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Statement of

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Senate Committee on Finance

Policies to Support the Middle Class

March 13, 2014

Chairman Wyden, Ranking Member Hatch, and Members of the Committee: Thank you for inviting me to participate in this hearing exploring innovative ideas and policies that can strengthen the economic foundations of American households and contribute to the growth of the middle class. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

I will start by outlining some of the challenges facing the middle class in 2014 and then explore policy options that might help better equip them to meet those challenges.

Here are my main conclusions. The middle class has suffered from stagnant incomes for more than a generation and the trend shows no sign of abating. Modest increases in total compensation have been largely consumed by the cost of fringe benefits; earnings for a median full-time worker have barely kept pace with inflation. Many factors have contributed to this phenomenon, but one that is likely to grow in importance is the role of technology. Machines are excellent substitutes for a growing list of occupations. One obvious response to this challenge is better access to affordable higher education and job training so that workers can differentiate themselves from their mechanized competitors.

The tax system has played a mixed role with respect to the middle class. On the one hand, federal tax burdens on middle class families have moderated over time. Moreover, the progressive income tax is now an important part of the safety net, automatically reducing tax liabilities or

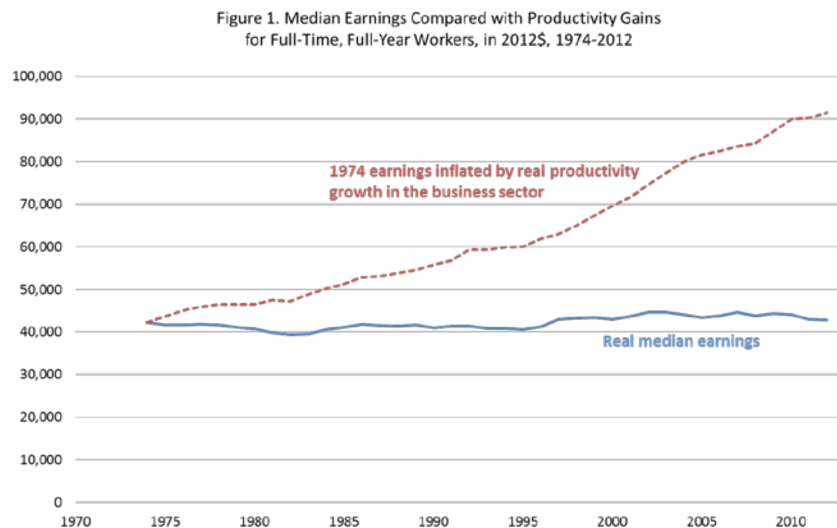
even providing subsidies through refundable tax credits like the EITC when households fall on hard times. On the other hand, especially generous tax treatment of the "carried interest" earnings of takeover specialists have contributed to downward pressure on wages and have cost many workers their jobs. Tax subsidies for saving have been relatively ineffective at encouraging middle income households to save enough to protect themselves from adverse shocks to income such as job loss. And a panoply of education tax breaks are confusing and less helpful than they might be.

I put forward several options that might help the middle class:

1. Improve access to higher education and job training and consolidate and target education tax subsidies.
2. Slow the growth of spending on health care.
3. Eliminate the carried interest loophole.
4. Encourage saving by offering automatic contributions to 401(k)-like accounts for low- and moderate-income households patterned after President Clinton's Universal Savings Accounts.
5. Replace automatic price indexing with annual indexation adjustments designed to partially counterbalance changes in the distribution of income on a revenue-neutral basis. That is, if inequality grows, indexation would automatically make the income tax more progressive.

