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**CAN THE MIDDLE CLASS MAKE
ENDS MEET? ECONOMIC ISSUES FOR
AMERICA'S WORKING FAMILIES**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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MAY 10, 2007
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**CAN THE MIDDLE CLASS MAKE
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AMERICA'S WORKING FAMILIES**

THURSDAY, MAY 10, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Lincoln, Stabenow, Salazar, Grassley, Lott, and Bunning.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR
FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order.

In the *Annals*, Confucius said, "When wealth is distributed, the people are united." Twenty-five hundred years later, the success of a broad middle class has been one of the keys to America's success.

Today's hearing will try to understand the question: Can the middle class make ends meet? Next month, we will hold hearings on continuing and expanding middle-class tax relief.

Lately, the incomes of middle-class households have not been doing that well. Between the year 2000 and 2005, median weekly earnings of full-time workers, adjusted for inflation, fell by $\frac{9}{10}$ of a percent. In the same period, total income for the median household, adjusted for inflation, fell by nearly \$1,300.

But when you adjust for taxes, the data tell a different story. Many view the middle class as the middle three-fifths, or quintiles, of the income distribution. Between 2000 and 2004, after-tax income for the three middle-income quintiles, adjusted for inflation, rose.

For the second quintile from the bottom it rose by 2.8 percent, for the middle quintile it rose by 5.4 percent, and for the fourth, it rose by 4 percent. That provides a strong case for the proposition that middle-income tax relief is doing its job.

Even so, income inequality is rising. Between 2004 and 2005, the average income of the top 1 percent of households, adjusted for inflation, increased by more than \$100,000. On the other hand, average income at the bottom 90 percent of households increased by only \$250.

So why aren't middle-class incomes doing better? One explanation is corporate profits. Corporate profits are at a record high as a share of the total economy. Corporations are distributing less of their revenue to workers as wages and retaining more as profits.

Corporate profits go primarily to the well-off through capital gains and dividends, taxed at a very low rate. In contrast, wages and salaries form most of the income for the middle class. Wages and salaries are at a record low as a share of the total economy.

Another concern is health care costs. Out-of-pocket health care costs for consumers who are not in group health insurance plans are much higher than for consumers who are in group insurance plans. The normal adjustments for inflation do not adequately reflect the expenditures of middle-class consumers who are not in group plans. They pay much higher out-of-pocket costs.

Another concern is college costs. The normal adjustments for inflation put too small a weight on the cost of going to college for those families incurring those costs, and college costs have been rising, as we all know.

Between the 2005–2006 school year and the next one, annual cost of tuition, fees, room and board at a 4-year private college grew by 5.7 percent, to more than \$30,000. The annual cost of a 4-year public college grew by 5.6 percent, to nearly \$13,000. Both are growing much faster than the cost of living generally.

Another concern is gasoline prices. In January of 2001, the average price of gasoline nationwide was \$1.47 per gallon; by March of this year, it more than doubled to \$3.05. Although the standard inflation adjustments cover gasoline costs, they understate the squeeze on drivers who need to use a lot of gasoline, for example, driving distances across the State of Montana, where long distances can take up and consume a lot of gas.

So far, I have been talking about income and expenditures for middle-class families. Another way to look at the middle class is to consider what happens when a calamitous event occurs to a middle-class family. Such an event might be an illness striking a member of the family, or it might be the loss of a job, and too often the result is bankruptcy. That suggests that we should consider expanding refundable tax relief, like the Earned Income Tax Credit. We will look at issues like that today.

So the story of the middle-class families makes a good case for middle-class tax relief. It argues for expanding health care affordability and coverage, it argues for making college more affordable, and argues for targeted tax relief, like the Earned Income Tax Credit.

So let us examine how to increase the distribution of wealth, particularly to the middle-class families. Let us look for ways to improve the success of America's broad middle class, and let us thereby work to maintain that key to success of America.

I might say to our witnesses who have very generously come here, the attendance here is low because we are still in the middle of a vote on the Senate floor. We are concluding the roll call right now.

When Senator Grassley, the ranking member of the committee, arrives, I will ask if he wants to make a statement. But pending

that, I would like to begin now with introducing all of you, and also encourage you to go ahead with your testimony.

The first witness is Gary Burtless, who holds the John C. and Nancy D. Whitehead chair in economic studies at the Brookings Institute in Washington, DC; then Elizabeth Warren, the Leo Gottlieb professor of law at the Harvard University at Cambridge, MA. Then we have Sarah Blackburn, a social worker in pediatric oncology at the Billings Clinic in Billings, MT. Sarah has worked very hard, helping a lot of people in the Billings area for more than 25 years. She is a patient advocate, counselor for runaway children, and manages a clinic and other programs in Montana. Thank you, Sarah, for making the extra time and effort to come here. It is a long way from home to get here to Washington, DC. And finally, Scott Hodge. Scott is the president of the Tax Foundation in Washington, DC.

Again, thank you all for coming. You can all make statements of 5 minutes, and, if you have longer statements, they will be automatically put in the record.

So, Mr. Burtless, why don't we begin with you?

STATEMENT OF GARY BURTLESS, JOHN C. AND NANCY D. WHITEHEAD CHAIR IN ECONOMIC STUDIES, BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. BURTLESS. About a month ago, CBS News commissioned a poll to determine whether people believe that middle-class Americans have seen their circumstances improve over the last decade. Its polling organization asked 1,000 adults whether they thought life for the middle class had gotten better, worse, or remained about the same.

Fifty-nine percent said they thought the middle class was now worse off, 30 percent said it was now better off, and the rest had no opinion or thought the middle-class circumstances had not changed very much. By the way, among the respondents who actually had middle-level incomes, the answers were roughly the same.

A majority believes the middle class is worse off. For an economist who studies income statistics, the answers might seem a bit puzzling. Inflation-adjusted incomes today are almost certainly higher than they were a decade ago, and this is just as true for people in the middle class as it is for folks with higher or lower incomes. Maybe they have not gone up as much, but they certainly have increased according to income statistics available to us.

The last business cycle peak occurred in 2000, and a recession began and ended in 2001. Comparing average incomes today with those in the last business cycle peak in 2000, an impartial observer would have to say that average incomes have improved, even after we make a suitable adjustment for the effects of inflation.

In my formal statement I summarized some of the aggregate statistics that economists look at when they track the progress of Americans' real incomes. According to these statistics, U.S. GDP per person increased 9.5 percent between 2000 and 2006, personal disposable income per person increased almost 9 percent, and personal consumption spending increased more than 13 percent per person.

If average income and consumption are growing at a moderate pace, how is it that middle-class Americans are feeling so stretched? I think that are three main explanations. First, many people in the middle class are faring poorly. Even in an economy that is growing, millions of people a year lose their jobs or receive pay increases that are not big enough to cover the increases in cost of living.

Other people get sick or injured and have to cut back on their work hours, and then they have to scrounge up the money to pay the resulting medical bills.

But in an economy that is generally growing, we should expect people in improving circumstances to outnumber those who are facing rough times. The ups and downs of capitalism and some folks' sheer bad luck can explain why a minority of people say things are getting worse. They cannot explain why a majority of folks feel that way.

