CHAPTER ONE

Middle Out vs. Trickle Down

On April 30, 2012, Edward Conard, a former director for the financial management company Bain Capital and multimillionaire who retired at age fifty-one, sat across from Jon Stewart, host of *The Daily Show,* to promote his new book. Conard smiled and stared intently through his black-rimmed glasses as Jon Stewart, the liberal host of the comedy show, held up his book and described its contents. Conard's book argued that America's economy would be stronger if people like Conard were even richer and the country had even higher levels of economic inequality.

Stewart was puzzled by Conard's argument and joked that it didn't seem right because inequality in the United States was approaching the level in countries with "kidnapping-based economies," generating laughter in the audience.[1] Then Stewart shifted to an opening that would give Conard a chance to explain himself. "My question to you about the premise of the book," Stewart stated, pausing for effect before setting up his punch line, "is huh?"

Conard laughed along with the audience, and then launched into his argument that great rewards for the "most talented" people were the secret to America's success. Making the rich richer is good for everyone, he claimed because high levels of inequality provide strong incentives for risk taking and innovation that are essential for economic growth.

Though Conard's comments were provocative—indeed his book tour generated significant press, including a multipage feature in the *New York Times Magazine*—he was merely stating the barely hidden premise underlying supply-side economics.[2] Supply-side economics, the misguided theory that has controlled economic policymaking for the past three decades, is built on the idea that inequality is good. Tax cuts for the rich and less regulation of business supposedly provide incentives for the wealthy to invest and work more. Enabling "job creators" to get richer helps us all, the theory goes.

Conard's former boss at Bain, Mitt Romney, the 2012 Republican Party nominee for president, ran on a platform of supply-side policies, as have virtually all Republicans since Ronald Reagan was elected president. Even a number of prominent Democrats support supply-side policies and logic. Not only do these wrongheaded ideas about inequality have great political influence, but—until quite recently—they were largely shared by academic economists. For the past several decades, the idea that high levels of inequality were good for the economy dominated economic thought.

Fortunately, these flawed ideas are beginning to be challenged. Academics have begun to rethink their views about the decline of the middle class and progressive politicians are finally starting to openly contest the logic underlying supply side after years of failing to do so. It is about time because our economy is suffering deeply from a financial crash caused in large part by high levels of inequality. And though we may not have a kidnapping-based economy, as Stewart joked, the American middle class is so weakened that we are experiencing the kinds of problems that plague less-developed countries, including high levels of societal distrust that make it hard to do business, governmental favors for privileged elites that distort the economy, and fewer opportunities for children of the middle class and the poor to get ahead, wasting vast quantities of human potential.

This book explains the rethinking of inequality that is happening in academia and in politics. The American economy has been thrown off balance because the middle class is so weakened and inequality so high. An economy that works only for the rich simply doesn't work. To have strong and sustainable growth, the economy needs to work for everyone.

A strong middle class is not merely the result of a strong economy—as was previously thought—but rather a source of America's economic growth. Rebuilding the middle class would provide the stable base of consumer demand necessary to increase business investment and job creation. It would also enable the country to fully develop the human capital of its people, increase the social trust that makes transactions possible, and balance political power to produce a government that works for the whole country, not just those at the top.

Elements of this line of thinking date back to some of history's most prominent economists—from John Stuart Mill to John Maynard Keynes—but until the Great Recession of 2007–2009 snapped the field back to attention, most economists ignored the importance of the middle class. Now, as they revise their models and assumptions that failed to predict the financial crisis, economists are rediscovering classic scholars, opening their eyes to the work of researchers in other fields such as history, political science, and sociology, and developing promising new lines of inquiry to try to understand the role of the middle class.

Hollowed Out brings together this long-standing and recent research. The book shows how the hollowing out of the middle class has harmed the US economy, clarifies how previous thought got it so wrong, and illuminates how this new middle-out synthesis could shape economic policymaking for generations to come.

To some readers, the argument that America's economy grows from the middle out, not from the top down, might seem intuitive and uncontroversial. But the argument is a direct criticism of conventional wisdom in academia and in politics. That a relatively simple and commonsense approach to the economy presents a radical challenge to the status quo indicates just how far off base economists and politicians went over the past few decades, and it explains why this book is necessary.