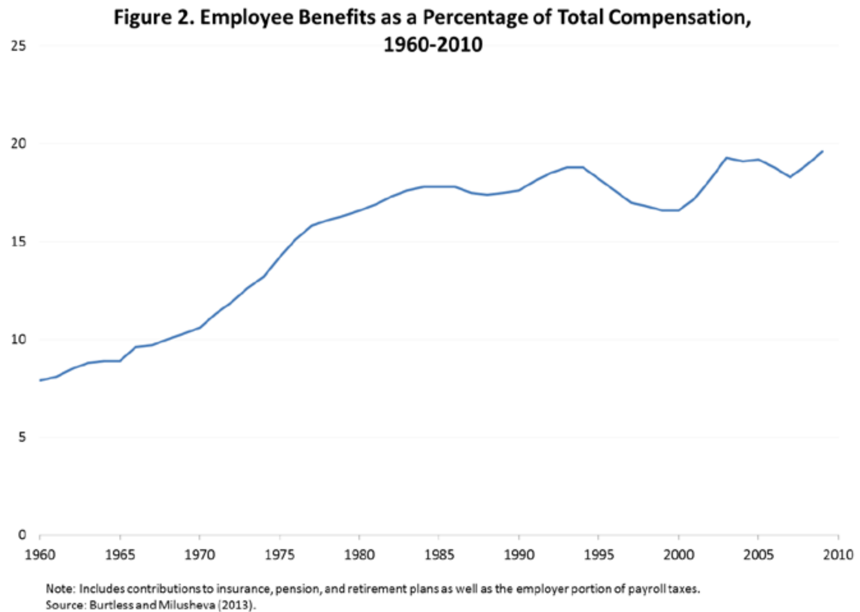
Challenges Facing the Middle Class

After adjusting for inflation, earnings for the median full-time worker have barely budged over the past 40 years (see Figure 1).[1] In 1974, it was $42,000 (in $2012). In 2012, it was just under $43,000. If average wages had kept up with worker productivity since 1974, wages would have more than doubled to almost $92,000 in 2012. This isn't quite an apples-to-apples comparison because the composition of both the labor force and compensation have changed over that period, but the flatness of median earnings while worker productivity soared strongly suggests that workers are, at best, capturing only a fraction of the gains from robust economic growth.

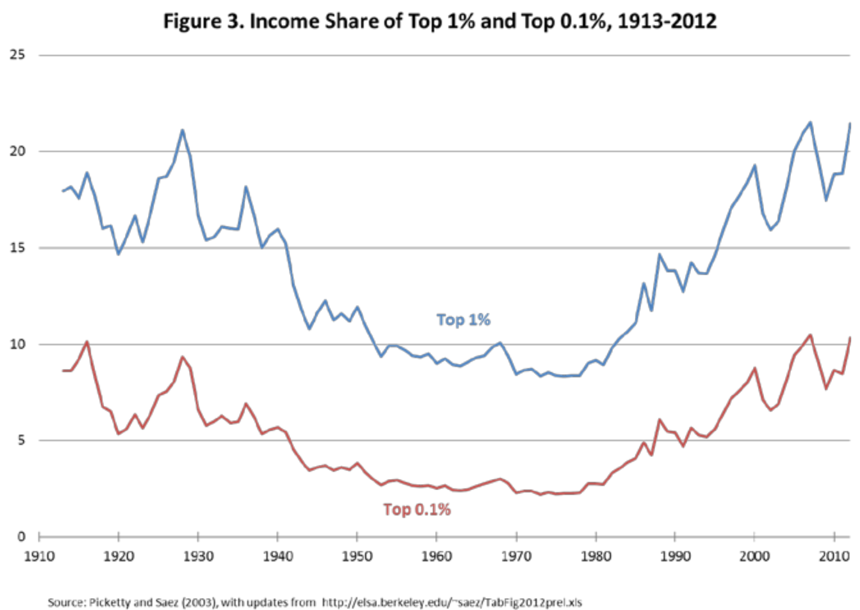


[1] Some of this testimony is drawn from Burman (2013).

Part of the wage stagnation story is rising employer costs for benefits, especially health insurance and payroll taxes. Between 1974 and 2010, benefits rose from 13 percent of compensation to 20 percent (see Figure 2). But even if all those additional costs had been added back to wages, they would have accounted for only a fraction of the gap between earnings and productivity.



While middle-class wages have stagnated, incomes at the top have surged. Figure 3 shows the now-famous data on inequality compiled by economists Thomas Picketty and Emmanuel Saez. In 2007, on the eve of the Great Recession, the top 1 percent of households received more than 21 percent of all income for the first time since 1928.[2] The income share of the top earners plummeted during the Great Depression and stayed around 10 percent in the 1950s, 1960s, and 1970s before starting to rise in the 1980s. A similar pattern applies to the highest-income 1 in 1,000 households. Their share of income reached an all-time record of 10.5 percent in 2007.



As in the Great Depression, top income shares fell during the Great Recession. But, unlike the earlier episode, top incomes quickly rebounded after a temporary dip in 2008 and 2009.

Increased income concentration has *not* arisen because the middle class is working less. Indeed, the opposite seems to be the case. Women between the ages of 25 and 54 are 20 percent more likely to be working outside the home now than they were in 1979, while male labor force participation in the same age group has declined