A second reason many of us feel our incomes are growing too slowly to cover our growing expenses is that some things that count as income gains in the national statistics are just not that visible to us. One thing that counts as income in the national accounts is the money that is spent by the government to pay for doctor and hospital bills through public health insurance programs. Another thing is the contributions our employers make so workers can have health insurance coverage through their companies.

Now, as it happens, these two things have been growing pretty fast. The extra spending on them counts as higher disposable income, and it is one reason disposable income was higher in 2006 than it was in 2000. How many people know how much their employers are contributing to their health plans and how many people insured under Medicare know the cost to the government of paying for their doctor and hospital bills? The answer is, not very many.

In my formal statement you will find a picture labeled "Chart 3." It shows how compensation increases between 2000 and 2005 were divided up. According to the Commerce Department, a full-time equivalent worker was paid a little less than \$45,000 in 2005. However, the worker's total compensation was closer to \$55,700. This amount is \$3,000 more than a full-time equivalent worker was paid back in 2000. All these numbers are adjusted for inflation.

This means that average compensation for a full-time worker increased 5.5 percent. So where did the extra \$3,000 go? Only \$850 was received by the worker in his pay packet as higher money wages, \$1,060 was spent by the employer in higher health insurance premiums, \$710 was spent by the employer on higher pension contributions, and the rest went for social insurance contributions and other items.

Even though total compensation increased 1.1 percent a year, after inflation, a full-time equivalent worker, on average, saw gains of only 0.4 percent a year in money wages.

In the census money-income statistics, which I discuss in some detail in my formal statement, the extra \$850 in wage increases shows up as an increase in income, but the other \$2,150 does not show up at all.

That is a big reason the census money-income statistics look so gloomy compared with the aggregate statistics on income growth.

My guess is, this kind of income gain is also missing when workers are asked to tote up their circumstances: are they better off or worse off? They do not know about that money either.

Now, one thing middle-class people should be aware of is the taxes they pay. Income and payroll taxes, after all, subtract from the income they have left over to pay for their bills.

Congress cut income taxes in the early part of this decade. The cuts added to net incomes up and down the income distribution. They certainly added to the net incomes of middle-class families.

My tabulations, which are reported in the full statement, show that Federal taxes fell by 1.5 percent of pre-tax money income of a person who is in the exact middle of the American income distribution. For some people, this may have made the difference between whether they experienced a net income improvement or net income loss over those 5 years.

It is hard to say why middle-class people miss this fact when they tote up the pluses and minuses of their current condition relative to what it was 5 or 6 years ago.

Let me make one last observation, and it is not a very complicated one. The national average statistics on income growth tell us how much incomes went up in total, that is, on average, across the entire population. Let us say the increase is 1 percent a year. Now suppose that incomes grew faster among people with high incomes than among people with low incomes.

When that happens, the people with lower incomes will see their incomes grow more slowly than 1 percent a year, possibly much, much more slowly. Given the way incomes are distributed in the United States, if people in the top one-fifth of the income distribution see their incomes climb 1.5 percent a year, and if average income growth is 1 percent a year, then folks in the bottom four-fifths of the distribution will only see their incomes grow by a half-percent a year.

Now suppose the folks in the top one-fifth enjoy income growth of 2 percent a year. Then incomes in the bottom four-fifths will not grow at all. In fact, on average they are going to decline slightly. So it does not take very big differences in income growth when incomes are growing more unequally, so that a very large majority of American families experience only very tiny growth in income or actually experience losses.

If incomes are growing more unequally, there will be a lot more people who see their incomes grow more slowly than average than there are people who see their incomes grow faster than average.

That is precisely what has been happening to the U.S. income distribution for most of the past quarter century. American incomes have been growing more unequally, and this is true whether incomes are measured on before-tax or on after-tax basis. Thank you.

The CHAIRMAN. Thank you, Mr. Burtless.

[The prepared statement of Mr. Burtless appears in the appendix.]

The CHAIRMAN. Ms. Warren?

STATEMENT OF ELIZABETH WARREN, LEO GOTTLIEB PROFESSOR OF LAW, HARVARD LAW SCHOOL, CAMBRIDGE, MA

Ms. WARREN. Thank you, Senator. Thank you for inviting me here today to talk with you about the changing economics of the middle class.

In the last generation, middle-class families have undergone a powerful economic transformation that has attracted little attention, but that is quietly reshaping America. What I am going to talk about today, I am going to change the focus slightly from where Mr. Burtless took it, and that is look at one generation, what it was like for a family in the early 1970s versus what it is like for a family in the early 2000s; what has happened to us over a generation.

I had some cool pictures for you, but they are not here, so I will dance them out and see if I can make this work.

Senator BUNNING. Will you get up on the table?

Ms. WARREN. I could. I could. But we will do the more subdued version. I will gesture a lot.

The CHAIRMAN. You know, if you want we could put those photographs in the record, too.

Ms. WARREN. That would be fine. Actually, they are in my testimony in small pictures.

The CHAIRMAN. All right.

Ms. WARREN. I just cannot point to them here for you.

The CHAIRMAN. All right. Well, you can refer to them in your testimony and we can look at them if you want.

Ms. WARREN. Good. If you want to start, you can follow in your hymnals on page 2 and get the first graphic. This is the graphic about income, what has happened in a single generation, inflation adjusted to income.

It has two critical parts to it that you will want to keep in mind when people talk to you about income over the last generation. The first is that a fully employed male today is earning about \$800 less than his father was earning a generation ago when adjusted for inflation.

The CHAIRMAN. That is since 1970?

Ms. WARREN. That is since 1970. So basically, over one generation, if you are a man and you are fully employed, your income has not gone up.

Household income has gone up. Family income has gone up. The principal reason has been because the median family in the United States has gone from being a one-earner family to being a two-earner family. That is, principally, mothers have gone back into the workforce, and that is what has boosted family income.

Now, one would think, with that second income, the family would be wealthier. If you flip over to page 4, you will see at least one indication of the trouble that families are in, and that is comparing that family from the early 1970s. That one-income family was putting aside about 11 percent of its take-home pay in savings and carrying about 1.3 percent in revolving debt, essentially credit cards and other short-term debt.

Move forward a generation and you will see that today's two-income family is putting aside nothing, that is, the savings rate is below zero—it is about minus 0.7 or 0.8 percent—while they are

carrying, on average, about 12 percent of their income in credit card and other revolving debt.

So there is the box. There has been no income growth for a fully employed male. Today's family has no savings and is spending money it does not have. So where has the money gone?

The classic story in the United States today is one of over-consumption. Everyone likes to tell the story about \$200 sneakers and designer toddler outfits. But the reality is actually on page 7, and that is that, in principal categories that we think of as consumption—clothing, food, appliances, what you spend on a car, per-car cost—the actual costs for the American family in a generation are down.

That is actually what the median-earning mom, dad, and two kids—this has been adjusted for changes in family size—is actually spending in those categories. They have changed what they wear, they have changed how they eat, they have changed how they shop, and they spend less on consumption.

Now they are spending more on electronics, a whopping \$225 a year; more on computers, about \$300 a year. But by and large, many of these expenses, one washes out another. Those two expenses alone are more than offset by the savings on appliances. We spend more on telephones, less on tobacco; more on pets, less on carpets; more on air travel, less on dry cleaning than we did a generation ago.