TRICKLE-DOWN

Edward Conard is more explicit about the supposed benefits of inequality than most supporters of supply-side policies. But from its beginnings, supply-side proponents have argued that inequality is good for the economy. Jude Wanniski, an economist and editorial writer for the *Wall Street Journal,* who wrote the *The Way the World Works* in 1978, which helped put supply-side economics on the map, claimed that the "basic economic problem that for all time has confronted the global electorate … is the tension between income growth and income distribution."[3] For the good of the country, Wanniski maintained, income growth was the right choice and that required reducing taxes, especially on the wealthy, and greater levels of inequality.

George Gilder, an early promoter of supply side, put it more bluntly in *Wealth and Poverty,* published in 1981: "Equality . . . [is] inconsistent with the disciplines and investment of economic and technical advance."[4] Gilder was very clear that economic growth required people becoming very rich. "Material progress is ineluctably elitist," he wrote. "It makes the rich richer and increases their numbers, exalting a few extraordinary men who can produce wealth over the democratic masses who consume it." President Ronald Reagan—the first powerful political proponent of trickle-down—frequently quoted Gilder and in a speech in 1982 put Gilder in his own words by arguing that "we're the party that wants to see an America in which people can still get rich."[5] Because of this belief that helping the rich get richer will cause economic benefits to drip onto the middle class and poor, detractors of supply-side economics often call it trickle-down.

For decades, academic economists helped provide cover for trickle-down economics and the obvious harm it was doing to the middle class and the economy. Most academics didn't buy into all of supply-side dogma—they rejected the idea that tax cuts pay for themselves, for example—but in general the logic of the theory fit with many of their preconceptions about inequality and economic incentives.[6] Until quite recently, the vast majority of the economics profession believed—like supply-siders do—that inequality helped the economy to function properly. Even those who were troubled by high levels of inequality generally felt it was necessary for the good of the economy. According to the standard view in economics, policymakers faced a trade-off between economic growth and economic equality.

This underpinning of economic thought was most clearly demonstrated by Arthur Okun, a Yale University economist and the chief economic advisor to President Lyndon Johnson, in his book *Equality and Efficiency: The Big Tradeoff,* published in 1975.[7] Inequality, according to Okun, provided positive incentives that encouraged people to work hard and invest, making the economy more efficient. Further, Okun claimed that efforts to reduce inequality generally involved some level of waste that hindered the economy. Though Okun argued that the trade-off between equity and growth was less than most economists thought, the fact that even a liberal economist believed that high levels of economic inequality were good for the economy underscores how ingrained the idea was in economics departments.

At the time Okun wrote, the American middle class was still relatively strong and inequality low. But soon after his book was published, inequality began rising and the middle class weakened. Most economists were untroubled. Some even defended the changes. Indeed, a keynote address at the American Economic Association conference in 1999—the main association for academic economics—was titled "In Defense of Inequality," and argued that "inequality is an economic 'good' that has received too much bad press."[8] The keynote speaker, Finis Welch, was later elected by his colleagues as vice president of the economics association.[9]

Economists thought this way about inequality because the kind of logic they used ignored many of the downsides of inequality. Economists generally believe that long-run economic growth is determined by the productive use of physical capital, such as buildings and factories, and human capital, the knowledge that people have. The key to economic growth, then, is to provide the right incentives to encourage people to increase the supply of human and physical capital and make more efficient use of them. A greater payoff for people who increase society's capital—holding everything else equal—seemingly provides the right incentives.[10]

Holding everything else equal is of course key to making this logic work. But, as inequality has risen to extreme levels in the United States, everything else has not remained equal: the foundations of the economy have weakened. Society has changed so that people trust one another less and are reluctant to do business with one another. Government has become captured by the elites. Opportunities for the less well off to get an education and develop their skills have weakened in comparison to the rich. And the nature of consumer demand has changed and become less stable.

Most economists got it so wrong because they were trained to think of individuals as untouched by institutional or social influences. In the economic worldview, individuals act based on their narrow self-interest. Supposedly, according to most economic models, this leads to efficient results without much need for social or legal constraints. As a result, economists generally ignored the importance of good government and societal trust to a properly functioning economy. On the rare occasions they did look at these issues, it was almost always to study developing countries—not the United States—and thus they missed that these basic underpinnings of growth in America were sharply deteriorating.

