The fall of the US middle class and the hair-raising ascent of Donald Trump

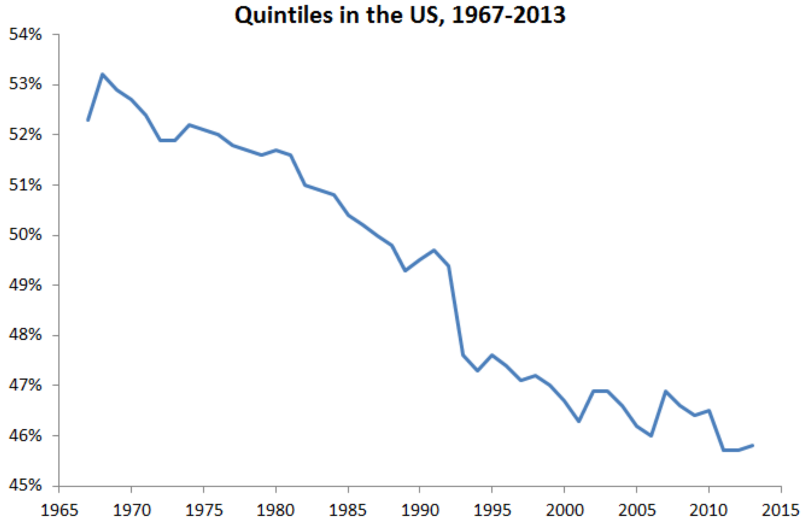
Steven Pressman [Colorado State University, CO, USA]

1. Introduction

According to Thomas Piketty (2014), between 1980 and 2010 the share of total US income going to the top 10% of earners rose from around 30-35%, where it stood for several decades, to nearly 50%. These are very conservative estimates. Piketty's figures come from the distribution of adjusted gross income (AGI), reported by the US Internal Revenue Service. AGI subtracts from income things like investment losses, retirement account contributions and their returns (see Pressman 2015, Chapter 2). With large adjustments, someone can make a lot of money but have little AGI; or, as in the case of Donald Trump, you can report a *negative* AGI of nearly $1 billion. In addition, tax-free income (such as unrealized capital gains and interest on municipal bonds), as well as returns on money hidden in tax havens, are not reported to the IRS and do not appear in AGI. Like the adjustments helping Trump avoid taxes, this income mainly goes to the wealthy and has been growing for several decades (Zucman, 2015).

As the rich received a bigger piece of the pie, everyone else got relatively less. We can see this in the falling share of income going to the middle-three income quintiles (Figure 1).

Figure 1: Percentage of Income Going to the 3 Middle Quintiles in the US, 1967-2013



Source: US Census Bureau, *Current Population Surveys*, various years

One standard economic argument for great inequality is that it generates incentives to make money and contributes to economic growth, which increases average living standards. Even if this is true, not everyone benefits from growth. Saez and Piketty (2013) estimate that since the late 1970s nearly 60% of all gains from growth have gone to the top 1%, roughly those making $500,000 or more in 2016.[1] Consequently, a typical US household has seen little improvement in their absolute standard of living for several decades. We can see this in figures on real median household income, which increased only slightly over the past quarter century – growing from $54,432 in 1988 to $56,516 in 2015.[2]

We focus here on another distributional measure – the size of the middle class. A thriving middle class is important for a number of reasons. First, there are political factors. Rothstein & Uslaner (2005, p. 52) argue that inequality reduces social capital or the trust needed to sustain democracy. Second, Robert Malthus (2008[1803], p. 594) noted: "Our best grounded expectations of an increase in the happiness of the mass of human society are founded in the prospect of an increase in the relative proportions of the middle parts." For Malthus, the additional income that moves one from poverty into the middle class is what makes life worthwhile. Finally, a large middle class improves economic performance. Alfred Marshall (1920, pp. 529-32, 566-9) noted that higher earnings may improve the habits of working people, thereby improving productivity and everyone's standard of living. From a Keynesian perspective, a large middle class increases consumption, effective demand and economic growth because middle-class households tend to spend larger fractions of their income than wealthy households.