The short version is that, in these ordinary consumption expenses, there is just no evidence that families have gone crazy. If anything, median-earning families shop carefully and spend carefully. Where the changes are, as the chart on page 7 shows you, is in the big fixed expenses. Housing has gone from being 5.8 rooms to 6.1 rooms.

This is not an issue about granite counter tops and spa bathrooms and McMansions, this is an issue for median-earning families. The median family in the United States has either gone from two bedrooms to three bedrooms, or from one bath to two baths, but not both.

So how much more do they spend in mortgage payments on that house? The answer, in inflation-adjusted dollars in a single generation, is a 76-percent increase that families are spending. In short, many families in America today cannot buy the houses they grew up in, even if those were quite modest homes.

Health insurance, 74-percent increase. Cars have actually gone up 52 percent, but that is because, with two people in the workforce, families have gone from one car to two cars.

Child care. Not an expense of a generation ago, so I gave it a 100-percent increase. And taxes. Because her paycheck is taxed at the margin, her first dollar of earnings is taxed at the margin for the last dollar that he had earned, if both of them are in the workforce, or vice versa if you want to play it on margins, taxes have also gone up about 25 percent for this median-earning family.

So the short version. I will just summarize by saying this. If you take a look on page 9, it is sort of the money shot of what has happened to the median-earning American family. A generation ago, that family earned less money. That is, if you take a look at these numbers, they had roughly about \$42,000. About half of it was

committed to big fixed expenses—mortgage, health insurance, transportation and taxes—that they had to pay.

Today's two-income median-earning family is earning a lot more money. Take a look at the numbers. Gosh, they have gotten up in the \$70,000, \$78,000 range that they are making here. But three-quarters of that money is now committed to five fixed expenses: the mortgage, health insurance, car payment, child care so that they can earn that income, and taxes. They now have only a quarter of their income left over to pay for every other expense they need: clothing, food, savings, flexibility if anything goes wrong.

So I will stop there, but I will stop by saying, if we want to understand what is happening to middle-class American families, it is right here in the numbers in a generation. Incomes have been flat. Families have coped by sending more people into the workforce, which works for families that have been able to do that, but does not work for families that have only one parent or that want to keep a parent at home with small children. And all around them, expenses have moved up.

The expenses that have moved up are not for the stuff you can easily cut out. You cannot sell off a bedroom when you are out of work for a while. You cannot cut back on health insurance for 6 months and expect to survive economically.

So, families have been caught in this enormous squeeze. They have tried individually to cope by sending more people into the workforce, by cutting their expenses in consumption, and yet they are trapped. I am delighted that you are talking about these issues. If I can be helpful, I will answer questions later.

The CHAIRMAN. I might say, Ms. Warren, you have been very helpful. That is very illuminating testimony. Thank you so very, very much.

[The prepared statement of Ms. Warren appears in the appendix.]

The CHAIRMAN. Ms. Blackburn?

**STATEMENT OF SARAH BLACKBURN, SOCIAL WORKER,
BILLINGS CLINIC, BILLINGS, MT**

Ms. BLACKBURN. Thank you, Senator Baucus and members of the Senate Finance Committee, for the opportunity to testify both personally and professionally on an issue that is very important to me, to a great many people in Montana, and to the rest of the country. For lack of a better term, I refer to this issue as the middle-class crunch.

As you know, wages in our country have remained stagnant, while cost of living has increased exponentially. When we start out, we consider building a life and shooting for the American dream as an adventure. We attend college, graduate, marry, find a job, and begin our families.

My husband and I married 24 years ago, hoping to raise successful, educated children much like ourselves. For brevity's sake, I will not take you through the years of diaper changes, skinned knees and broken hearts.

After high school graduation, college was the next step for our oldest, who attended Montana State University in Bozeman for 2

years. The value of higher education is priceless, but the cost of higher education is next to impossible.

In-State tuition makes no difference to those of us who have worked so hard for so many years to provide the same opportunity to our children that our parents did. Prices have risen to the point that we can no longer even consider paying for everything involving the starting of a new life for our children. The prices of housing, books, et cetera are sky high. Extra-curricular activities are out of the question.

We have had to dip into our savings and our retirement to pay the price of providing our daughter the education she has earned. We have since had to move her to a college in Wyoming that allows substantial discounts to surrounding States. Sadly, our son will pay the price as well. Education has become a luxury of the wealthy.

As a social worker for the Billings Clinic in Montana, I and my colleagues across the country have far too often seen the toll that a catastrophic illness takes on our families. No matter that many of them have excellent insurance; the cost of medications with co-pays can be counted in the thousands.

One story I know of through a colleague is that of a 16-year-old girl with cancer being treated in Missouri. Her family has insurance through the University of Missouri Columbia but is unable to afford the medication to quell her nausea because the 20 percent co-pay for 20 tablets is \$1,200.

Another example of the problem is a 6-year-old girl in Montana who was unable to take a medication for her cancer, as the medication was experimental and the insurance would not pay for it. The cost of the medication was staggering and would have had to be paid out of pocket. Her parents, who are hard-working and self-employed, could not afford the cost. Their daughter has since died.

Hundreds of families across the United States are required to travel outside their areas for treatment, as resources are not available. Children in Montana diagnosed with cancer and other life-threatening diseases must travel to Denver, Seattle, Phoenix, Salt Lake City, or other large areas with the appropriate medical services. Insurance does not cover the cost of wear and tear to vehicles, gas, lodging, or meals.

The majority of our families do not qualify for government programs, as they make too much money. Yet, once faced with the added expenses of such a situation, they find themselves getting further and further behind. They must rely heavily on charitable organizations just to keep their heads above water.

At our clinic, we have a fund which we have tapped into in order to help our patients make car payments, house payments, and simply to put food on their family's tables.

Those children diagnosed with such chronic illnesses as diabetes are also affected. Even with insurance, the necessary supplies, meters, and often unexpected hospitalizations can become tremendous financial burdens.

Many of our parents with healthy children have to forego routine medical care for them as the parents, who are self-employed, cannot afford the cost of insurance, yet do not qualify for Medicaid or SCHIP. These children are going without medications that would

aid them in focusing better at school or that would clear up a bacterial infection far sooner than letting it run its course.

In summary, we as middle-class citizens are no longer finding that, to get a good education, work hard, and pay our taxes is as much the American dream as it used to be. With the rising cost of education and health care, and wages staying the same, it is becoming more and more difficult to maintain a lifestyle commensurate with our education and work ethic.

Thank you.

The CHAIRMAN. Thank you very much, Ms. Blackburn.

[The prepared statement of Ms. Blackburn appears in the appendix.]

The CHAIRMAN. Mr. Hodge?

**STATEMENT OF SCOTT HODGE, PRESIDENT,
TAX FOUNDATION, WASHINGTON, DC**

Mr. HODGE. Thank you, Mr. Chairman and members of the committee. It is an honor to testify today about this very important topic.

Like Professor Warren, I have a series of charts that are in a handout that is available for the committee.

The CHAIRMAN. Sure. Do you want to refer to them in your testimony?

Mr. HODGE. I will.

The CHAIRMAN. Sure.

Mr. HODGE. But they are available as you follow along.

The CHAIRMAN. Sure.