Even for factors that economists commonly studied, such as demand and human capital, they hardly considered how the economy was impacted by a weakened middle class. Economic analysis of consumer demand and its relationship to economic growth was generally based on a stylized version of a typical consumer and ignored the impact of growing differences in income, wealth, and debt.[11] As a result, on the eve of the Great Recession most economists failed to recognize that consumer demand was dependent on middle-class debt and thus unstable. In a similar vein, too many studies of human capital and economic growth assumed that because some inequality provides an incentive for individuals to acquire greater skills, extremely high levels of inequality must be a good thing.[12] Though some economists were able to recognize that inequality had the potential to hinder the development of human capital, the profession rarely reflected on whether this was harming America's growth. It didn't take much looking to see that inequality was so high that it was providing much greater opportunities for the children of the rich to develop their human capital while the children of the poor and middle class were falling behind. Nor did it take great insight to consider the broader impact this was having on the economy, but few made the connections.

Because of these widespread failures, on the eve of the Great Recession, most economists were caught unaware that the ground supporting the American economy was collapsing.[13] They missed the forest for the trees.

Economists originally incorporated a broad conception of humanity and society in their study: Adam Smith, the founder of the discipline, was a moral philosopher as well as a political economist after all.[14] But, over the past five or six decades, economists who wanted to study the influence of government or cultural factors or challenge the hyperrational view of economic-man were pushed to the fringes.[15] As a result, the study of economics in recent decades has often been "asocial and ahistorical," according to Ben Fine, an economist at the University of London, and Dimitris Milonakis, an economist at the University of Crete.[16]

Criticisms of the excessively narrow and theoretical perspective of the economics profession have come not just from those on the outside, but also from some of the most credentialed economists in the world.[17] And since the Great Recession, criticism has been particularly forceful.[18] Nobel Prize–winning economist Ronald Coase, for example, wrote in an essay in 2012 that "ignoring the influences of society, history, culture and politics on the working of the economy" is "suicidal" for the field of economics.[19] Similarly, Thomas Piketty, the French economist who some leading economists think will win the Nobel Prize for his work on inequality, argues in *Capital in the Twenty-First Century,* published in 2014: "The discipline of economics has yet to get over its childish passion for mathematics and for purely theoretical and often highly ideological speculation at the expense of historical research and collaboration with the other social sciences."[20]

To be sure, economists—like all social scientists—need to make simplifications and set aside certain factors from analysis in order to try to understand the complex system they are studying. Yet the simplifications that economists made were fundamentally flawed because they ignored issues that were critical to the economy. As a result, they turned a blind eye—or even gave their blessings—as trickle-down policies and changes in the global economy drove inequality to record levels and significantly weakened the middle class.

THE WEAKENING MIDDLE CLASS

The United States was founded as a middle-class country. On the eve of the American Revolution, America's carpenters, shopkeepers, and farmers enjoyed a higher standard of living than workers in other parts of the world.[21] Further, economic inequality was lower in the United States than any place else. In an era of kings and peasants, America's middle class stood apart.

America had its share of rich people, and of course it had slavery. But even so, the rich were not that much richer than the middle class. As Peter Lindert, an economic historian at UC Davis, explains: "Compared to any other country from which we have data, America in that era was more equal."[22] Those who lived during America's founding sensed that the country's economic equality was special. Thomas Jefferson noted in a letter that "we have no paupers.... The great mass of our population ... possess property [and] cultivate their own lands.... The wealthy, on the other hand, and those at their ease, know nothing of what the Europeans call luxury."[23]

The strength of America's middle class ebbed and flowed over time, especially as industrialization took hold.[24] But after World War II, America returned to its roots and built a mass middle class that was the envy of the world, with rapidly rising incomes and decreasing inequality.[25] The mid-1940s to the mid-1970s was a period "without extremes of wealth or poverty," as Nobel Prize–winning economist Paul Krugman explains.[26] To be clear, America in this era had rich people and poor people, but the bulk of society formed a prosperous middle class that was in relatively close proximity to both the top and the bottom.

Yet, over the past three to four decades, middle-class America has come undone. The American middle class was already hurting when the Great Recession struck and is now in deep trouble. While there's no official definition of the middle class, it's not hard to see that it is in decline. By most every measure, most Americans are struggling.