This paper focuses on one particular political consequence of a shrinking middle class. It contends that this was a key factor in Donald Trump becoming President of the United States. Then it argues that the policies promulgated by Trump will not help the US middle class but will exacerbate recent inequality trends. The paper concludes with some suggestions for reviving the middle class. But first a measurement issue.

2. Who is middle class and what has happened to the middle class?

Numbers are important for understanding how economies work and developing policies that improve economic performance. Simon Kuznets developed national income accounting to measure economic growth. Irving Fisher developed price indices to compute the rate of inflation. And Mollie Orshansky developed the official US poverty rate. These enabled us to study the factors affecting these variables, and how we might increase growth, control inflation and reduce poverty.

Presently there is no accepted definition of "middle class", and no figures get calculated and reported regularly. This makes it difficult to ascertain if the US middle class has declined, identify factors that expand or shrink the middle class, or develop policies that might bolster the middle class. To measure the size of the middle class this paper follows the Orshansky methodology for measuring poverty.

Orshansky (1965, 1969) began with data on the minimum food requirements for families of

[1] The thresholds in Saez and Piketty (2013) need to be increased due to inflation and income not included in AGI.
[2] Remarkably, the 2014 figure was *below* the 1988 figure.

different sizes to survive during one year; then she estimated the cost of purchasing this food. Government surveys of household expenditures, undertaken during the 1940s and the 1950s, found that families (on average) spent around one-third of their income on food. So Orshansky multiplied the cost of a minimum food budget for each family size by three in order to arrive at their minimum income needs. These became the official US poverty thresholds. Each year they get increased by the annual rate of inflation.

To measure the size of the middle class we start, like Orshansky, with some data. In 2010 the Pew Research Center asked people how much income was necessary for a four-person family to be middle class in their neighborhood. While answers varied by location and income level (those living in cities and making more money provided larger figures), $70,000 was the median response. Wider Opportunities for Women (WOW) estimated that a household with two working parents and two children needed $68,136 in 2010 to have some economic security. This bought basic necessities and allowed some savings for retirement and emergencies. Finally, median income for a family of four in the US in 2010 was $68,274. If the Pew figure stems from the fact that people like nice round numbers, we can take the median income for a four-person family as the midpoint of the middle-class income range for a family of four.[3] The Pew Research Center (2012) also found that a preponderance of responses fell between two-thirds and twice the median income. Some differences stemmed from different perceptions regarding what was necessary to be middle class and some from regional cost of living differences.

Rather than focusing on income, we focus on *disposable income* to define the "middle class" because this is what people care about and what households use to purchase a middle-class standard of living. Moreover, changes in taxation over time affect a family's standard of living. One frequent criticism of the Orshansky poverty definition is that it failed to account for taxes paid by low-income households (Pressman 2013).

To compute the size of the middle class for any country in any given year, we start with the median income for a family of four. Next we convert this to median disposable income based on income taxes and payroll taxes paid, as well as government benefits received, and compute the percentage of households whose disposable income falls between two-thirds and twice median disposable income. For households of other sizes, we adjust median income for a family of four using the Orshansky adjustments for families of different sizes. Middle-class households are those whose disposable incomes fall between 67% and 200% of the median disposable income for a household of that size.

Table 1 shows middle-class income ranges in 2013 based on market income (rather than disposable income) since this is the typical reference point for most people. These numbers all seem reasonable. The lower figure is more than twice the Orshansky poverty thresholds, meeting the Horrigan and Haugen (1988) criterion for defining the middle class, and the top figure is not so high that we would consider a family wealthy.

One minor flaw in this procedure is that it doesn't account for falling median household income, as occurred during the Great Recession. In such situations, households may still be counted as middle class because of the fall in median income, but they will not feel middle class any longer. To deal with this issue we make one adjustment to our estimates. When real

[3] This is a better data source than the similar WOW estimate because it is available annually and over a long time period.