Mr. HODGE. Before we think about how to help middle-class working families, we need to understand that today's middle class is not our father's middle class. If we focus too much on the median taxpayer, we will get a false picture of today's middle class and our policy prescriptions will likely be mistargeted.

You may be surprised if you listen to the media, but June and Ward Cleaver, the stereotypical middle-income family of the 1960s, have retired and they have been replaced by a new middle-income taxpayer. That comes from the cast of the popular TV show, "Friends."

In 1960, there were twice as many married couples in the statistical middle as there were single taxpayers. Today, that ratio has completely flipped. There are now twice as many singles in the statistical middle as there are married couples. Phoebe and Joey have replaced June and Ward.

Today's working couples with children now populate the top 40 percent of taxpayers. Why? Because more than 65 percent of those working couples are dual-income. They also tend to be college-educated, they are older, they are business owners, they live in high-cost, high-tax urban areas.

Taxes—Federal, State and local—are some of the chief sources of anxiety facing these new middle class, but dual-income, families; AMT and property taxes are most in the news these days.

Phoebe and Joey are not immune. When singles get married, they move from the statistical middle to the top simply by saying "I do." Today's working families look rich compared to the 44 million tax filers who have no income tax liability after taking credits

and deductions. Simply said, a family of four earning about \$40,000 would likely pay no income taxes whatsoever, and many will often get the Earned Income Tax Credit.

A new Tax Foundation study shows that today's higher-income working households are not only shouldering their own tax burden, but they are shouldering the tax burden for millions of their fellow Americans.

We find that the government is redistributing more than \$1 trillion from the top 40 percent of households to the bottom 60 percent. What that means is, the majority of American households today receive more in government spending than they pay in taxes.

At the bottom, the bottom 20 percent receive \$31,000 more in government spending than they pay in taxes, and the middle—the forgotten middle—receive \$6,400 more in government spending than it pays in taxes.

The top 20 percent pay more than \$48,000 more in taxes than they get in government spending. I think the fact that a majority of Americans are now receiving more in government spending than they pay in taxes ought to be a great concern for all of us. I think that it could lead to, and be, the seeds of social conflict, and it undermines the fabric of democracy to have a majority of Americans as consumers of government and not payors.

I think we can actually do more for working families by doing less for them. The current tax base is so carved up right now. Trying to achieve more social policy through the tax code will be like pushing on a string; neither the IRS nor the tax system are functioning very well right now.

Professor Warren has written that many of the consumer products that we use today—cars, appliances, clothing, and food—are better and cheaper than they were a generation ago, but the items that families are having a hard time paying for today—health care, education, and housing—are the three areas where government has been most involved over the past 3 decades.

Our efforts to use the tax policy to help these sectors of the economy have produced not only a byzantine tax system, but have actually created economic distortions that are hurting today's working families.

To wrap it up, the vast majority of Americans see themselves as middle-class. A recent Tax Foundation poll showed 80 percent of respondents thought that they were in the middle class; only 2 percent thought that they were actually upper class.

Americans see the term “middle class” as a value system, not a point on the income scale. The way to help middle-class working families, whether they work in Manhattan, in Billings, or even Davenport, IA, is to implement policies that make all Americans richer, not tax those at the top to bring them back down to the middle. Our attempts to achieve and promote equality should not lead to mediocrity.

And, as I point out in my extensive testimony, greatly simplifying the tax code while cutting tax rates across the board will boost economic growth, boost incomes, and, interestingly enough, boost the progressivity of our fiscal system. This is an outcome that should have broad-based bipartisan support.

Thank you very much, Mr. Chairman. I appreciate the opportunity and will happily answer any questions that you might have today.

The CHAIRMAN. You bet. Thank you very, very much.

[The prepared statement of Mr. Hodge appears in the appendix.]

The CHAIRMAN. I see Senator Grassley has arrived. I will let him get settled a little bit.

Before we turn to Senator Grassley, I will turn to Senator Bunning.

Senator BUNNING. You have already questioned?

The CHAIRMAN. I will let you go ahead first.

Senator BUNNING. Well, I have a statement I would like to put into the record.

The CHAIRMAN. All right.

Senator BUNNING. Thank you.

[The prepared statement of Senator Bunning appears in the appendix.]

Senator BUNNING. Mr. Burtless, in your written testimony you noted that Americans across the income distribution levels have derived notable benefits from the recent tax cuts. You further noted that, for many middle-class families, President Bush's tax cuts may have made the difference between suffering a loss and experiencing a gain in spendable income.

Would it be fair to conclude from your testimony that reversing those cuts, something that will happen in the year 2011 if Congress continues on its present course, will have a detrimental effect on working families?

Mr. BURTLESS. The working families that derived benefits from those tax cuts will have to pay higher taxes. That is true. They will have less spendable income. I agree.

Senator BUNNING. To Mr. Hodge or Mr. Burtless, can you clarify for the committee who is rich and who is middle-class? What difference would allowing the Bush tax cuts to expire have on the middle class? So I want your definition of who is rich and who is middle-class, because we are having trouble up here deciding.

Mr. HODGE. Well, I clearly think that the term "middle class" is a value system and not a point on the income scale. A person who is distinctly middle-income in Manhattan, earning \$150,000 a year, would clearly be rich if they were in Mississippi, Kentucky, or other areas in which the cost of living is much lower.

So the unfortunate thing about the tax system is that it is not adjusted for the cost of living. So that family earning \$150,000 in Manhattan is taxed as if they were wealthy, living in Davenport, IA. So we need to consider the facts and the wonderful differences in America and not try to just hone in on the statistical middle or some sort of an average. There is no average in America.

Senator BUNNING. But you have not answered my question. Maybe Mr. Burtless could answer it. The reason I say that is, you have not taken into consideration the cost of raising 5, 8, or 10 children. That could make a major difference in whether someone is middle-class or whether you can afford to send that child to college. I believe that was brought out very clearly by our third witness. Go ahead.

Mr. BURTLESS. Defining who is in the middle class is not a matter of theology. As we have already heard, about 80 percent of the population considers itself middle-class, and I think that is probably a good thing. Many people who have very low incomes and many people who have very high incomes consider themselves "middle-class."

In thinking about tax legislation, however, I do think it makes sense to just talk about where in the distribution of income you would like to place more burden and less burden rather than getting into, I think, a fruitless discussion about which person in the United States is in the middle class and which person in the United States—

Senator BUNNING. That is what our brilliant Congress did when they put the Alternative Minimum Tax in. We were going to nail those people who were not paying taxes, and those corporations. All of a sudden, that Alternative Minimum Tax is hitting families in the \$50,000, \$60,000 range.

Believe me, I have a daughter and son-in-law around the \$70,000 range, joint incomes, who are now paying Alternative Minimum Tax. That is completely outrageous as far as this committee is concerned.

We think that the Alternative Minimum Tax was never, ever intended to do some of the things that it is doing today. So middle-income people are being affected by that, where in fact they were never supposed to be.

Do you have a solution to that?

Mr. BURTLESS. Look, I am not an expert on tax policy.

Senator BUNNING. All right. Some of us up here are not either.

Mr. BURTLESS. Some people make the argument that, because of its dramatic simplicity, the Alternative Minimum Tax actually offers a simple blueprint for the tax code. It has less complication in it than the regular tax system does. I do not have enough knowledge to subscribe to that view or to say it is wrong. I just do not know what the answer is.