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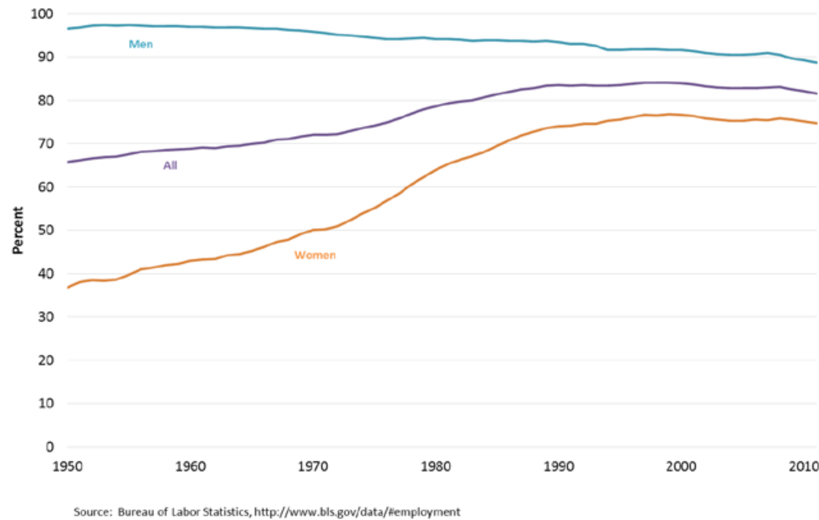
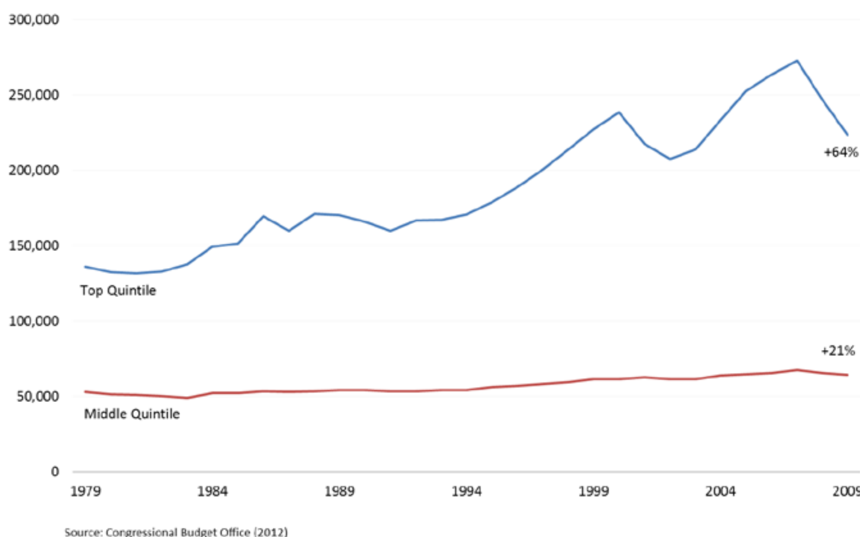
[2] The original time series published in Picketty and Saez (2003) has been periodically updated on Saez's website. See http://elsa.berkeley.edu/~saez/TabFig2011prel.xls.

only slightly (see Figure 4). Hout and Hanley (2003) found that married women with children increased their average time at paid work by nearly half between 1979 and 2001, and married women without children worked over 25 percent more hours each week in 2001 than in 1979. As a group, married couples increased their hours worked by more than 10 percent, whether they had children or not.

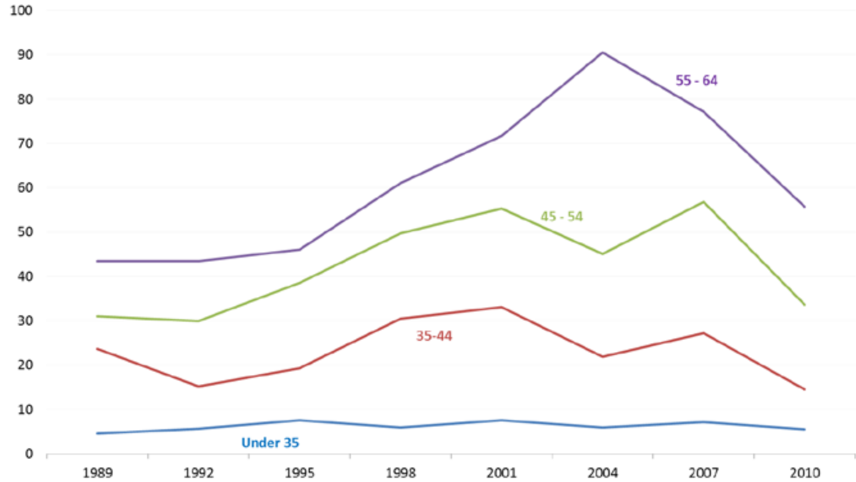


The average American family is working longer hours but, except at the top of the income scale, family income does not reflect the extra effort. Between 1979 and 2009, average income for households in the middle quintile rose less than 1 percent a year, climbing just 21 percent after adjusting for inflation (see Figure 5). In contrast, households in the top quintile saw their average income double between 1979 and 2007. The recession cut their incomes significantly, but their incomes rebounded quickly, in contrast to middle class and by 2009 was 64 percent higher than in 1979.