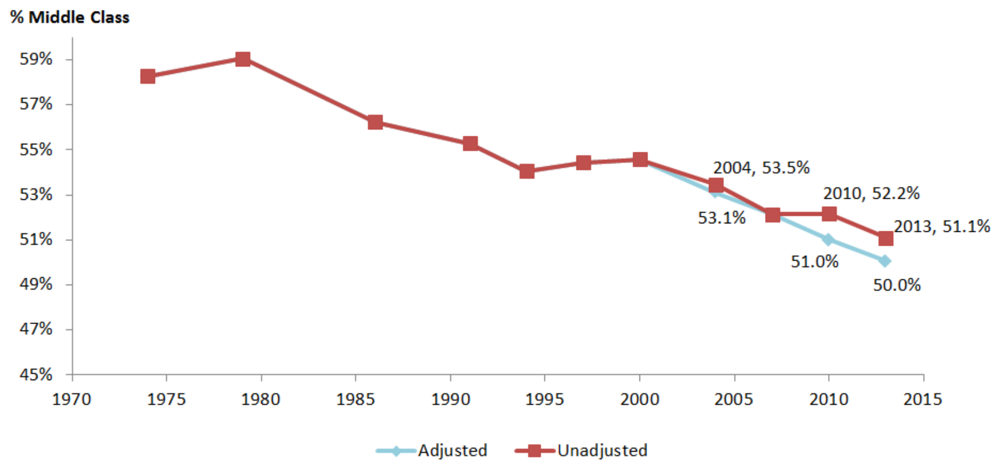
median income falls, we use the *highest previous real median income* and calculate the size of the middle class using that figure.

Table 1: Middle-Class Income Range for 2013	
HOUSEHOLD SIZE	INCOME RANGE (Household Income)
1	$28,569-$85,281
2	$37,140-$110,865
3	$45,710-$136,449
4	$54,281-$162,033
5	$62,852-$187,617
6	$71,422-$213,201
7	$79,993-$238,786
8	$88,564-$264,370
9+	$97,135-$289,954

Source: See Paper

Figure 2 plots the percentage of middle-class households in the US between 1974 and 2013 using our methodology and the Luxembourg Income Study (LIS),[4] an international database of income and socio-demographic information. LIS data for the US came from annual Census Bureau household surveys.

Figure 2: US MIDDLE CLASS OVER TIME



Source: Luxembourg Income Study Database

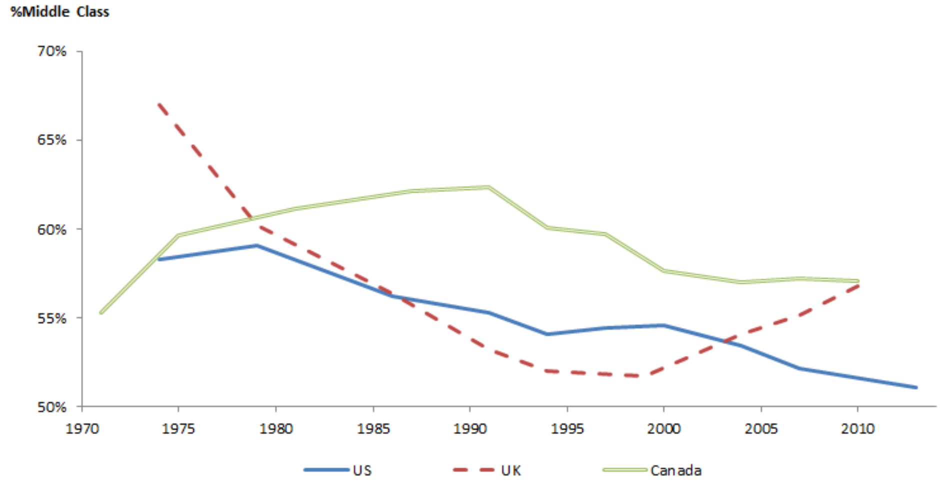
Undoubtedly the US middle class has shrunk since the 1980s, when it comprised 59% of all households. The only exception was the economic boom of the late 1990s when the size of the US middle class held steady. Figure 2 also shows what happens when our computations

[4] For more on LIS, see their homepage at www.lisdatacenter.org.

do not allow median household income to fall. The main adjustments occur after the Great Recession. In 2010, median household income for a family of four was $4,800 below the inflation-adjusted figure for 2007. Taking this into account reduces the size of the middle class by 1.2 percentage points. In 2013 median household income for a family of four was more than $5,100 below the inflation-adjusted figure for 2007. Using the higher real median income from 2007 reduces the size of the US middle class to just 50% in 2013.