First, there is the basic level of income earned by the typical American. Median household income—meaning half make more and half make less—was lower in 2013 than it was in 1989.[27] This means that middle-class households now earn less than they did two decades ago. Similarly, incomes for poor and even upper-middle-class households have also stagnated.[28] It is true that over an even longer time period, the middle class have seen some income gains. But these gains have been quite small: over the past four decades, median compensation, including both wages and benefits, has grown at a snail's pace of just 0.27 percent per year—far slower than the overall economy or output per worker.[29] The miniscule gains that households have made have largely come because women have increasingly entered the workforce—meaning families are working longer hours, as they run faster and faster to stay in place.[30] Indeed, the hourly wage earned by a typical man is less than it was in 1973.[31]

Even these gloomy figures may be too rosy because they show what is happening to the typical household—but the typical worker is getting older, and older workers generally make more than younger workers.[32] Income trends are even worse when workers are compared to those of a similar age from a few decades ago. Median incomes for male workers now in their thirties are about 12 percent lower than the income was for their fathers' generation at the same age.[33]

While incomes have been stagnant for most Americans, the cost of middle-class basics like healthcare and gas have risen much faster than inflation, and some basics like housing and college have risen at double the rate of inflation over the past four decades.[34] It costs a lot more to maintain a middle-class lifestyle, but no matter their efforts most families have not been able to earn much more income. Not surprisingly, debt levels have jumped sharply—total household debt has nearly doubled since 1975.[35]

In contrast to the middle class and the poor, incomes of the rich, especially the very rich, have grown by astronomical amounts over the past three decades: in 2007, the year the Great Recession started, the top 0.01 percent, the richest one in ten thousand, earned in today's dollars the equivalent of about $38.8 million, compared to $6.4 million per year in 1979.[36] Because of rapidly rising incomes for the rich and stagnating incomes for everyone else, the economic distance between the rich and the middle class has grown by leaps and bounds.[37] CEO compensation, for example, increased from less than 30 times that of the average worker in 1978 to over 350 times what the average worker made in 2007.[38] Though incomes for the rich fell during the Great Recession more than they did for the middle class, incomes for the rich have come roaring back, while middle-class incomes have not—so much so that income differences are now back to near the prerecession levels.[39]

To picture how big these differences are, think of a strange building housing the middle class on the bottom floor and the very rich on the top story. In the late 1970s, the CEO's penthouse would have been on the thirtieth floor, making this apartment building a tall one, but one that would fit in many American cities. In 2007, the penthouse was 351 floors up, meaning the apartment building would need to be more than three times the size of the Empire State Building.

The rich now make so much more than the middle class because they captured the vast majority of the economy's gains over recent decades. The share of the nation's income going to the top 1 percent has approximately doubled over the past three decades, while the share of income going to the middle 60 percent of income earners has fallen precipitously and is now stagnating near the lowest level ever recorded since the government began keeping track of the statistic.[40] These changes in income share are "the equivalent of shifting $1.1 trillion of annual income to the top 1 percent of families," according to Princeton economist Alan Krueger.[41] Since the Great Recession ended, fully 95 percent of the income gains have gone to the top 1 percent of income earners.[42]

And wealth differentials are even bigger than income differences. The bottom 90 percent of Americans have lost wealth over the past two and a half decades and now hold only about one-quarter of the country's wealth.[43] In contrast, the top 1 percent have seen dramatic gains in wealth and now hold 40 percent of total US wealth.[44] To put the wealth of the very rich in context, the average net worth of the 400 wealthiest Americans is "about the same as the gross domestic product of Brazil," according to Forbes Magazine.[45]

For most Americans, incomes are stagnant, debt levels are rising, and they are taking home a smaller share of the pie than they once did and falling further behind the rich. This means, as economists put it, that the opportunities for the poor and middle class are increasingly constrained in comparison to those of the rich.

THE EMERGENCE OF MIDDLE OUT

As dramatic as these trends are, by themselves they were not enough to force economists to rethink their ideas about inequality. Rather, there were three developments that really pushed economists to pay serious attention to inequality and study its impact on the economy. Improved measurement of the incomes of the very rich helped, as did patterns of economic growth around the globe that didn't conform to expectations, but most important was the Great Recession

Traditional measures showed that inequality in the United States had become higher than in many other countries, including notoriously unequal ones like the Philippines, Nigeria, and Russia.[46] But in recent years, economists such as Thomas Piketty and as UC Berkeley's Emmanuel Saez developed more accurate data about the incomes of the very rich over time which showed not only that the top 1 percent in America took home a much greater share of the nation's income than did the rich in most of the world, but also that the share the very rich received equaled record levels in American history.[47] The improved data not only elucidated these comparisons but also enabled economists to perform more nuanced analysis than they had been able to do before.