The CHAIRMAN. Thank you, Senator.

Senator BUNNING. Thank you very much.

The CHAIRMAN. Frankly, the subject of this hearing is an extraordinarily important issue that this country should spend a lot more time addressing. That is, the plight of middle-income Americans is getting tougher, and tougher, and tougher.

Mr. Burtless's poll data shows that the middle-income class is a lot worse off, and I think it is very important. I also think that Ms. Warren's testimony comparing the 1970s with today, what that family went through then compared to today, basically outlines the problems that the middle class is facing.

For me, "middle-class" is basically the three quintiles. You provide income at five different levels, you take one, two, three, four, according to income levels. The middle three is probably the middle class, which is a bit large.

I mean, it is very difficult to come up with a better definition, but I just say the second, third, and fourth quintiles are probably middle-class. The bottom certainly is not, and the top is not, but those three in the middle are.

The data I think that is coming through, not only today but by others, is just devastating. Americans are just having a tough time today compared with an earlier time in our history. The question is, what can be done about it?

I would like, Ms. Warren, for you to describe a little bit about bankruptcies. You have some data and some studies. What happens? How many people have to go into bankruptcy? I suppose it is primarily due to health care costs.

There may be other reasons too, but just kind of tell us what happens. How many bankruptcies, family bankruptcies, are there, personal bankruptcies, and why does that occur? If you would just kind of go through the steps. How in the heck do people get out of it?

Ms. WARREN. Well, Senator, the first place we start is, it is an appropriate question when we are doing a conversation about what is happening economically to the middle class, because at least it is measured by whether or not they have been homeowners, whether or not they have gone to college, whether or not they have occupations. In the upper 80 percent of occupational prestige scores, the people who filed bankruptcy, by and large are solidly middle-class. They are moms and dads.

Indeed, a child in America, up until we had our recent dramatic changes in filing rates with the change in law, was more likely in any given year in the 2000s to live through her parents' bankruptcy than to live through her parents' divorce. So, as common as divorce has become for children, bankruptcy is more common.

The picture of bankruptcy and who files for bankruptcy are the economic issues we are talking about here. Ninety percent of all bankruptcies can be accounted for by just three factors: job loss, some kind of income interruption—and by the way, I should point out, dual-earning families are more likely to end up in bankruptcy than single-earning families—and medical problems.

The CHAIRMAN. And that is because their incomes are lower.

Ms. WARREN. They are more vulnerable. It now takes, instead of 52 paychecks to make the mortgage payment, 104 paychecks to make the mortgage payment. It just doubles the odds that one or the other of you loses a job and the whole thing comes unwound in a hurry.

Medical problems and family break-up, death, or divorce, or he takes off or she dies—those three account for more than 90 percent of the filings. A majority of families have two out of three that have hit them, and a substantial number, all three.

About half of all the families that file for bankruptcy do file in the aftermath of a serious medical problem. What is really stunning about this is, 75 percent of those families have some form of health insurance at the onset of the illness or accident that ultimately triggers their bankruptcy.

So what we are watching here is, we are watching families, the kind of data we have talked about. When everything is going right, they are right at the margin. There is no savings, there is a modest amount of debt, they are barely making it one paycheck to the next paycheck, sometimes borrowing, sometimes getting a tiny little bit ahead.

And then an illness hits, and it can be the wage earner, the principal wage earner, either mom or dad. It can be a child who gets sick, and someone has to take off work to take care of them. Grandma falls and breaks a hip. The combination of medical debts and loss of income and the other expenses associated with illness, driving to get medical care, that combination up-ends the family.

I will tell a very short story about one of the people who showed up in our sample who was very typical. He worked for a big delivery company, and on a weekend was playing touch football and tore up his knee. As he fell, he said he heard it.

As his friends took him in, he said, not to worry, I am insured, I have good insurance, as they carried him off the field to great cheers. And sure enough, when the surgeon said it was going to take surgery to fix this, medical insurance is going to cover this. But he ended up having to pay 20 percent of his hospital stay. He had to pay all of the drugs himself.

It turned out that his health insurance did not cover crutches and other supplies, and no rehabilitation. So if he wanted to walk again without a limp, he had to pay for 12 weeks of rehab himself. And he was out of work for 3 months.

The combination took a steadily employed, hardworking, play-by-the-rules sort of individual and, within a year, landed him in bankruptcy court. The best bankruptcy can do for him is help wipe out the old debts. Whether he will ever recover his old life or not, we just do not know. All that from just falling and breaking a knee.

The CHAIRMAN. Well, thank you very much. My time has expired. Senator Grassley?

Senator GRASSLEY. I am going to put my statement in the record and go to questions with Mr. Hodge.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator GRASSLEY. In your testimony you state that our government's attempt to use tax policy to promote certain sectors of the economy over others has not only produced a byzantine tax system, but it has also created economic distortions in the very areas we have tried to help, such as housing, health care, and education. It is as simple as wanting you to give us an elaboration of that statement.

Mr. HODGE. I think most economists are agreed, Senator, that the way in which we provide health care in America through the taxpayer exclusion for employers has distorted the market in the health care arena. It has taken patients out of the role of being the customers, the consumers, and actually put their employers in that role as the customer.

So, the person paying the bills, the party paying the bills—the employer—and the doctor negotiate over the quality and cost of the care. Until we can change the dynamic there away from putting employers in the driver's seat and putting patients in the driver's seat, we are going to have these economic distortions.

We see a similar case in education, where out of good intent our efforts to both subsidize students and offer them various tax credits actually get capitalized into the cost of a college degree. Universities have no incentive to lower costs or be competitive because

they know that somebody else is helping the student pay or they are taking a tax credit.

So, if you have a \$3,000 tax credit, that gets factored into the cost of a college education, much like a tax credit for buying a hybrid vehicle gets subsidized into the cost of the hybrid vehicle. I think we need to take a step back and understand that our best efforts in some of these cases have actually produced results that we do not want.

Another big instance is the tax deduction for State and local taxes paid. About 65 percent of those people who take the State and local tax deduction earn more than \$100,000 a year, so our efforts there to help the so-called "middle class" are actually helping upper-income people.

It is also allowing State and local governments to raise their taxes—and property taxes in particular—exorbitantly, which then ends up putting people in AMT, so we have this vicious cycle. I think we need to re-think the tax policy.

If we simplify the tax system dramatically, take away these exclusions but lower tax rates, we will bring some rationality back into those marketplaces, and eventually these middle-class families will be much, much better off.

Senator GRASSLEY. All right.

Then my next question is to Mr. Burtless, but I would ask Mr. Hodge to pay attention and would ask for your thoughts.

In recent years, Congress has attempted to address the marriage penalty by doubling the standard deduction and tax brackets for married couples relative to single individuals.

In your testimony, Mr. Burtless, you point out that economists often attempt to adjust income for difference in family size by dividing household income by the square root of the number of persons in the household.

While there may be some statistical elegance to the approach, I suspect most Americans would find it rather odd to suggest that a family of four making \$40,000 does not equal \$10,000 per person, but rather, under the square root method, equals \$20,000 per person.