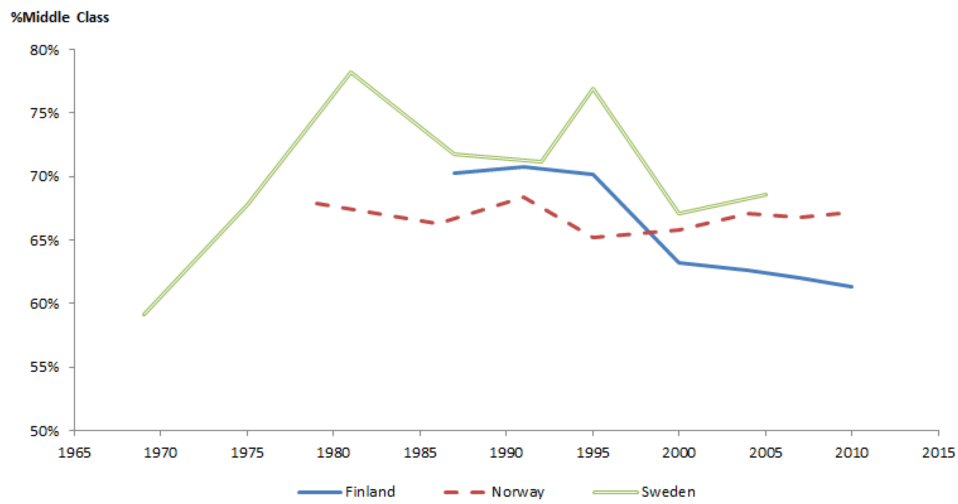
For comparison purposes, Figures 3–5 show changes in the size of the middle class over time in eight other developed nations. Nations are divided into three groups – Anglo-Saxon countries, continental Europe and the Nordic nations. These three figures make clear that what happened in the US did not happen elsewhere. In some countries (Canada, Italy and Norway) the size of the middle class has remained relatively stable since the 1980s; in other countries (France) the middle class increased in size. Some countries show a U-shaped curve over time (the UK), while for others it looks more like an inverted U (Canada).