At the same time as income data was improving, growth trends in many countries were defying economists' models. Well before the Great Recession struck, it was becoming increasingly clear that the American economy grew more rapidly in the middle part of the twentieth century when the middle class was stronger than it did in recent, highly unequal decades.[48] Further, other rich countries that were more equal were growing at least as fast as the United States—and some actually had higher per capita growth rates.[49] Economists who studied growth, especially in the developing world, began to think that an important reason why countries like South Korea were growing much more rapidly than countries like the Philippines was because they had lower levels of inequality.[50] NYU's William Easterly, for example, argued that in countries around the world "middle-class societies have more income and growth."[51] In one of the more important papers in this line of research, Andrew Berg and Jonathan Ostry, economists at the International Monetary Fund, found that more equal countries tend to have significantly longer periods of growth while unequal countries had great trouble maintaining their growth for any sustained period.[52]

These observations about growth around the world didn't prove that inequality was harming the US economy, but they did at least suggest that the old ideas about inequality might be wrong and indicated the need for more research. This line of international comparative research became bogged down over data and methodological questions—and not every scholar came to similar conclusions—but the research clearly showed that simple assertions about inequality being good for the economy were not accurate and demonstrated that economists needed to think more deeply about exactly how inequality impacts economic growth.[53] As Heather Boushey, the executive director of the Washington Center for Equitable Growth, and Adam Hersh, a senior economist at the Center for American Progress, wrote, this cross-country analysis indicated that economists "need to understand the mechanisms through which inequality and the strength of the middle class affect the economy."[54] The actual experiences of countries around the world showed that scholars had to start looking at how inequality and the strength of the middle class impacted the underpinnings of growth. Especially before the Great Recession, these international comparisons were critical for challenging economists' preconceptions about inequality.

Then the Great Recession struck just as economic inequality in the United States was reaching the same level as had occurred right before the start of the Great Depression in 1929. The dramatic economic collapse forced many economists to look at inequality in a new way. Though the relationship between economic inequality and financial collapse is not as simple or direct as some have tried to claim, inequality and the weakness of the middle class clearly played a big part in driving the Great Recession.[55] The Great Recession began in the United States and was so severe in large part because our financial regulations were weakened by the political power of Wall Street and because the middle class was heavily indebted.[56] As Joseph Stiglitz, a Nobel Prize–winning economist, explained, "The most recent financial crisis has shown the errors" of ignoring inequality."[57]

When thinking critically about economic inequality and throwing off the blinders that have restricted the vision of economists, it is clear that America's economy depends upon a strong middle class. The middle-out theory of economic growth that emerges has deep historical roots in economics and other disciplines but also benefits from newer lines of research.[58]

A strong middle class performs four primary roles in the US economy. First, a strong middle class helps society function relatively smoothly, with higher levels of trust among people. Trust may seem a bit abstract, but it has a dramatic economic impact. People need to be able to trust one another enough to do business with one another. When there is little trust, the cost of doing business shoots up—or, as economists put it, transaction costs increase. As the middle class has weakened over the past few decades, trust has declined and transaction costs have risen sharply. Businesses and individuals, for example, have hired lawyers and security guards much more frequently than they previously did.[59] While these occupations may provide a valuable service, they don't increase the productivity of the economy, and merely add to the cost of doing business. Even worse, in part because of the decline in trust, businesses are increasingly focused on the short-term instead of long-term results.

Second, a strong middle class leads to better governance. A thriving economy depends on a well-functioning government that provides critical services, such as roads and schools, with relatively little corruption. But as the middle class has weakened and inequality risen, the wealthy have gained excessive political power and the middle class has become less civic, leading to a host of governmental dysfunctions. The failures of American government over the past few decades have increasingly harmed the economy. America has underinvested in public goods like schools and roads in large part because the wealthy don't want to pay the taxes to fund them and has, for example, cut spending on infrastructure by $89 billion per year compared to what we spent several decades ago.[60] Corruption has increased sharply according to government data and surveys of experts. And the costs of special favors for business, especially for Wall Street, have risen to astronomical levels.

Third, the middle class is a source of stable demand. A stable and growing base of consumer demand enables businesses to invest in new products and hire additional workers, fueling growth. But because consumer demand in the years prior to the Great Recession was based heavily on middle-class debt, the economy was unstable. And now that the middle class is so weak, burdened by stagnant incomes, high debt levels, and underwater mortgages, they can't consume enough to keep the American economy going. In the aftermath of the Great Recession, the US economy is stuck in a cycle of low demand and low growth.