When thinking about different ways to address the marriage penalty, and perhaps even geographical differences in cost of living, what do you think would be the best approach?

Mr. BURTLESS. I agree, everybody would consider the square root of the number of people in a household to be a very odd adjustment. It is just a crude way to do it. There are other ways to make adjustments. But with regard to the marriage penalty, I always thought that Congress, in the early 1980s, hit upon a pretty smart idea.

I think that, in calculating the income tax, if I recall this—I repeat, I am not a tax expert—I think that they allowed the lower-earning spouse to just subtract 10 percent or 15 percent of the wages from the amount that was included in taxable income. It means that the initial tax paid by the second earner in the family is then subject to a lower tax than it would be if it was the last dollar earned by the primary earner in the household.

This is not a very complicated thing. I think it was tax reform in 1986 that did away with it, probably for good reasons. You will

remember, in 1986 we greatly simplified the tax code in many other ways, and so it was probably a defensible thing to do.

But we now have, as people have mentioned, a lot more complications, even for ordinary taxpayers, so maybe making this little revision so that we go back to taxing the second earner more lightly than we tax the first one for their earnings would make some sense.

Senator GRASSLEY. Mr. Hodge, my time is about out, so make the answer short so we do not bother other colleagues here.

Mr. HODGE. It clearly makes no sense to take two people who say "I do" at a much higher rate than they would when they were single. While Congress has done, I think, a marvelous job in helping some of the lower-income married couples by doubling the bracket, the 15-percent bracket, for instance, it is not helping some of the upper-income families.

So you have two mid-level professionals, each earning about \$60,000 a year, who get thrust into those higher brackets, and they are not helped quite as much through the marriage penalty relief. I think we ought to consider raising that all the way up the income scale.

Virginia, for instance, I think, allows people to figure out their incomes, their tax, in two different ways, whether they were single or married.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lincoln, you are up.

Senator LINCOLN. Well, thank you, Mr. Chairman. A special thanks to you and Senator Grassley for calling this hearing today.

I have to say, I feel very clearly in the box here, having, for 3 weeks now, tried to get an appointment with the pediatrician and was able to beg, borrow and steal to get there early this morning so I could be here for a vote at work, and having to rush my child to school and go through all those motions. But then I stopped to think, I actually do have insurance. There are a lot of mothers who do not, working mothers, working families that do not have insurance.

I think that that is one of the issues, obviously, that you have brought up in the example that you used, Ms. Warren, in terms of both having insurance, but having good insurance as well that really will make the difference of being able to help you mitigate your risk over the time that you are suffering and to be able to stay afloat.

One of the things I have been working on is the ability to try to put a large dent in those 46 million Americans who are uninsured, and the best way that I have seen to put the largest dent in that is to try to provide health coverage and health insurance to small business owners, their employees, and self-employed.

The easiest and most comprehensive way I have found to do that would be to try to give them exactly what I have, and that is, put them in a risk pool, just like I am put into a risk pool of Federal employees, to give them better coverage at a lower cost.

If we combined all 22, 23 million small business owners, their employees, as well as self-employed individuals, we could create a pretty phenomenal pool and operate a plan through the Office of

Personnel Management, just very similar to what we do, in giving those people that kind of health insurance.

We are certainly looking at the opportunities of how we provide the tax incentives to encourage both the small businesses to be involved in it, as well as the individuals, in a way that will encourage that.

But in looking at Ms. Warren's comment, there is less frivolous spending today, and fixed expenses—particularly housing, health insurance, education—are critical. The Chairman had a wonderful hearing about the issues of education and trying to save for education, and how we do that.

Do we combine the programs and the tax incentives that exist, along with the grant programs and others to be able to access that? Because I have to say myself, finding the additional dollars on a monthly or yearly basis to put aside for what I think college is going to cost in 8 years from now is tough, and we are a 2-income family. So, it is interesting to see what people are going through and witnessing the challenges that they face.

I guess one of the questions, I would say, the three that you list, Ms. Warren, housing, health insurance, and education, seem to be the most paramount on our minds. I would just ask any of you all which of those you think would be probably the most immediate that would have the most impact in terms of helping the middle class.

The other would be, in the housing initiative, we are also seeing a tremendous amount of individuals suffering from the mortgage crisis that we are going through, which is not going away. As those things mature, we will have probably a consistent 3 more years of mortgage crisis on our hands in the ability of these middle-class families to be able to either talk to and visit with their mortgage companies, to be able to refinance those deals, or whether they do end up having to go into bankruptcy or deal with those kinds of issues from that perspective.

But that would be my question, really. Of those three things, which do you think would have the most immediate impact on the middle class, housing and mortgages, health care and health insurance, or education help that we can provide them?

Ms. WARREN. Senator, I will make two quick points, if I can. The first one is something we have not talked about, and that is the importance of credit practices.

Senator LINCOLN. Financial literacy.

Ms. WARREN. It can really have an effect on these middle-income economic issues. And I will just point out two quick ones. We are on target for about 2 million families to lose their homes over the next year and a half on products that were sold to them, people who made enormous profits off them in the first 18 months, profits that they knew in many cases were going to cost these people their homes.

The CHAIRMAN. Are you talking about subprime loans? What are you talking about?

Ms. WARREN. I am talking about what we are calling subprime. But let us keep in mind, this is not always about trying to get home mortgages to people who are poor. This was about calling people and refinancing people out of home mortgages that they

could afford and putting them into home mortgages that they knew they could not afford.

This was about people who could have afforded to borrow \$200,000 and buy a modest house with it being talked into borrowing \$500,000 and being completely wiped out in the 25th month when their 228s readjusted. So there is a lot of room for relief for the middle class that has nothing to do with spending another dollar of taxpayer money. It has to do with having rules that are fair and safe for middle-class families.

Now, that is not responsive to your point, so I will try to say really fast an important point about education. When we talk about what it is to educate a child in America today, let us just remember what it was like a generation ago.

A generation ago, parents believed 12 years of education was what a child needed. If you look back at the old Gallup polls, what will determine a child's success after high school is the good work ethic. Right? College was on the list, but it was not at the top of the list.

Today, more parents believe that the moon shot landing was faked than believe that a child can make it in America without a college diploma. We have moved into a world in a single generation where college is the absolute bare minimum ticket to maybe make a place in the middle class.

At the same time, we have gone from 4 percent of American children back in the 1970s in early childhood education programs to well over half of all children, moving up toward about 70, 80 percent of all preschoolers, 3- and 4-year-olds. Who is paying for that? Parents are paying for it.

So let me just point out to you what has happened. The government, State governments and Federal Government combined, a generation ago, combined 100 percent of what most families in the middle class believed were the educational needs of their children—12 years in 1970 in what most families believed were very good schools. Families could afford to buy homes wherever they could afford them and then send their kids to the school down the street, and they knew they would be all right.

Today that has changed in two fundamental ways. Families no longer believe they can buy the homes they can afford and safely send their children to school, so they are buying up, up, up the ladder. That is why they are paying more on mortgages, to try to get into decent school districts. And, more importantly, the number of years in education has stretched from 12 to 18, but going from 100 percent paid by the taxpayer—that is, all of us provide this education for the children—now shrunk to two-thirds of the cost.