Figure 3: MIDDLE CLASS, ANGLO-SAXON COUNTRIES

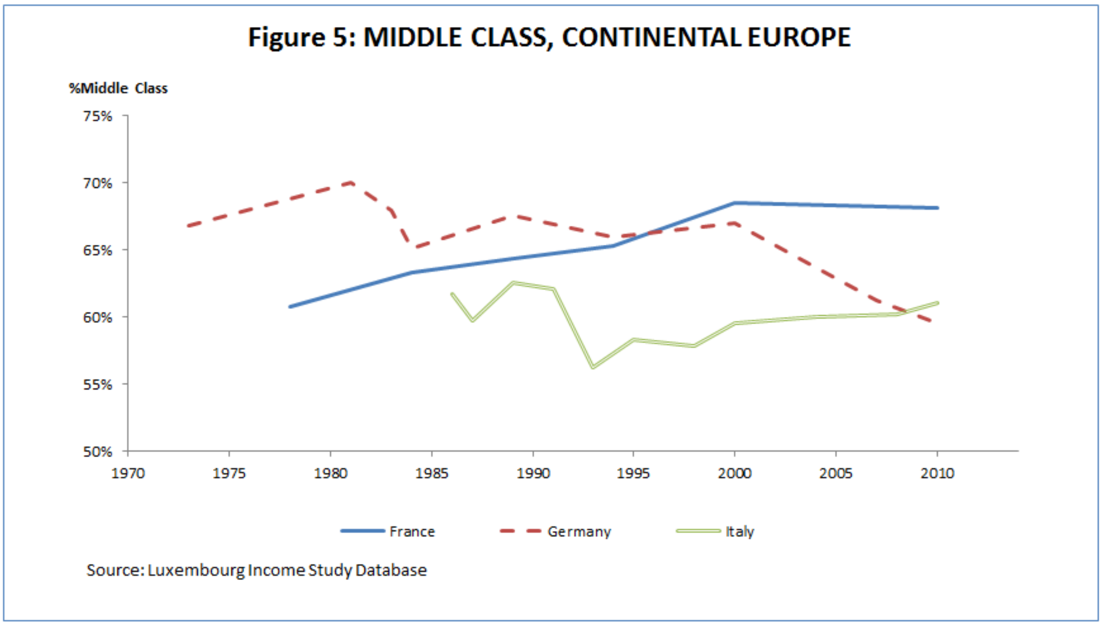


Source: Luxembourg Income Study Database

Figure 4: MIDDLE CLASS, NORDIC COUNTRIES



Source: Luxembourg Income Study Database



Finally, like Piketty's computations of top income shares, these figures underestimate the true decline of the US middle class. More people work in a typical household today compared to 1980, and people work more jobs. This increases living costs because households must spend more on clothing, food and transportation. Most important is the additional cost of child care (Giannarelli and Barsimantov 2000). This means that the higher income from sending another family member into the workforce does not result in an equivalent increase in the family living standard. In addition, a weaker social safety net means that in hard economic times most people must resort to borrowing. Households must then repay this debt, with interest, thereby lowering their standard of living. Consumer debt (excluding mortgage debt) has been rising sharply in the US with time. Subtracting just the interest on consumer debt, reduced the size of the US middle class by 3.6 percentage points in 2010 according to Scott and Pressman (2013).

3. The decline of the middle class and the rise of Donald Trump

The American Dream of a middle-class life has been slowly receding. This is evident in Figure 2, and in survey data (Pew Research Center 2012). It is not clear from other government data. At the end of 2016 the US unemployment rate fell below 5%, inflation was under 2%, real wages were rising, and GDP grew at a 2% rate. Such good numbers typically result in victory for the political party currently in power. Not in 2016 – mainly due to distributional factors. Recovery from the Great Recession bypassed many households. Those without a college degree fared worst of all. Feeling the effects of this, and worried about their future, many Americans lashed out the only way possible – at the voting booth.

Donald Trump's political genius was to tap into this rage and fear. Appealing to millions of families who felt left behind in 21st-century America, Trump promised a return to the glory days of the mid-20th century, when the future appeared bright and middle-income households did much better. He denounced Washington, especially the trade and immigration policies that he blamed for destroying the America he wanted to make great again.

Trump's Democratic opponent, Hillary Clinton, failed to address the problems facing average Americans and failed to develop a simple message about restoring middle-class jobs. She rejected future trade deals like the Trans-Pacific Partnership, but said nothing about old trade deals like NAFTA, which was signed by her husband President Bill Clinton. More positively, she talked about raising the minimum wage, providing free education and improving Obamacare (rather than replacing it with something better). But it is not clear how any of this solves the problem of a shrinking middle class. A $15/hour minimum wage does little good if there are few full-time jobs available. Free college education doesn't help people not prepared to go to college. And while Obamacare has provided some security to tens of millions of American families, it hasn't generated jobs or higher incomes; yet it requires everyone to buy health insurance or pay a tax penalty.

Instead of attacking Trumponomics, Clinton went after the low-hanging fruit – Trump's personality and behavior. For those struggling on a daily basis, with little savings for emergencies and worried about the future, this provided little hope. Many people cared more about their own economic prospects than Trump's misogyny or his mocking impersonation of a disabled reporter.