The story is not notably rosier when we look at assets. In 2010, the median level of financial assets was the same or lower than it was in 1989 for every working age group except those nearing retirement (see Figure 6). In 2007, as the Great Recession hit, median asset balances (including cash, stocks and bonds, mutual funds, cash value life insurance, and retirement accounts) were $25,000 for households headed by someone between ages 35 and 44, $57,000 for 45–54-year-olds, and $77,000 for 55–64-year-olds. By 2010, median asset balances in every group had fallen—precipitously in all but the youngest group (which has little in financial assets and

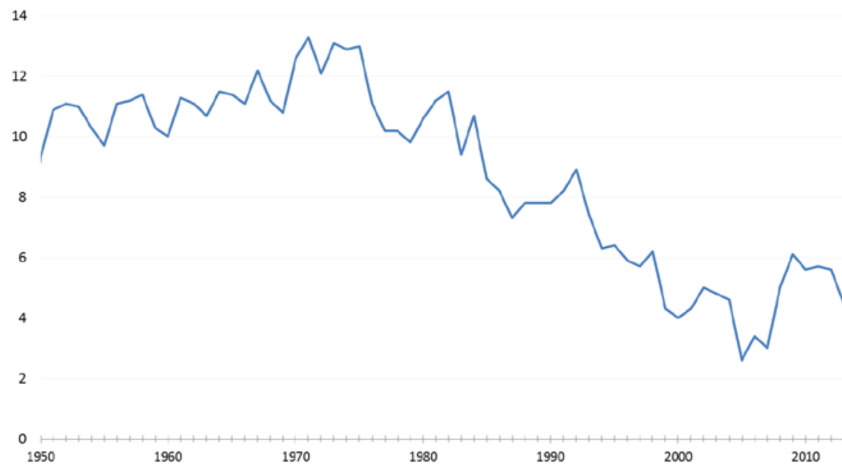


much debt)—although they likely have rebounded given the surge in the stock market, but more recent asset data are not yet available.



Modest amounts of assets make many middle-class families vulnerable to income shocks. McKernan, Ratcliffe, and Vinopal (2009) concluded based on the 1996 and 2001 Surveys of Income and Program Participation that more than half of families in the middle third of the income distribution did not have enough liquid assets to support a poverty level of consumption for three months. (85 percent of households in the bottom third of the income distribution were in that situation.)

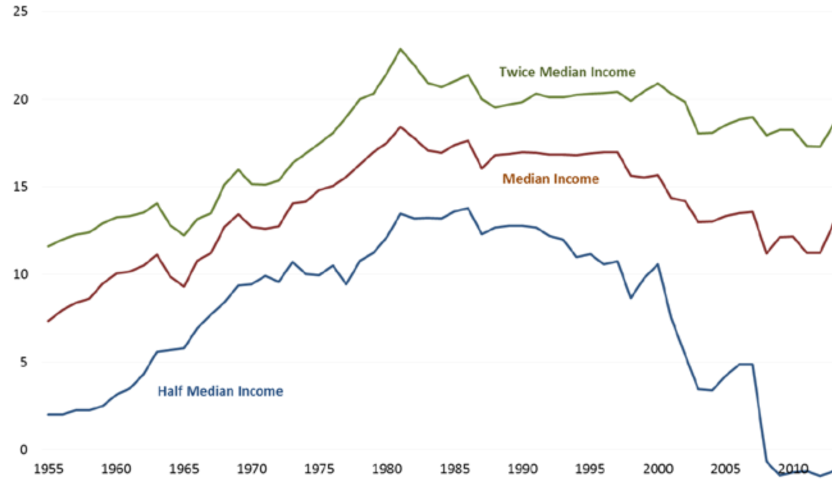
A fundamental problem is that Americans do not save much. Personal saving had been on a downward trajectory from the mid-1970s until the Great Recession hit, reaching a low of 2.6 percent in 2005 (see Figure 7). It rebounded to 6.1 percent in 2009 as economic insecurity and a tightening of credit sharply curtailed Americans' spending, but is starting to creep downward again.



Direct Effects of Taxes on the Middle Class

The federal tax system has direct and indirect effects on the plight of the middle class. Its direct effect is mostly benign. After increasing through the 1970s, average tax burdens for middle-income families stabilized in the 1980s and then declined through the 1990s and 2000s (see Figure 8.) A median-income married couple with two children in 1980 who took the standard deduction would have faced an average federal tax burden (including income tax and the employee's share of payroll tax) of 18.4 percent. By 1990, the tax take fell to 17 percent. In

