



The Crisis of the Middle Class and American Power

John Mauldin | January 11, 2013

Thinking about the long term is all too rare a talent these days and one I really appreciate. When you take a longer view, it is easier to see how all the moving parts, the bits and pieces, fit together. And you can see other streams of action impacting your original line of thought.

In today's Outside the Box, my (and our) old friend George Friedman thinks about the future of employment and how it impacts the expression of American social order and geopolitical power. Sitting here in Stockholm tonight, that was the very point we were making in our dinner conversation with the management team of the Skagen funds. It is not just a US problem, although George looks at the US. This is a global issue as the gulf between the middle class and the upper income classes is widening, and it is widening for structural reasons. There are no easy answers. Dennis Gartman quotes PJ O'Rourke, who basically launched a shot from the right. It speaks for itself:

Mr. President, the worst thing that you've done is that you sent a message to America in your reelection campaign that we live in a zero-sum universe.

There is a fixed amount of good things. Life is a pizza. If some people have too many slices, other people have to eat the pizza box. You had no answer to Mitt Romney's argument for more pizza parlors baking more pizzas. The solution to our problems, you said, is redistribution of the pizzas we've got—with low-cost, government-subsidized pepperoni somehow materializing as the result of higher taxes on pizza-parlor owners.

In this zero-sum universe there is only so much happiness. The idea is that if we wipe the smile off the faces of people with prosperous businesses and successful careers, that will make the rest of us grin.

There is only so much money. The people who have money are hogging it. The way for the rest of us to get money is to turn the hogs into bacon. The evil of zero-sum thinking and redistributive politics has nothing to do with which things are taken or to whom those things are given or what the sum of zero things is supposed to be. The evil lies in denying people the right, the means, and, indeed, the duty to make more things.

But George notes the other side (bold emphasis mine):

Last week I wrote about the crisis of unemployment in Europe. I received a great deal of feedback, with Europeans agreeing that this is the core problem and Americans arguing that the United States has the same problem, asserting that U.S. unemployment is twice as high as the government's official unemployment rate. My counterargument is that unemployment in the United States is not a problem in the same sense that it is in Europe because it does not pose a geopolitical threat. The

United States does not face political disintegration from unemployment, whatever the number is. Europe might.

At the same time, I would agree that the United States faces a potentially significant but longer-term geopolitical problem deriving from economic trends. **The threat to the United States is the persistent decline in the middle class' standard of living, a problem that is reshaping the social order that has been in place since World War II and that, if it continues, poses a threat to American power.**

These issues and the threat they pose have to be resolved. The structural mechanisms are creating the imbalance. We need to nurture creativity and we need to reward it, but it creates a wide dispersion of income.

I think you will find George's analysis quite thought-provoking, and you may find yourself wanting a Stratfor subscription. They are offering my readers a discount on their excellent products, and, you can get on board by clicking here: <https://www.stratfor.com/subscribe/mauldin-jmf>.

I am in Stockholm tonight (and did Copenhagen and Oslo) on my way to the south of Spain for a few days, for what is hoped will be a vacation, then a day in London for a Soc-Gen Conference and one of my famous "dinners with interesting people." Dylan Grice (Soc Gen), Anatole Kaletsky (GaveKal, Simon Hunt (serious expert on copper and China), Dan Stetler (chief econ and Boston Consulting and wicked brilliant), Jonathan Tepper (of Variant Perception and my co-author). Just found out Richard Howard of Hayman Partners (Kyle's Bass's operation) and a few others will be there, too. I shall learn a lot. Then I'm off to Greece for five days with Christian Menegatti of Roubini Economics before ending up in Geneva and then returning to Dallas.

Have a great week. I am having a blast and will write your Thoughts from the Frontline letter tomorrow. Three computer crashes in five days! What are the chances? Ugh. But Life is fun and you take it all in stride. Just means I needed to think more about this next letter – maybe I will get it right.