Trump became President because he won several states that typically vote Democratic (Pennsylvania, Michigan and Wisconsin) in Presidential elections plus two key swing states (Florida and Ohio). With one exception, these are all states where real median incomes dropped considerably between 2007 and 2015. While the average state decline was $600, Florida ($-3,524) Michigan ($-2,234), Ohio ($-2,826) and Wisconsin ($-3,192) all experienced sharp drops in median household income. Only in Pennsylvania (+$5,019), a state that Clinton lost by only around half a percentage point, did median household income rise. But Pennsylvania also experienced one of the largest increases in equality over several decades (measured in terms of the share of state income going to the top 10%); only three reliably blue New England states (Connecticut, Massachusetts and Rhode Island) did worse on this metric (Frank, 2014). While other factors affect voting, polling data also indicate that Trump's greatest support came from those groups experiencing the greatest financial problems over the previous decade (Kolko, 2016). Clinton's support came from well-educated voters; she did poorly, and Trump did extremely well, in counties with a small share of college graduates (Silver, 2016). And those with a college educated did best in recovering from the Great Recession.

4. Will Trumponomics help the middle class?

"Make America Great Again" is essentially Trump's promise to revive the US middle class. But sometimes promises are hard to keep. According to Trump, the problem is that immigrants and the US trade deficit took good jobs from hard-working Americans. Going further, his inauguration speech claimed that the wealth of the middle class was ripped away and distributed to the rest of the world. This analysis gets most everything wrong.

Foreign countries did not abscond with US wealth. Housing, the largest source of wealth middle-class wealth (Piketty, 2014), was lost because large US financial institutions traded campaign contributions for deregulation (such as repealing Glass-Steagall). This enabled these institutions to develop an array of toxic securities, leading to the housing bubble, its implosion and the Great Recession.

Likewise, immigration and large US trade deficits are not destroying good jobs with high incomes. Here's one way to clearly see this. Developed nations look rather similar in terms of the size of the middle class based on market income; large differences arise only when we look at disposable income (Pressman, 2010). This indicates that the problem is *not* globalization or foreign competition, since all developed countries experienced greater competition from low-wage nations. Nonetheless, many counties managed to maintain the size of their middle class; a few even saw a growing middle class. The reason for these cross-national differences, it seems, depends on what happens within each nation or on the government policies that transform market income into disposable income.

The problem is that the US government has failed to support working Americans, believing that the free market will solve all economic problems. This belief system has led to lower incomes and less wealth for many households. It has decimated the US middle class. This belief system also underpins Trump's main policy prescriptions – deregulation and large tax cuts for the wealthy, protectionism ("the wall") and repealing Obamacare. None of these policies will actually help Trump supporters or help rebuild the US middle class.

The US has given large tax cuts to the wealthy many times, most notably during the Reagan years and the 2000s with George Bush. In part, the policy was successful; Keynes (1936) was right that tax cuts boost spending and output. But tax cuts provide a smaller bang for the buck than increased government expenditures.

Even with large tax cuts stimulating demand, business investment also depends on what Keynes (1936, p. 161) called "animal spirits". Trump is his own worst enemy here. If a company makes a decision that Trump dislikes or a CEO says something critical of him, Trump can rant on Twitter, leading his supporters to boycott the company. We have already seen such behavior by Trump after Nordstrom dropped his daughter Ivanka's clothing line from their department stores. It is impossible to predict who Trump might lash out against and what economic impact it might have. Facing such uncertainty, firms will be reluctant to invest in the US. And without large business investment, large job gains are unlikely.

Further, large tax cuts for the wealthy provide incentives to cut wages and increase corporate profits. Workers are pushed harder but don't gain from their extra efforts. As we saw, the average worker has seen little gain from their greater productivity since large cuts in marginal tax rates were passed during the Reagan era. Most gains have gone to the top 1%.

Piketty and Saez (2013) show that those countries lowering their top marginal tax rates the most tended to have the largest increase in the share of total income going to the top 1%. They contend that this relationship is causal. First, they argue that income stems from bargaining power rather than marginal productivity. Second, they contend that incentives matter. When marginal tax rates are very high it is not worth it for CEOs to fight compensation committees for a little more income since most of it will go to the government. With low marginal tax rates, CEOs keep a large fraction of any extra income and have great incentives to fight for higher pay. We can add a third factor. Since the 1980s CEO compensation has increasingly come to depend on stock performance and comes in the form of stock options. Economists argued that this would solve principal-agent problems by aligning the incentives of CEOs and the incentives of investors (Jensen and Meckling 1976). However, this is true only in the short run. A focus on stock prices creates incentives to cut costs, and labor constitutes the largest cost for firms. As a result, senior executives sought to reduce wages and benefits. Although this might reduce demand and harm long-run firm performance, CEOs cared more about their current pay; their successor would have to deal with any long-run problems. It is for this reason that tax cuts for the rich have not helped the middle class in the past. What Trump proposes will increase pressure for wage cuts.