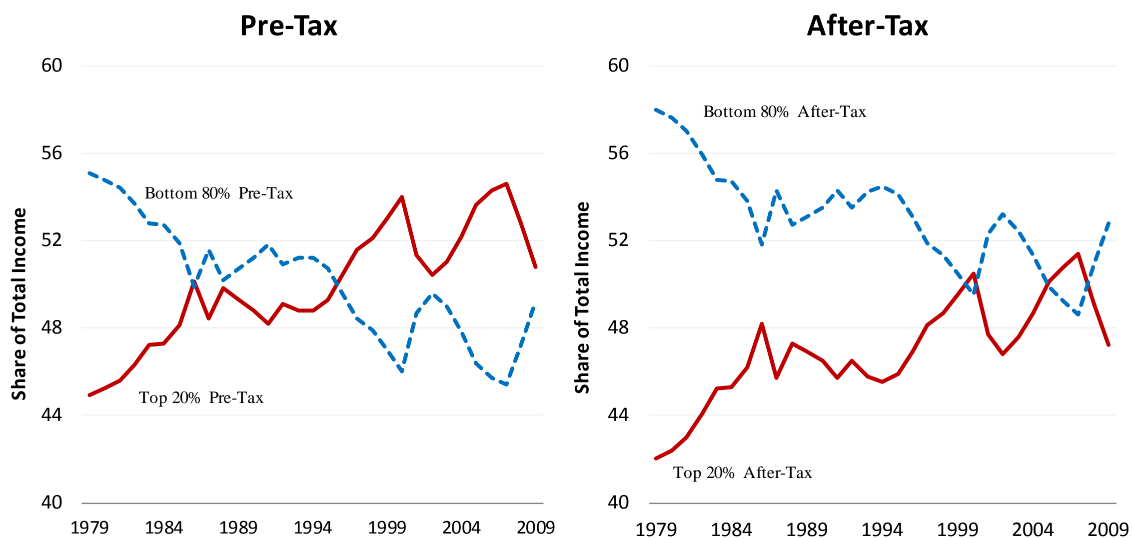
2007, it was 13.6 percent. The temporary tax cuts aimed at boosting the economy cut the tax burden even more in 2008, but by 2013 it was back to 13 percent. A low-income family saw an even more dramatic cut in tax liabilities, while a similar, but more moderate trend applied to families at twice median income.



The progressive federal tax system diminishes income disparities. In 1979, the bottom 80 percent of the income distribution earned 55 percent of pre-tax income and the top quintile earned the remaining 45 percent (left-hand panel of Figure 9). Over time, the higher-income households earned an ever larger share of pre-tax income. In the late 1980s and first half of the 1990s, the two groups roughly split total income; the top 20 percent pulled ahead in 1996, and the gap has widened since then (although the 2000 and 2007 recessions both temporarily narrowed the gap).

The right-hand panel in Figure 9 shows how taxes change that comparison. Until 2000, the bottom 80 percent always received a larger share of after-tax income than the top 20 percent. The stock market surge in the late 1990s, which peaked in 2000, the capital gains tax cuts in 1997 and 2003, and the ordinary income tax rate cuts starting in 2001 allowed the top quintile to overtake

Figure 9. Pre- and After-Tax Shares of Household Income for the Top 20 and Bottom 80 Percent, 1979 to 2009



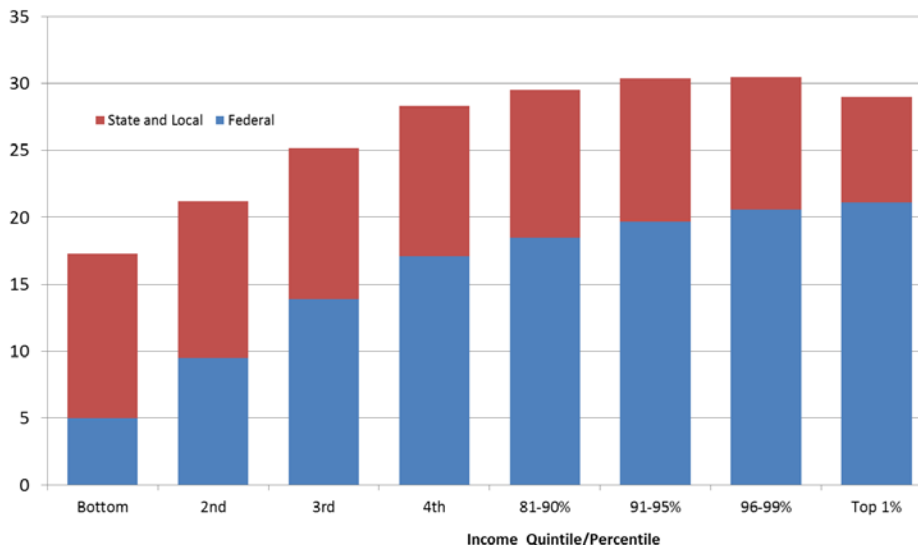
Source: Congressional Budget Office data and author calculations

the bottom four-fifths in 2000 and again in 2005–2007. Nonetheless, after-tax income remained significantly more equally distributed than pre-tax income.

In 1979, the difference in shares of after-tax income was 16 percentage points, compared with a 10 percentage-point difference in the share of pre-tax income. In 2009, taxes reversed the division from a 1.6 percentage-point advantage in pre-tax income for the top quintile to a 5.6 percentage-point advantage in after-tax income for the bottom 80 percent.