Your ready for some Costa del Sol analyst,



John Mauldin, Editor
Outside the Box

The Crisis of the Middle Class and American Power

By George Friedman

[Founder and Chief Executive Officer](#)

Last week I wrote about the [crisis of unemployment in Europe](#). I received a great deal of feedback, with Europeans agreeing that this is the core problem and Americans arguing that the United States has the same problem, asserting that U.S. unemployment is twice as high as the government's official unemployment rate. My counterargument is that unemployment in the United States is not a problem in the same sense that it is in Europe because it does not pose a geopolitical threat. The United States does not face political disintegration from unemployment, whatever the number is. Europe might.

At the same time, I would agree that the [United States](#) faces a potentially significant but longer-term geopolitical problem deriving from economic trends. The threat to the United States is the persistent decline in the middle class' standard of living, a problem that is reshaping the social order that has been in place since World War II and that, if it continues, poses a threat to American power.

The Crisis of the American Middle Class

The median household income of Americans in 2011 was \$49,103. Adjusted for inflation, the median income is just below what it was in 1989 and is \$4,000 less than it was in 2000. Take-home income is a bit less than \$40,000 when Social Security and state and federal taxes are included. That means a monthly income, per household, of about \$3,300. It is urgent to bear in mind that half of all American households earn less than this. It is also vital to consider not the difference between 1990 and 2011, but the difference between the 1950s and 1960s and the 21st century. This is where the difference in the meaning of middle class becomes most apparent.

In the 1950s and 1960s, the median income allowed you to live with a single earner -- normally the husband, with the wife typically working as homemaker -- and roughly three children. It permitted the purchase of modest tract housing, one late model car and an older one. It allowed a driving vacation somewhere and, with care, some savings as well. I know this because my family was lower-middle class, and this is how we lived, and I know many others in my generation who had the same background. It was not an easy life and many luxuries were denied us, but it wasn't a bad life at all.

Someone earning the median income today might just pull this off, but it wouldn't be easy. Assuming that he did not have college loans to pay off but did have two car loans to pay totaling \$700 a month, and that he could buy food, clothing and cover his utilities for \$1,200 a month, he would have \$1,400 a month for mortgage, real estate taxes and insurance, plus some funds for fixing the air conditioner and dishwasher. At a 5 percent mortgage rate, that would allow him to buy a house in the \$200,000 range. He would get a refund back on his taxes from deductions but that would go to pay credit card bills he had from Christmas presents and emergencies. It could be done, but not easily and with great difficulty in major metropolitan areas. And if his employer didn't cover health insurance, that \$4,000-5,000 for three or four people would severely limit his expenses. And of course, he would have to have \$20,000-40,000 for a down payment and closing costs on his home. There would be little else left over for a week at the seashore with the kids.

And this is for the median. Those below him -- half of all households -- would be shut out of what is considered middle-class life, with the house, the car and the other associated amenities. Those amenities shift upward on the scale for people with at least \$70,000 in income. The basics might be available at the median level, given favorable individual circumstance, but below that life becomes surprisingly meager, even in the range of the middle class and certainly what used to be called the lower-middle class.

The Expectation of Upward Mobility

I should pause and mention that this was one of the fundamental causes of the [2007-2008 subprime lending crisis](#). People below the median took out loans with deferred interest with the expectation that their incomes would continue the rise that was traditional since World War II. The caricature of the borrower as irresponsible misses the point. The expectation of rising real incomes was built into the American culture, and many assumed based on that that the rise would resume in five years. When it didn't they were trapped, but given history, they were not making an irresponsible assumption.

[American history](#) was always filled with the assumption that upward mobility was possible. The Midwest and West opened land that could be exploited, and the massive industrialization in the late 19th and early 20th centuries opened opportunities. There was a systemic expectation of upward mobility built into American culture and reality.