The rest of us have to bear individually the cost of sending our children to preschool, which is now regarded as essential, and the cost of sending them to college. We have taken something that was once a public responsibility and provided for the public generously and well, and we have turned it into something that does not work well for the public, and we have shrunk the coverage. It simply does not cover what it takes to be middle-class in America today. Sorry for going on.

Senator LINCOLN. No. But I am a believer in education, too. I see what it did for me.

Ms. WARREN. Me, too.

Senator LINCOLN. Thank you.

The CHAIRMAN. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, very much. Thank you to all of you. To Ms. Warren, thank you for your eloquence on this. As you were speaking, I could not help but have my own life flash in front of me, growing up in a small rural community in northern Michigan where I decided to go to college. I will not tell you the date, but I decided to go to college and went down to Michigan State University.

Most of my friends were going down to Lansing, the same area, to work at General Motors and made very, very good money, health care, pensions, raised their families. They all thought I was crazy because I was going into debt to go to college.

But now it is a very different picture for my friends who, in their 50s, are losing their jobs, they are seeing lower income, health care costs going up, pensions threatened. It is a very different world. So I do appreciate, Mr. Chairman, your holding this hearing on a very, very important topic.

Let me first say that I think we have seen a lot of interesting trends in the last decade, and you have spoken to them this morning. But when you look at the numbers, on the one hand, real GDP has increased 37 percent, real corporate profits have increased over 60 percent, real S&P 500 increased 49 percent, but real wages have gone down. So that is the question.

When we look at gas prices going up, which yesterday we were, an average, in Michigan, of \$3.15 a gallon. Then we look at Exxon posting the largest corporate profits in history last year and the same again this quarter; there is a disparity here. No wonder people are so concerned and feel like nobody is listening and they are squeezed on all sides.

The truth is, in the past in America when we have seen corporate numbers like this, and GDP, and S&P 500, we would be celebrating it, because, when the stock market went up, that meant everybody's standard of living went up.

Today it is different than that. The difference between the CEO and what happens when you walk out onto the plant floor or when you walk out into the business, it is a very different world that you spoke about today.

When we look at the fact that, not only are salaries not going up, and in many cases going down, we see a more productive workforce, but they are not seeing better pay as a result of that productivity. Their health care, education, training, housing, all of those things are going down and there is a huge gap, 250 times more that the CEO is making than the average person working, working very, very hard.

So you have gone through all the numbers, but I think it paints a very different picture than when we just look at the corporate profits end of things. And in my home State we have seen median income drop 11 percent in the last 5 years, and we are pretty proud people in Michigan, people who work very hard.

So I have a question, Mr. Hodge, for you, based on your testimony. One of the things you said in your written testimony was that lowering corporate taxes would change the trend. I do not see

where that is the answer at this point, particularly in a world where capital can easily go overseas.

My question is, how do we keep the capital in America for American jobs and American businesses? When we are focusing on tax policy in a world where the Internet or your cell phone would jump any barrier that somebody would put up, it seems to me we have to be much more vigilant about making sure there are incentives here at home rather than to drop corporate tax rates and then have those go overseas to lower-wage countries or places where they do not have to pay for health care, pensions, or environmental standards where you can breathe the air and drink the water.

So I question that whole approach, and I guess I would ask you, how do we really address creating jobs in America and American businesses? And I do not mean that we do not obviously have a global economy, but it is our job to make sure that the people who are working hard every day and face what you have already talked about have a job and can really raise their family and have the American dream. That is not rhetoric, that is a reality for too many people who are worried about what is happening in this country.

Mr. HODGE. Senator, I think one of the things that Congress needs to think about is what incentives we are creating for shipping jobs, capital, labor, and investment overseas. One of the things that is driving that is the fact that the United States has the second-highest overall corporate tax rate among industrialized countries.

In fact, when you add to our 35-percent Federal corporate tax rate the State and local tax rates—Michigan, for instance. General Motors pays a higher corporate tax rate, when they are profitable, than they would if they were in Sweden, Germany, France, anywhere else in the world.

Senator STABENOW. If I could just interrupt to say, they also pay over \$1,500 per vehicle on health care. If you were to ask them what they would like us to address, it would be the cost of health care.

Mr. HODGE. Well, we can address that as well. I think that if we had a choice-based system such as the Federal Employees Health Benefits system that would be available for all of us, that would certainly drive down health care costs, not only for General Motors but for all of us.

But cutting the corporate tax rate will make America more competitive. There is nothing more mobile today than capital, and capital is seeking out lower-cost places to do business.

Ireland, for instance, has a 12.5 percent corporate tax rate. American businesses are investing like crazy there. Why? Because the returns on that investment are higher because of those lower taxes. Where are the jobs going? They are going to Ireland. In fact, Irish expatriots are coming back to Ireland because that is where the jobs are.

We need to do the same. We need to realize that we are in a global marketplace and every other country on earth is cutting their corporate tax rates to be more competitive, and we are simply standing still, falling behind. Our corporate tax rate is 10 percentage points higher than the European average today.

Senator STABENOW. Mr. Chairman, I know that my time is up. I would just simply say that we have cut top income rates. We have seen a tax-cutting strategy now for a couple of decades and real wages are down 20 percent, folks in America are squeezed more than ever, and so I hope we will have broader debate.

Thank you.

The CHAIRMAN. Thank you very much.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus, for holding this hearing. Thank you to the witnesses for your excellent testimony this morning.

I have two questions, one about savings—increased savings—and the other about education. For you, Elizabeth and Sarah, my question is about education and what it is that we can do in this Congress to help make the American dream of access to higher education a greater reality for middle-class Americans.

In my family, I am a first-generation college graduate, along with seven other of my siblings. It was because of programs like the Pell grant and the Perkins programs and others that people like myself had an opportunity to do something that my parents, proud Americans and veterans of this country, were never able to have. I think that American dream is being lost on a lot of people.

I would like your number-one specific recommendation as to what it is we can do, and you will have about a minute each to answer that question.

To Gary and Scott, my question to you is in terms of savings. You know the statistics. Twenty-five years ago, 10 percent of the money that was being earned by Americans was going into savings. Today we are actually in a negative savings position among Americans.

What is it that we can do in terms of the Finance Committee and our tax code to try to incentivize people to change that reality of this negative savings rate? So why do we not take the education question first. You will have about a minute each, and then we will take the tax question.

Sarah?

Ms. BLACKBURN. Senator, I do not propose to be an expert on making recommendations. All I know is that the cost of education in Montana is very, very high. We, as my testimony indicated, had to move our daughter to a college in Wyoming that provided substantial discounts for the surrounding States.

We just find it very, very difficult to pay into the education, although it is essential for my daughter and for my son. He is going to have to pay the price too because we are not going to be able to afford to send two kids to college. So, it is just a very difficult thing. We have had to dip into our savings and into our retirement to pay for her college. I wish I had a recommendation to give you.

Senator SALAZAR. And your story, I think, Sarah, could be told a million-fold over this country.

Ms. BLACKBURN. I think it could, too.

Senator SALAZAR. Elizabeth?

Ms. WARREN. Thank you, Senator. I would say, I think the Federal Government could make adequate loans available directly through the government to pay the cost of books, tuition, and fees,

and I would make it room and board for the State university system for any student who wanted to go to college.