A related problem is how to pay for large tax cuts geared to the wealthy. While Trump claims that deregulation and tax cuts will generate faster growth, and while Congressional Republicans can force the Congressional Budget Office to use "dynamic forecasting" and conclude that economic growth and tax revenues will both increase, based on past experience and what we know about economic relationships this won't happen.

One possible solution is Trump's suggested 10% "repatriation rate", which would encourage corporations to bring profits earned abroad back into the US. With $2.6 trillion parked abroad, this will provide some money to fund a large tax cut (Huang, 2016). Other revenue may come from people selling assets now in the belief that low marginal tax rates will not last and they should benefit while the going is good.

Once these temporary revenue streams dry up, tax cuts will have to be paid for by some other means. Trump has blamed government waste and fraud for the US budget deficit, but the amounts involved are far too low to close an annual budget gap of $600 billion plus another $500 billion if Trump's tax cut plan passes (Cole, 2016). Popular measures among many Trump supporters, such as defunding the Corporation for Public Broadcasting and ending all foreign aid, won't significantly reduce a deficit exceeding $1 trillion. Hiring freezes and pay cuts for government employees won't do much better. The bottom line is that if you exclude military spending (which Trump wants to increase) and non-discretionary spending (Social Security, Medicare, interest on the debt) only $600 billion in government spending remains. If cut by half, this would not eliminate the current deficit and cannot finance Trump's tax cuts. While Trump has suggested negotiating down US debt, this "haircut" would lead investors to flee US government securities and raise government borrowing costs. So the only way to keep the Federal budget deficit from soaring due to Trump's tax cut plan is to cut Medicare, Social Security, and other programs that benefit middle-class households.

The big losers in this process will be Trump supporters, who get miniscule tax breaks, and Trump himself, who will have to explain why the budget deficit exploded under his watch. Additional borrowing by the US Treasury, plus news reports of massive deficits and record debt, will be hard to rebuff as "fake news". It will also put upward pressure on interest rates, raising borrowing costs for Trump supporters living hand-to-mouth and in debt. This too will be difficult to deny or dismiss.

Protectionism may save a few jobs, but tariffs and other trade restrictions will also push up prices and lower US living standards.

Trump is right that the US trade deficit reduces jobs and lowers incomes. Workers are hurt when production goes abroad and they must try to find new employment, possibly at a much lower wage. The big flaw in his argument is that manufacturing jobs comprise a small fraction of US employment and they do not require employers pay decent wages and benefits. Manufacturing firms producing in China and Mexico do not pay their workers well, and service jobs in the US actually pay production and non-supervisory workers more (on average) than manufacturing jobs do (Wolff, 2017).

Coal mining provides a good example of what is wrong with trying to save production jobs. In the US and elsewhere these jobs have paid good wages for many years. But this has not always been the case. Émile Zola's novel *Germinal* (and the excellent movie starring Gérard Depardieu) makes it clear that these were awful jobs paying bare subsistence wages. They became better only when French workers organized, demanded better wages and working conditions, and the French government supported their right to unionize. US manufacturing jobs have paid well historically because US workers unionized and they used their power to counter the power of large business firms and obtain higher wages, generous benefits and better working conditions. Something similar can take place in the service sector today – if we had a government willing to support unions and increase the minimum wage.

Another problem is that even if high-paying manufacturing jobs return to the US, they will not go to Trump supporters. These jobs require education and computer skills to run the actual production process. At some point, despite Trump's assertions that he has made America great again, Trump's supporters will come to realize that they don't have better jobs or bigger paychecks.