The Great Depression was a shock to the system, and it wasn't solved by the New Deal, nor even by World War II alone. The next drive for upward mobility came from post-war programs for veterans, of whom there were more than 10 million. These programs were instrumental in creating post-industrial America, by creating a class of suburban professionals. There were three programs that were critical:

1. The GI Bill, which allowed veterans to go to college after the war, becoming professionals frequently several notches above their parents.
2. The part of the GI Bill that provided federally guaranteed mortgages to veterans, allowing low and no down payment mortgages and low interest rates to graduates of publicly funded universities.
3. The federally funded Interstate Highway System, which made access to land close to but outside of cities easier, enabling both the dispersal of populations on inexpensive land (which made single-family houses possible) and, later, the dispersal of business to the suburbs.

There were undoubtedly many other things that contributed to this, but these three not only reshaped America but also created a new dimension to the upward mobility that was built into American life from the beginning. Moreover, these programs were all directed toward veterans, to whom it was acknowledged a debt was due, or were created for military reasons (the Interstate Highway System was funded to enable the rapid movement of troops from coast to coast, which during World War II was found to be impossible). As a result, there was consensus around the moral propriety of the programs.

The subprime fiasco was rooted in the failure to understand that the foundations of middle class life were not under temporary pressure but something more fundamental. Where a single earner could support a middle class family in the generation after World War II, it now took at least two

earners. That meant that the rise of the double-income family corresponded with the decline of the middle class. The lower you go on the income scale, the more likely you are to be a single mother. That shift away from social pressure for two parent homes was certainly part of the problem.

Re-engineering the Corporation

But there was, I think, the crisis of the modern corporation. Corporations provided long-term employment to the middle class. It was not unusual to spend your entire life working for one. Working for a corporation, you received yearly pay increases, either as a union or non-union worker. The middle class had both job security and rising income, along with retirement and other benefits. Over the course of time, the culture of the corporation diverged from the realities, as corporate productivity lagged behind costs and the corporations became more and more dysfunctional and ultimately unsupportable. In addition, the corporations ceased focusing on doing one thing well and instead became conglomerates, with a management frequently unable to keep up with the complexity of multiple lines of business.

For these and many other reasons, the corporation became increasingly inefficient, and in the terms of the 1980s, they had to be re-engineered -- which meant taken apart, pared down, refined and refocused. And the re-engineering of the corporation, designed to make them agile, meant that there was a permanent revolution in business. Everything was being reinvented. Huge amounts of money, managed by people whose specialty was re-engineering companies, were deployed. The choice was between total failure and radical change. From the point of view of the individual worker, this frequently meant the same thing: unemployment. From the view of the economy, it meant the creation of value whether through breaking up companies, closing some of them or sending jobs overseas. It was designed to increase the total efficiency, and it worked for the most part.

This is where the disjuncture occurred. From the point of view of the investor, they had saved the corporation from total meltdown by redesigning it. From the point of view of the workers, some retained the jobs that they would have lost, while others lost the jobs they would have lost anyway. But the important thing is not the subjective bitterness of those who lost their jobs, but something more complex.

As the permanent corporate jobs declined, more people were starting over. Some of them were starting over every few years as the agile corporation grew more efficient and needed fewer employees. That meant that if they got new jobs it would not be at the munificent corporate pay rate but at near entry-level rates in the small companies that were now the growth engine. As these companies failed, were bought or shifted direction, they would lose their jobs and start over again. Wages didn't rise for them and for long periods they might be unemployed, never to get a job again in their now obsolete fields, and certainly not working at a company for the next 20 years.

The restructuring of inefficient companies did create substantial value, but that value did not flow to the now laid-off workers. Some might flow to the remaining workers, but much of it went to the engineers who restructured the companies and the investors they represented. Statistics reveal that, since 1947 (when the data was first compiled), corporate profits as a percentage of gross domestic product are now at their highest level, while wages as a percentage of GDP are now at their lowest level. It was not a question of making the economy more efficient -- it did do that -- it was a question of where the value accumulated. The upper segment of the wage curve and the

investors continued to make money. The middle class divided into a segment that entered the upper-middle class, while another faction sank into the lower-middle class.