Finally, a strong middle class creates more human capital. In the modern economy a skilled, healthy, and entrepreneurial workforce is a driver of economic growth, at least as much as the physical capital of factories and machines. But as inequality has risen and the middle class has weakened, America has not developed the full human potential of its middle class and poor. We have been passed by our international competitors on measures of human capital because education and health outcomes for the middle class and poor have fallen sharply behind those of more affluent Americans.[61]

Further, entrepreneurship in America has declined as many would-be business leaders have been unable to take advantage of their human capital because members of the middle class no longer have the money necessary to start a business.[62]

In short, the decline of the American middle class has harmed the economy by restricting human capital, shrinking consumer demand, exacerbating governmental problems, and undermining trust.[63] The various ways the middle class is struggling affect these mechanisms of growth in slightly different ways. High levels of debt play a key role in reducing consumer demand, for example, while the declining position of the middle class compared to the rich undermines the quality of government. The middle class's lack of money is particularly important in explaining their inability to start a business, while extreme inequality has undermined societal trust. Stagnant incomes, rising debt, and record levels of inequality all impact growth and none can be ignored.

For people with economic models in their head, the weakness of the middle class can be thought of as harming the economy through both production (supply-side) and consumption (demand-side) mechanisms. Weak middle-class consumption has reduced aggregate demand, while declining trust and the inability of people to take full advantage of their human capital have limited the productive capacity of the economy. Inadequate government investments in infrastructure and education reduce the potential output of the country and are also part of why low levels of demand are holding back the economy in the aftermath of the Great Recession. As Robert Solow, who won the Nobel Prize for his analysis of economic growth, explained in a speech in 2013: "Any way you look at it, a highly unequal society is not exploiting its full potential for growth."[64] Further, these problems with demand, government, trust, and human capital that are fueled by the weakness of the middle class often reinforce one another. When government policies favored Wall Street interests, the new types of financial engineering that were allowed not only created great risks for the economy, but also contributed to the rise in debt that made the economy more fragile and reduced consumer spending in the wake of the Great Recession. America's college graduation rates have stagnated not only because middle-class and poor families have had a hard time affording college tuition when their incomes are declining but also because government investments in higher education have been inadequate because of the growing political power of the wealthy.

Because of this growing understanding of how inequality harms our economy, the stage has been set for transformative political conflict. We are now at a sea-change moment in economic policymaking in the United States.

THE DEBATE OF OUR TIMES

After 30 years of political dominance, it is obvious that supply-side economics has failed in a number of ways and is thus vulnerable to a challenge from middle out. Supply side fueled the Great Recession of 2007–2009 by destabilizing consumer demand and encouraging the deregulation of Wall Street—directly costing the United States 8.7 million jobs and trillions of dollars in reduced economic growth.[65] The Great Recession alone is more than enough reason to get rid of supply side. But even excluding the Great Recession and its aftermath, growth was much slower over the past several decades, when trickle-down was ascendant, than it was in prior decades.[66] Even within the supply-side period, growth was weaker after President George W. Bush cut taxes for higher earners than it was after President Bill Clinton raised taxes on the rich.[67]

Moreover, trickle-down's supposed growth mechanisms haven't occurred the way the theory predicted. Savings, investment, employment, and productivity didn't increase after trickle-down policies were enacted, as a host of studies have shown.[68] And budget deficits skyrocketed when tax cuts didn't pay for themselves, contrary to the claims of trickle-down proponents.[69]

President Barack Obama has taken important first steps to take advantage of the opening provided by the failures of supply-side economics, arguing in several important speeches that "our economy doesn't grow from the top down; it grows from the middle out."[70] Importantly, President Obama has presented his argument as a direct challenge to the underpinnings of supply-side, stating that "we need to dispel the myth that the goals of growing the economy and reducing inequality are necessarily in conflict."[71] President Obama has even begun to explain some of the mechanisms of middle-out economics, noting, for example, the importance of middle-class consumer demand to the economy.[72] And a number of progressive governors and other rising political leaders have started to make similar arguments.[73]

These speeches have challenged supply-side economics in a way previous criticism has not. Previous criticism attacked supply-side indirectly—arguing, for example, that tax cuts make it harder to pay for important investments in education—but did not directly challenge the basic premise that the rich are job creators, or provide a comprehensive, alternative theory of economic growth.