A complete assessment of tax burdens, however, must include state and local taxes, which constituted about 40 percent of total taxes in 2009. State and local governments rely much more heavily on regressive taxes, such as sales taxes, than does the federal government. States also often assess income tax liability on households near, or even below, the poverty line. Citizens for Tax Justice (2012) has shown that when state and local taxes are included, the overall tax system is much less progressive (see Figure 10).

Figure 10, Federal, State, and Local Taxes as Percent of Income, 2011



Source: Citizens for Tax Justice, "The Five Most Common Myths we Hear on Tax Day," April 2012. http://www.ctj.org/pdf/newsletter/JustTaxes_2012_04.pdf

<u>Indirect Effects of Taxes on the Middle Class</u>

Taxes affect families' well-being in many indirect ways. For one thing, a progressive income tax reduces the volatility of uncertain income. The earned income tax credit, for example, is a critical part of the safety net. It not only augments the incomes of households with permanent low earnings, it also can provide a boost when a middle-income earner suffers a significant cut in earnings and becomes eligible for a subsidy.

More generally, a progressive income tax provides a kind of insurance. The income tax makes government a partner (albeit a mandatory one) in income production. When taxpayers do well, they pay more tax as a percentage of income. When things go badly, they pay less (or even get a

net subsidy). Even a flat tax reduces the variance of after-tax returns (since the government takes on a fraction, *t*, of any gain or loss, where *t* is the tax rate), but a progressive income tax allows for a higher level of after-tax income when things go badly than a flat tax system that raises the same amount of revenue. Effectively, it provides insurance in the case of bad luck. (And, just like other forms of insurance, it also creates moral hazard by reducing the incentive to avoid bad outcomes, which is a principle criticism of high marginal tax rates.) To the extent that the income distribution reflects luck, risk-averse households would prefer a system that smooths after-tax incomes (for the same reason that people purchase insurance).

Economist Hal Varian (1980), who developed the theory of taxation as insurance in a seminal paper, argued that this aspect of taxation might justify especially high tax rates on people with very high incomes—say over $1 million a year. The logic is that incomes that high must have a substantial luck component. It is not plausible, he argued, that people reach that level of income simply by working especially hard or saving much more than their neighbors. To the extent that very high incomes derive from factors outside taxpayers' control, taxing those incomes at high rates might have little or no effect on behavior. However, that theory did not account for the possibility of tax shelters that may be especially attractive to those with high incomes. Participation in tax shelters is likely to be very sensitive to marginal tax rates.

A second, more subtle mechanism occurs because the tax system has encouraged entrepreneurs to purchase public corporations, restructure them to extract cash and eliminate waste, and sell them at a profit. To the extent that companies are managed inefficiently, this kind of activity would occur even in the absence of taxes. But, under current law, the private equity managers who structure these deals earn a substantial amount of their income in the form of a "carried interest," which is typically taxed at long-term capital gains rates far below ordinary income tax rates. It is likely that many more of these restructurings occur when taxed at the 20 percent capital gains rate than would if taxed at the 39.6 percent top ordinary income tax rate.[3]

The tax incentives to restructure companies add to the problems of the middle class and increase inequality at the same time. When companies go private, many rank-and-file workers are often laid off. Restructuring also puts downward pressure on wages for three reasons. First, it may include wage and benefit cuts because managers have an incentive to keep labor costs low to improve the attractiveness of the company for resale. Second, even companies that have not been the target of private equity specialists may feel pressure to keep wages and benefits low to ward off a possible takeover. Third, those who are laid off are unlikely to find new jobs that pay as much as the ones they lose.

Structural Explanations for Wage Stagnation

The standard explanations for wage stagnation include the decline in the power of labor unions, increased immigration, and the effects of international trade and the growth in information technology (Goldin and Margo 1992). Despite remarkable gains in labor productivity, the benefits of those gains have mostly accrued to the highest-income 10 percent. All other income classes have seen their wages grow more slowly than productivity. Ian Dew-Becker and Robert

[3] Rosenthal (2013) argues that this income should properly be subject to ordinary income tax rates under current law, but that is still a controversial proposition.

Gordon (2005) attribute the increasing skew in earnings to "the economics of superstars," which richly rewards the top performers relative to others who are nearly as productive.

Larry Summers (2013) posited that there might be a structural shift in the way the economy produces many goods and services. In economists' standard (highly simplified) model, there are two inputs, capital and labor. More capital is good because it produces returns on capital to investors and the additional capital makes workers more productive, which translates into higher wages. It is the classic win-win.

Summers suggests that we think of a new kind of economy-wide production function—one in which there are two kinds of capital: the old kind that raises labor productivity and a new kind that is a perfect substitute for labor. Think of the self-checkout machine at the grocery store or the self-driving car (or truck or bus) that is safer than any human-driven vehicle. More and more activities that were once thought to be quintessentially human can now be performed competently by machines.