American society on the whole was never egalitarian. It always accepted that there would be substantial differences in wages and wealth. Indeed, progress was in some ways driven by a desire to emulate the wealthy. There was also the expectation that while others received far more, the entire wealth structure would rise in tandem. It was also understood that, because of skill or luck, others would lose.

What we are facing now is a structural shift, in which the middle class' center, not because of laziness or stupidity, is shifting downward in terms of standard of living. It is a structural shift that is rooted in social change (the breakdown of the conventional family) and economic change (the decline of traditional corporations and the creation of corporate agility that places individual workers at a massive disadvantage).

The inherent crisis rests in an increasingly efficient economy and a population that can't consume what is produced because it can't afford the products. This has happened numerous times in history, but the United States, excepting the Great Depression, was the counterexample.

Obviously, this is a massive political debate, save that political debates identify problems without clarifying them. In political debates, someone must be blamed. In reality, these processes are beyond even the government's ability to control. On one hand, the traditional corporation was beneficial to the workers until it collapsed under the burden of its costs. On the other hand, the efficiencies created threaten to undermine consumption by weakening the effective demand among half of society.

The Long-Term Threat

The greatest danger is one that will not be faced for decades but that is lurking out there. The United States was built on the assumption that a rising tide lifts all ships. That has not been the case for the past generation, and there is no indication that this socio-economic reality will change any time soon. That means that a core assumption is at risk. The problem is that social stability has been built around this assumption -- not on the assumption that everyone is owed a living, but the assumption that on the whole, all benefit from growing productivity and efficiency.

If we move to a system where half of the country is either stagnant or losing ground while the other half is surging, the social fabric of the United States is at risk, and with it the massive global power the United States has accumulated. Other superpowers such as Britain or Rome did not have the idea of a perpetually improving condition of the middle class as a core value. The United States does. If it loses that, it loses one of the pillars of its geopolitical power.

The left would argue that the solution is for laws to transfer wealth from the rich to the middle class. That would increase consumption but, depending on the scope, would threaten the amount of capital available to investment by the transfer itself and by eliminating incentives to invest. You can't invest what you don't have, and you won't accept the risk of investment if the payoff is transferred away from you.

The agility of the American corporation is critical. The right will argue that allowing the [free market](#) to function will fix the problem. The free market doesn't guarantee social outcomes, merely economic ones. In other words, it may give more efficiency on the whole and grow the economy

as a whole, but by itself it doesn't guarantee how wealth is distributed. The left cannot be indifferent to the historical consequences of extreme redistribution of wealth. The right cannot be indifferent to the political consequences of a middle-class life undermined, nor can it be indifferent to half the population's inability to buy the products and services that businesses sell.

The most significant actions made by governments tend to be unintentional. The GI Bill was designed to limit unemployment among returning servicemen; it inadvertently created a professional class of college graduates. The VA loan was designed to stimulate the construction industry; it created the basis for suburban home ownership. The Interstate Highway System was meant to move troops rapidly in the event of war; it created a new pattern of land use that was suburbia.

It is unclear how the private sector can deal with the problem of pressure on the middle class. Government programs frequently fail to fulfill even minimal intentions while squandering scarce resources. The United States has been a fortunate country, with solutions frequently emerging in unexpected ways.

It would seem to me that unless the United States gets lucky again, its global dominance is in jeopardy. Considering its history, the United States can expect to get lucky again, but it usually gets lucky when it is frightened. And at this point it isn't frightened but angry, believing that if only its own solutions were employed, this problem and all others would go away. I am arguing that the conventional solutions offered by all sides do not yet grasp the magnitude of the problem -- that the foundation of American society is at risk -- and therefore all sides are content to repeat what has been said before.

People who are smarter and luckier than I am will have to craft the solution. I am simply pointing out the potential consequences of the problem and the inadequacy of all the ideas I have seen so far.