But, even in the face of a direct challenge, supply side will not die easily because it is deeply ingrained in the thinking of both political parties. Supply side dominates the Republican Party and a number of leading independents and Democrats subscribe to its logic. Indeed, since the 1970s, taxes have been cut much more sharply for the rich than they have for the middle class, not just because of Republicans, but in large part because Democrats also supported these policies.[74] Certainly many Democrats opposed these changes, but Democrats often provided the critical support necessary for the proposals to become law.[75] President Bill Clinton, for example, signed into law a bill lowering capital gains taxes, which dramatically reduced taxes on the wealthy, especially the very wealthy, while doing little for the middle class—though he of course also increased income taxes in opposition to trickle-down orthodoxy.[76]

Further, trickle-down logic can frequently be heard in the statements of prominent politicians who are not part of the Republican Party. To take just a few examples: Andrew Cuomo, Democratic governor of New York, said that tax cuts for business and individuals are "the centerpiece" of his agenda, and his announcement of a commission to study how to do so was seen as the kickoff to his reelection campaign in 2014.[77] In 2013, Independent Michael Bloomberg argued that increasing the number of billionaires in New York City—even though it would increase inequality—would be a "godsend" because "they're the ones that spend a lot of money in the stores and restaurants and create a big chunk of our economy."[78] Douglas Gansler, a Democratic candidate for governor in Maryland in 2014, announced that he planned to cut taxes on business to help generate growth, according to his campaign.[79]

Tickle-down logic is also endlessly repeated in the media, where it is often accepted as fact. A recent study by Occidental College political scientist Peter Dreier and University of Northern Iowa communications professor Christopher Martin found that between 2009 and 2011 four elite media outlets (the *AP, Wall Street Journal, New York Times,* and *Washington Post*) frequently quoted people using the term "job killer" or used the term without attribution.[80] In over 90 percent of cases, the media failed to provide evidence to back the claim and simply bought into supply-side dogma. Leading issues portrayed as job killers were proposals to increase taxes on business and the wealthy or to raise the minimum wage. That proposals to raise revenue for schools and roads or put more money in the pockets of workers were portrayed in such a negative light is exactly what we would expect after over 30 years of trickle-down economics.

As a result, it is fair to say that the trickle-down worldview has impacted policymaking for more than three decades, from the late 1970s to today. Not only is trickle-down still lodged firmly in place, but since the Great Recession, adherents of supply side have sharpened their claims and doubled down on their policies, showing that they will not go down without a fight.

Republican presidential candidate Mitt Romney ran against Obama in 2012 by proposing tax cuts for the wealthy that were far larger than the cuts enacted by President George W. Bush.[81] The budget proposal by the House Republicans in 2013 would have provided bigger tax cuts to the wealthy than even the Romney plan.[82] Further, these federal proposals for additional tax cuts for the rich would likely have required tax increases on the middle class, according to a number of analyses.[83] Similarly, in state houses, Republican governors like North Carolina's Pat McCrory, Kansas's Sam Brownback, Wisconsin's Scott Walker, and New Jersey's Chris Christie have recently proposed policies that cut taxes for businesses and the wealthy, but raise them on the middle class.[84] In contrast, supply-side proposals of the past cut taxes most dramatically for the wealthy, but still reduced taxes for most everyone.[85]

That supply-side supporters have become even more dogmatic in the aftermath of the Great Recession is not particularly surprising. American history shows that proponents of the dominant theory often do not admit the error of their ways, but rather become even more strident as evidence mounts that their logic has failed.

The dominant economic philosophy during the late 1800s and early 1900s was called laissez-faire. Like supply side, laissez-faire was based on a belief that high levels of inequality were morally just and economically beneficial.[86] Laissez-faire's proponents similarly pushed for big tax cuts for the wealthy and little regulation of business.[87] Andrew Mellon, a wealthy banker and treasury secretary to a line of Republican presidents from Warren Harding to Calvin Coolidge to Herbert Hoover, exemplified the dominant thinking of his era, arguing that "high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business."[88]

Even the complete economic failure of the economy during the Great Depression did not change the thinking of proponents of laissez-faire. After the economy collapsed in 1929, supporters of laissez-faire continued to push their favored policies. The Great Depression was an opportunity to "purge the rottenness out of the system" according to Mellon and "liquidate labor, liquidate stocks, liquidate farmers"—further extending the economic power of the remaining rich.[89]

