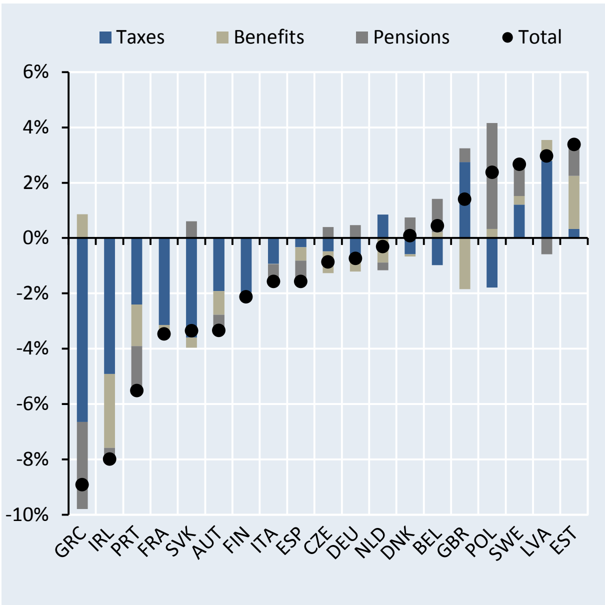
The increasing gap between top and middle incomes may also harm middle-class living standards by distorting costs and prices of goods, services and assets which are typically associated with a middle class lifestyle. In the last three decades, housing prices have grown twice as fast as general inflation and more than one third faster than median income, on average across the OECD (see Figure 5b). Furthermore, this may even affect the middle class consumption patterns by prompting a rise in the expectations of living standards (and subsequently the spending patterns) through a process of "expenditure cascades" or "trickle-down consumption" – in which the expenditure pattern of one income group is mimicked by the income group immediately below.

Related to this, there is a growing concern about middle-class indebtedness. In OECD countries, over-indebtedness (defined as having a debt-to-asset ratio of over 75 percent) peaks in middle income households, affecting more than one in ten of them. Similarly, in emerging economies a considerable share of the "new global middle class" has been able to raise their living standards only through credit and is particularly exposed and vulnerable to shifts in interest rates, life events and the economic cycle.

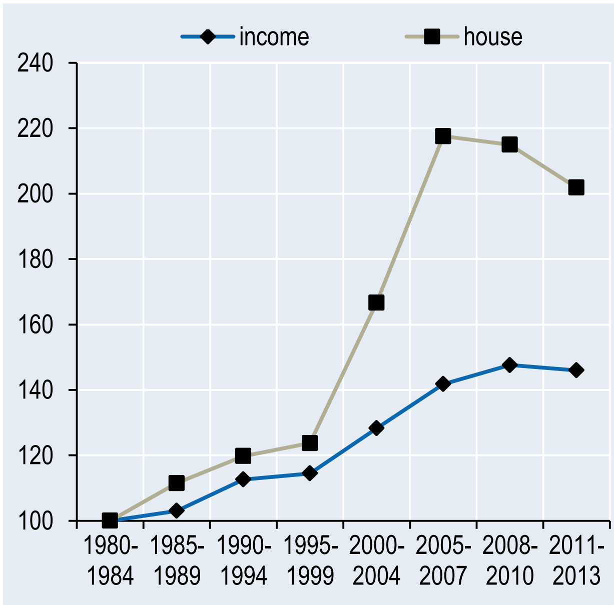
In recent years, governments across OECD countries have increasingly expressed the importance of protecting middle class living standards and financial security in the face of economic challenges. At their summit this year in Japan, G-7 leaders affirmed their commitment to direct fiscal policy towards investments in middle class well-being. In some OECD countries, such as Canada and the United States, recent policy reforms and proposals have been explicitly developed with a "pro middle class" focus and priority for middle-class prosperity. These proposals include, beyond reforms of benefits and services, policies which aim to enhance labour market prospects for middle earners but also to improve housing affordability.

Figure 5. Struggling middle class

A. Percentage changes in household disposable income of middle income households (75-200% median) due exclusively to tax-benefit changes between 2010-2015



B. Changes in median income and housing prices (OECD Average 1980s-2013)



Source: OECD Secretariat calculations - for Panel A: OECD Secretariat calculations based on EUROMOD/EU-SILC 2012/FRS 2012-13; for Panel B: OECD Average comprises Australia, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom, and United States.

Questions for discussion

- How do middle class attitudes towards redistribution influence welfare policy?
- Have policy makers been complacent towards the middle class?
- Does targeting of benefits on the poor undermine support for the welfare state by the middle class?
- How can policy strengthen the resilience of the emerging middle class and protect them from falling back into poverty?

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