Copyright 2013 John Mauldin. All Rights Reserved.

Share Your Thoughts on This Article

Post a Comment

Like *Outside the Box*? Then we think you'll love John's premium product, *Over My Shoulder*. Each week John Mauldin sends his *Over My Shoulder* subscribers the most interesting items that he personally cherry picks from the dozens of books, reports, and articles he reads each week as part of his research. [Learn more about *Over My Shoulder*](#)

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting <http://www.mauldineconomics.com>.

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.mauldineconomics.com

Please write to subscribers@mauldineconomics.com to inform us of any reproductions, including when and where copy will be reproduced. You must keep the letter intact, from introduction to disclaimers. If you would like to quote brief portions only, please reference <http://www.mauldineconomics.com>.

To subscribe to John Mauldin's e-letter, please click here: <http://www.mauldineconomics.com/subscribe/>

To change your email address, please click here: <http://www.mauldineconomics.com/change-address>

If you would ALSO like changes applied to the Mauldin Circle e-letter, please include your old and new email address along with a note requesting the change for both e-letters and send your request to compliance@2000wave.com.

To unsubscribe, please refer to the bottom of the email.

Outside the Box and JohnMauldin.com is not an offering for any investment. It represents only the opinions of John Mauldin and those that he interviews. Any views expressed are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest and is not in any way a testimony of, or associated with, Mauldin's other firms. John Mauldin is the Chairman of Mauldin Economics, LLC. He also is the President of Millennium Wave Advisors, LLC (MWA) which is an investment advisory firm registered with multiple states, President and registered representative of Millennium Wave Securities, LLC, (MWS) member FINRA, SIPC. MWS is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB) and NFA Member. Millennium Wave Investments is a dba of MWA LLC and MWS LLC. This message may contain information that is confidential or privileged and is intended only for the individual or entity named above and does not constitute an offer for or advice about any alternative investment product. Such advice can only be made when accompanied by a prospectus or similar offering document. Past performance is not indicative of future performance. Please make sure to review important disclosures at the end of each article. Mauldin companies may have a marketing relationship with products and services mentioned in this letter for a fee.

Note: Joining the Mauldin Circle is not an offering for any investment. It represents only the opinions of John Mauldin and Millennium Wave Investments. It is intended solely for investors who have registered with Millennium Wave Investments and its partners at www.MauldinCircle.com or directly related websites. The Mauldin Circle may send out material that is provided on a confidential basis, and subscribers to the Mauldin Circle are not to send this letter to anyone other than their professional investment counselors. Investors should discuss any investment with their personal investment counsel. John Mauldin is the President of Millennium Wave Advisors, LLC (MWA), which is an investment advisory firm registered with multiple states. John Mauldin is a registered representative of Millennium Wave Securities, LLC, (MWS), an FINRA registered broker-dealer. MWS is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB). Millennium Wave Investments is a dba of MWA LLC and MWS LLC. Millennium Wave Investments cooperates in the consulting on and marketing of private and non-private investment offerings with other independent firms such as Altegris Investments; Capital Management Group; Absolute Return Partners, LLP; Fynn Capital; Nicola Wealth Management; and Plexus Asset Management. Investment offerings recommended by Mauldin may pay a portion of their fees to these independent firms, who will share 1/3 of those fees with MWS and thus with Mauldin. Any views expressed herein are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest with any CTA, fund, or program mentioned here or elsewhere. Before seeking any advisor's services or making an investment in a fund, investors must read and examine thoroughly the respective disclosure document or offering memorandum. Since these firms and Mauldin receive fees from the funds they recommend/market, they only recommend/market products with which they have been able to negotiate fee arrangements.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.mauldineconomics.com

TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop.

All material presented herein is believed to be reliable but we cannot attest to its accuracy. Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs may or may not have investments in any funds cited above as well as economic interest. John Mauldin can be reached at 800-829-7273.