It took John Maynard Keynes developing an alternative understanding of the economy in 1936—explaining how the favored policies of laissez-faire were counterproductive because low levels of demand were causing the economy to remain stuck in a prolonged depression—and years of political debate to finally establish broad, popular support for a new, working theory of the economy.[90] Once the Keynesian perspective was firmly in place after World War II, it dominated American economic policymaking for a generation or more. Beginning with President Franklin Roosevelt, and continuing through President Richard Nixon, the Keynesian perspective prevailed.[91]

But, in the late 1970s, high levels of inflation (fueled largely by external oil shocks), combined with a high unemployment rate, provided an opening to challenge Keynesian economics. Followers of Keynes were unprepared to deal with these problems and had lost credibility because they had helped exacerbate inflation by promoting governmental stimulus during times of full employment—contrary to Keynes's argument that government stimulus was only for recessions while balanced budgets should be maintained at other times.[92] As the economy soured in the late 1970s, supply side garnered a growing base of political supporters and seemed to have more compelling answers.[93] For several years, followers of Keynes and supply side battled, but with the election of Ronald Reagan as president and the passage of his economic agenda through Congress, supply side replaced Keynesian economics and became the prevailing view of policymakers.

Now, there is clearly an opening to challenge supply side. But the theory continues to have great political influence not just because it has powerful supporters, but more fundamentally because an alternative theory has not yet replaced it. Without a different way of understanding the economy, politicians hang on to what they know. Too many politicians today continue to push supply-side policies that exacerbate the economy's woes, just as politicians did in the aftermath of the Great Depression when they championed laissez-faire policies that further weakened the economy. As Keynes explained in the 1930s: "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."[94] Ideas—both when they are right and when they are wrong—are often more powerful than vested interests.[95]

Replacing supply side will of course take a fight. But more than that, it requires understanding why it hasn't worked and why middle out does a better job. Political speeches are an important part of this educational process, but they cannot convey the wealth of information supporting middle out.

This book explains what's behind middle-out economics.

A handful of important books have highlighted elements of middle out—most notably explaining how a strong middle class is critical to maintaining adequate demand—but the divergent research disciplines that contribute to middle-out economics have not been fully explored.[96] As this book explains, not only is inadequate consumer demand causing businesses to hold back on hiring, but the decline of the middle class is causing a host of other problems that for too long have been hidden from view. The decline of the middle class is undermining trust, driving poor government performance, and restricting human capital—all of which are harming the economy. Further, this book provides concrete examples of how the US economy has been harmed by extreme levels of inequality. The weakening of the middle class has led to a rapid rise in the percentage of security guards and lawyers, corporations increasingly focusing on short-term results, a measurable growth in corruption in government, reduced spending on public goods like infrastructure, and the United States falling behind our international competitors on a host of measures of human capital including education, health, entrepreneurship, and mobility, not to mention the collapse of the economy during the Great Recession. Moreover, *Hollowed Out* explains the political significance of these facts.

The claims of middle out are grounded in time and place. And the argument for middle-out economics is grounded in reality, rather than abstract theory.

Defenders of trickle-down often make universal claims—that tax cuts are needed no matter how low taxes are, that higher levels of inequality are good no matter the level. And to shut down debate, they sometimes resort to arguments about how perfect equality, where everyone has the same amount of money, would stifle growth. Indeed, Paul Ryan, Republican nominee for vice president in 2012 and current chair of the powerful House Ways and Means Committee, falsely argues that opponents of trickle-down maintain an "insistence on equality of outcome."[97] Similarly, "Imagine a society with perfect economic equality" is the first line of an article from 2013 titled "Defending the One Percent" by Greg Mankiw, a Harvard economist and the former chief economic advisor to President George W. Bush and Republican presidential nominee Mitt Romney.[98]

Of course, absolute equality of conditions would reduce growth by stifling incentives. Just as perfect inequality, where one person held all of society's wealth, would reduce growth because no one would have any money to buy anything. Equality is good up to a point, just as inequality is good up to a point.

The real question is whether the current, extremely high levels of economic inequality are hurting the US economy. The answer is a resounding yes. As *Hollowed Out* will explain, the economy is an interrelated system of people, laws, and culture that has been destabilized by extreme levels of inequality and a weakened middle class. For the economy to work properly, we need to rebuild the middle class and make sure everyone has an opportunity to succeed.