The implication is straightforward. The cashier is now competing with a machine that can do almost exactly the same job. The cashier's wages will depend only on how much it costs to purchase and operate his machine equivalent. As the price of the machine falls, there will be more and more downward pressure on wages. An employer that is reluctant to cut wages or lay off employees will find herself the target of a takeover or simply go bankrupt.

Meanwhile, owners of capital will garner ever-increasing shares of national income. This seems to be a reasonably good explanation for the trends in income inequality and middle-class wages that we have seen recently. Summers argues that without fundamental changes, those trends will grow only more pronounced over time.

Possible Approaches to Supporting the Middle Class

The foregoing discussion suggests several approaches to aiding the middle class:

- Improve access to higher education and retraining for workers displaced by technology
- Slow the growth of spending on health care
- Reduce subsidies to rent seeking
- Encourage saving
- Use the tax system to reward work and dampen the effects of rising inequality

Improve access to higher education

In response to a question after his lecture, Summers said that to avoid falling or stagnant wages, people needed to learn to do things that cannot be done cheaply by machines. The first item on a middle-class agenda should be better access to higher education and retraining opportunities for those displaced by technology—or those who would like to take advantage of new opportunities created by technology.

Access to affordable higher education is getting more difficult for many families with increasingly confusing rules and information. Published prices of higher education have long outpaced inflation. Tuition, room, and board at private universities averages $45,000 a year (College Board 2013a), with some elite universities exceeding $60,000. In-state tuition at public universities is more affordable—averaging $8,900—but those costs have risen dramatically as states have responded to budget crises by cutting support for higher education. Federal aid for higher education has increased dramatically over the past decade, but rules are often confusing and students are often uncertain about the full cost.

Colleges have attempted to maintain access for lower-income households by increasing financial aid. High-income families can still afford to pay the high costs, but upper-middle-income households face a tremendous squeeze, which is exacerbated by the anemic rate of savings for many families. There's also concern that lower-income families may be dissuaded by the high sticker price and stories of students graduating from college with unmanageable debt burdens even though most qualify for financial aid that would make school affordable and investing in higher education is still their best route to the middle class (Baum 2014).

There are also issues with the quality of some higher education institutions. While some for-profit colleges have offered students needed flexibility, many others have a track record of saddling students with debt and a low probability of successful completion or a degree with little or no value. A significant amount of public support goes to these institutions; about one-quarter of Pell grant funds went to for-profit institutions in 2009–2010 (College Board 2013b). The percentage fell to 21 percent in 2012–2013 with tighter eligibility rules. New restrictions and proposals have been suggested to help students make better choices that will lead to more federal aid being channeled to support institutions that show they can graduate most of the students who enroll. These include the introduction of College Scorecards by the Obama administration last year (White House 2013) and laws like S. 1156, which would standardize the financial aid award letters sent to college applicants (Gardner 2013).The president has proposed for several years to support community colleges that develop training programs in collaboration with employers to help workers develop skills to earn high wages. With about half of Pell Grant recipients age 24 or older, this is a promising approach for both new high school graduates as well as returning students who have been displaced or wish to develop more lucrative job skills.

On the tax side, Ways and Means Chairman Dave Camp's approach of consolidating tax incentives for higher education is a good idea and similar to many other proposals being proposed both inside and outside Congress. The current panoply of incentives is bewildering and poorly targeted. Consolidating them in a revamped refundable American Opportunity Tax Credit, as Camp proposes (or rechanneling the tax expenditure into better targeted direct subsidies such as Pell Grants) would improve the tax code and expand access to higher education.

Slow health care spending

Health care spending, like spending on education, continually outpaces inflation. Since workers ultimately pay for health insurance through lower wages, controlling health care costs would be enormously helpful, especially for households with incomes too high to qualify for substantial

subsidies under the Affordable Care Act. The solution to excess spending on health care is beyond the scope of my testimony, but I'll note that any effective approach is likely to require bipartisan cooperation since it is so easy to demonize opponents for proposing controls on unnecessary medical spending (e.g., "death panels"). It is encouraging in this regard that Chairman Wyden has attempted to craft a bipartisan approach to control Medicare spending.

Reduce subsidies to rent seeking

As noted above, one driver of the gulf between the middle class and the super-rich is the activities of takeover specialists in private equity firms and hedge funds. They earn enormous windfalls and squeeze workers. To the extent that these activities improve market efficiency, they may be useful, although relentless downward pressure on wages can ultimately be counterproductive if alienated workers become less productive (Yellen 1984). But there is no reason for the tax code to subsidize them.

Carried interest and hedge fund profits should be taxed as ordinary income.