Finally, there is Obamacare. After taking office, President Obama saw affordable health care as one way to help middle-class and working-class households priced out of insurance markets. To the detriment of Democrats and the benefit of Trump, Obamacare insurance premiums rose sharply right before the 2016 election. And, as noted earlier, Obamacare did not result in any economic gains to make the required insurance more affordable.

Repealing Obamacare will help some young and healthy workers who can get by without health insurance. If these people don't buy insurance, the cost of providing insurance to everyone else increases and companies will raise rates. This will drive others from the insurance pool, mainly those less expensive to insure because they are healthier. Again, rates will rise. The end result will be extremely costly insurance for those who need it most and many people without health insurance.

Trump promised to replace Obamacare with something better, but this will not be easy. Repealing any aspect of Obamacare will cause the whole thing to collapse. Ending the insurance mandate will lead to problems described in the paragraph above. Ending the requirements that insurance companies cover pre-existing conditions and pool risks to determine rates will either increase rates or leave important health care needs uncovered. Low-income individuals lacking a college degree (strong Trump supporters) will be hurt the most. They are less likely to have health insurance through work, and more likely to require health care given the relationships between education level, income, and health.

After criticizing Obamacare vehemently while campaigning, Trump will have to do something to replace it. As this was being was written (in mid-February), the solution seemed to be tax credits to purchase insurance for those without health insurance through work or the government. This won't do any good for those with some pre-existing condition. Worse yet, the tax credits will increase with age rather than decline with rising income, as under Obamacare (Sanger-Katz 2017). The likely result is that many middle-class households will find themselves priced out of the health insurance market. We can count on gruesome news stories about people denied health care as a result of these changes, and we can expect similar results from any other Republican plan for replacing Obamacare. Trump can Tweet that these horror stories are lies, but when many people know someone that this has happened to, and when real people appear on TV to speak about their problems, many will long for the good old days when we had Obamacare to kick around.

In sum, Trump's main policy proposals will not help the people who voted him into power. The losers (to use one of Trump's favorite expressions) will be working-class voters without a college degree who were recently pushed out of the middle class or are struggling hard to remain there.

5. Where do we go from here?

It is not enough to point out that Trump's policies won't revive the US middle class. Policy failure should open the door for practical alternatives. Here are a few suggestions.

First, there needs to be a focus on creating good jobs. The US has a long tradition of building a middle class through education (Lindert, 2004). Germany uses apprenticeship programs that prepare people for high-paying jobs (Nortdurft, 1989). Either approach would help. Strengthening unions and raising the minimum wage are also crucial. Union jobs helped build the US middle class after World War II. France grew its middle class, in part, because the government supported unions and a high minimum wage (Piketty, 2014).

On the demand side, standard fiscal policy is needed for job creation. Well-paid, public-sector employment should be *an automatic response* to economic stagnation or falling real wages. I strongly prefer infrastructure spending, but if this is not possible for political reasons, we need a contemporary equivalent of burying money in abandoned coal mines (Keynes, 1936, p. 129) – perhaps building a wall along the US border with Mexico.

Second, the US lacks many of the programs in advanced economies that bolster the middle class. This helps explain why the US middle class is smaller than the middle class of other developed countries. Paid parental leave helps parents around the birth of a child by providing an income replacement for lost wages. Child allowances, strongly supported by Keynes, assist larger families having greater economic needs (Pressman, 2014b). These policies each reduce child poverty and increase the percentage of families with children that are middle class – by around 10 percentage points (Pressman, 2014a).

Third, we need more generous unemployment insurance, disability insurance and old-age pensions. The US has the weakest such programs in the developed world. This is one more reason the US has the smallest middle class among major developed nations. Governments are supposed to protect their citizens from risk; social insurance programs are designed to do this. They enable families to continue to live a middle-class existence following some unexpected setback (Hacker, 2006).

Donald Trump was elected president because he understood the fear and anger growing in America. But governing requires accomplishments that make good on campaign promises. The problem is that Trump's campaign promises will not make America great again, if this means bringing the US middle class back up to around 60 percent of all households. At some point his supporters will recognize they have been had. The real danger we face is what might come next.

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Author contact: pressman@monmouth.edu

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