Encourage saving

Saving serves the important roles of providing a buffer against income shocks that come with a job loss or illness and improving the standard of living in retirement. The tax code has a wide array of subsidies aimed at saving for retirement, education, and medical expenses, but it is not clear that they have worked all that well. As noted earlier, the personal saving rate in the United States is near a historic low despite all the tax-based prods to thrift.

Several factors, however, discourage saving, especially for the middle class. One is the availability of Medicaid to pay for nursing home care for people who cannot afford to pay for it. This is a humane and life-saving program for frail and indigent seniors, but it amounts to an almost 100 percent tax on assets for those who need long-term care and have modest assets (Burman 2012).

College financial aid formulas also strongly discourage middle-class people from saving for the higher education expenses of their children. Financial aid implicitly imposes very high tax rates on liquid financial assets of parent and children (Feldstein 1995). It is not entirely clear what to do about this, but it provides an additional rationale for public policies aimed at encouraging saving targeted at the middle class to offset the anti-saving bias in financial aid rules.

One obvious approach is to encourage employers to do what we know works, which is to nudge workers into participating in retirement plans. There is now overwhelming evidence that automatic enrollment significantly increases participation (Madrian and Shea 2001). The president's proposals to encourage employers to offer simple low-cost retirement plans with auto-enrollment features (MyRAs) seems like a promising approach, but is only a partial solution.

A more ambitious plan would be to revisit an option that I helped develop when I was a Treasury official in the Clinton administration. Universal Savings Accounts (or USAs) were intended to

provide a new subsidized savings vehicle that would have bipartisan appeal. A $300 refundable tax credit would be automatically deposited into a 401(k)-type account for low- and moderate-income households. They would also be eligible for a dollar-for-dollar match up to a maximum total contribution of $1,000 per year. The automatic contributions would phase out at higher income levels, but higher-income savers would be eligible for a 50 percent match on voluntary contributions up to the $1,000 maximum. Low-cost accounts would be available to guarantee that even those with small balances could earn competitive returns on their savings. I suspect that had it not been for the Lewinsky scandal, there might have been bipartisan support for something like USAs.

This program would not necessarily have to be run through the income tax—and probably would be simpler as an adjunct to Social Security where a set percentage of earnings up to a cap could be deposited in the account (with additional subsidies added directly to the accounts for low-income workers).

One advantage of helping low- and middle-income workers establish substantial nest eggs is that it might make it easier to adopt sensible reforms to Social Security, such as increasing the retirement age as life expectancies increase. Social Security is one part of the safety net that is working well for middle-class people. But the fact that it appears headed for insolvency in 20 years is a major source of risk for the middle class.

<u>Use the tax code to partially offset the effects of wage stagnation</u>

The income tax is currently automatically adjusted for inflation so that rising prices do not automatically increase taxes through "bracket creep." This works well for people whose incomes grow at least as fast as inflation, especially those with very high incomes. However, if wages stagnate or even fall, the benefits of price indexation dissipate quickly. Indeed, some low-income parents whose earnings fail to keep up with inflation could actually lose child tax credits if the threshold for refundability is indexed, as scheduled under current law.

Robert Shiller, Jeff Rohaly, and I (2006) laid out a radical alternative to price indexing—indexing the income tax parameters to reflect changes in inequality. In the most extreme version, if incomes of low- and middle-income households continued to lag, brackets and refundable tax credits would automatically adjust to keep the after-tax distribution of income the same. A variant would offset only part of the change in the income distribution.

A major drawback of that approach is that if the income distribution continues to widen as it has historically, tax rates at the top would have to get quite high, which could entail significant economic costs (as well as political resistance). It also could lead to lowering top tax rates during a year like 2008, when top incomes temporarily fell.

A more modest alternative would be to set a budget for progressivity adjustments whose cost would equal the revenue loss that would be attributable to price indexation. Instead of adjusting all tax brackets and other parameters automatically by the amount of price increases, bracket adjustments would be designed to get closer to the target distribution of after-tax income. If pre-tax incomes at different levels grow in proportion, then this scheme would be identical to the

price indexation that occurs under current law. If not, then some bracket thresholds and other indexed parameters would adjust faster than others. In addition, the credit rate for the EITC might be adjusted to help hit targets at the bottom of the income distribution. This would directly take on the failure of the market to provide adequate wage growth in a way that seems to be garnering some bipartisan support.

Potentially, the adjustments could add up to a substantial amount over time. The Tax Policy Center estimates that indexing adjustments will reduce revenues by more than $200 billion a year by 2025, based on CBO's inflation projections. This could pay for a doubling of the EITC with more than $100 billion left over to adjust middle-income tax liabilities.

One possibility would be to combine this option with USA accounts. If low-income families continue to lag, the automatic contribution to the USA account could be adjusted upward. This would have the advantages of raising low-income families' wealth, increasing access to education for their children, and providing a more robust buffer against the risk of job loss or other income shock.

Thank you for giving me the opportunity to think about how to help support the middle class. I will be happy to answer your questions.

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