Then what I would do is, I would offer a year of forgiveness for each year of loans if people wanted to go into public service for a period of time after graduation. It is like the GI bill. Get your 4 years in college and then spend your 4 years in the military, in foreign service, in Teach for America. We have lots of places where we could use these bright young people.

Senator SALAZAR. Have you written up that proposal and figured out how much it would cost?

Ms. WARREN. Yes, sir, I have. It is actually being scored now, Senator.

Senator SALAZAR. Can you get me a copy of that?

The CHAIRMAN. We would be very interested in that.

Ms. WARREN. I would be delighted.

The CHAIRMAN. Very interested in that. Very interested.

Senator SALAZAR. I appreciate that very, very much, Elizabeth.

And on the savings question and the tax issue, Gary, what is your response to that question?

Mr. BURTLESS. It is true, saving out of personal income has declined a lot and private saving—

Senator SALAZAR. Now, we know that fact. We know that as a fact. So, therefore, what do we do about it?

Mr. BURTLESS. But let me point out that Congress and administrations since the early 1980s have done many things to reduce the tax that people pay on saving. We have created many kinds of retirement savings accounts so that essentially people do not pay taxes on the capital income that they derive from those accounts until the point at which they start withdrawing, which is a big incentive to save.

So I think I would just tell you, looking at tax incentives as a way to address this is something that Congress always does, but it is very doubtful that it works.

Senator SALAZAR. What works?

Mr. BURTLESS. We have much lower savings in spite of much bigger incentives.

Senator SALAZAR. What does work?

Mr. BURTLESS. Well, one reason that saving has declined is because the assets of people who do a lot of saving have appreciated a great deal in value. So if you want to raise saving, I mean, it is a very terrible thing to say, but the value of the assets that people already own may have to go down.

The ratio of wealth to income in the United States at given ages, among 45-year-olds, has not changed much in spite of the big reduction in savings. It is an amazing fact that the appreciation of assets has made up for the drop in the saving rate.

Senator SALAZAR. Thank you, Mr. Burtless. I am out of my time, but I want to give Scott 10, 15 seconds to respond to the question.

Mr. HODGE. Very quickly, the savings rate does not include things like 401(k)s, stocks, and so forth. America's savings patterns are changing. We are no longer putting money in passbook savings accounts. We are becoming a Nation of investors, and we need to take that into account.

On the tax side, however, I would encourage us to look at how we are taxing savings and what penalties that is creating on people, or even putting money into a passbook savings accounts, you are likely to get taxed on that. I think if we taxed savings less, we would get more of it.

Senator SALAZAR. So your proposal would be to look at taxing savings less.

Mr. HODGE. Yes. But look more broadly at what savings is. It is no longer just sticking money in a bank in a passbook savings account. Saving is coming in all kinds of different ways, whether it is mutual funds, 401(k)s, and other things. We need to remove the taxes on those to relieve people of that pressure not to save.

Senator SALAZAR. Thank you. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Thank you, Senator.

Ms. Blackburn, I would like you to please just give us a couple of examples, in your experience, of what people have gone through. You have, for over 25 years, been working with an awful lot of people. In all the work that you do, you have seen a lot of people in trying to help them out. Just give us a couple representative examples that give us a sense of what people are coping with and what they are doing.

Ms. BLACKBURN. Sure. Just a couple of weeks ago, I spoke with two people who, sadly, had the same diagnosis in their child, which is a very rare diagnosis, a child being born without a left ventricle. One family, three kids.

Then they have this baby who needs immediate surgery being, actually, Life Flighted to a center further away from home. They eventually had to declare bankruptcy because they had \$2 million worth of medical expenses incurred. Both hardworking folk and paying their taxes and everything, and they just eventually could not maintain their household.

Another one, where actually the baby has not been born but they know that they have to get things in place for when the baby is going to be born, because they are not going to be able to afford having such a child with this kind of a disability. Not only do they need to have continued surgeries throughout their childhood, they eventually will need heart transplants. So those are just a couple of examples.

We have kids across the country who are diagnosed with cancer. That is my primary practice at Pediatrics in Billings, is through oncology. Folks who have really, really good health insurance, yet are looking at huge bills for travel, and for lodging, and for meals, and for child care, and these are things that are not covered by insurance. So, these are catastrophic examples.

With chronic diseases such as childhood diabetes, there is the same thing. They are looking at, out-of-pocket, every single year, \$2,000 to \$5,000 a year for out-of-pocket expenses.

Technology has changed to the point where the insurance companies are not keeping up with this either. They are not paying for pumps. Pumps cost anywhere from \$2,000 to \$2,500. So they are talking about—insulin has gone up. The price of insulin has gone up.

The testing strips are \$1 apiece. Kids are needing to check their diabetes anywhere between 4 and 8 times a day, and at a dollar a shot it gets to be a lot of out-of-pocket expenses. So, that is something that we see. I work for the pediatrician in our area who sees more than 300 kids a year who have pediatric diabetes.

The CHAIRMAN. I appreciate that. We have our work cut out for us here as a country.

Ms. Warren, I was also struck by your chart on page 4 about debt. What is that? Twelve percent of income goes to—if you could explain that chart. The trend is quite alarming.

Ms. WARREN. Is that one not a stunner?

The CHAIRMAN. It is. And a deeper question is, what in the world is going to turn that trend around? And pretty soon that trend is going to reach some kind of a breaking point, it would seem to me.

Ms. WARREN. Yes. What we are really talking about here is the amount that families carry in short-term, high-interest debt, largely credit card debt, and that the typical family is carrying at any given time. This is the revolving debt.

This is not how much you put on your charge and pay off at the end of the month. This is the part that is revolving from month to month. It has gone from being a little over 1 percent of annual income to up around 12 percent.

What is happening is that families who carry credit card debt are carrying about 2 months' worth of income in their credit card debt, which in turn means they have picked up an additional expense, somewhere in the neighborhood of about \$1,400 in interest and fees that does not go to groceries, does not go to new shoes, does not go to paying down the mortgage, does not go to savings. What it goes to is just to pay off interest to keep that mountain of debt rolling on forward without paying down a single dollar of it.

Now, part of that is because many American families are just having trouble holding it together. As my daddy used to say, they have 26 days' worth of income and 30 days worth of month, so debt becomes the way you do that last little part.

For another group of families, it is because we have no effective social safety net in the United States today for many kinds of things that go wrong. They turn inward, and so they put down that credit card in order to be able to pay for these expenses for the strips for the child, for diabetes, and to be able to pick up the additional costs, the gasoline when you have to travel 200 miles to take a child somewhere.

So for some, the debt is part of building a personal safety net, if we want to call it that. They are going to have to pay it back at 19-percent interest. And for a third group, frankly, it is because they have gotten into credit products that have tricked and trapped them and ended up costing them additional money.

So people who could afford to borrow at 9.9 percent and put \$2,000 on their credit cards—credit card companies are amazing in the United States. They are the only ones that, after you buy their product—that is, borrow at 9.9 percent—you can meet all the terms of the contract and they can change the price 2 months later to 29.9 percent.

So some people get caught, and that can put you into late fees and over-limit fees. For some people, the reason we see these debt

loads is that they had a manageable amount of debt and their creditors just began—

The CHAIRMAN. But given your studies and the thought you have given the subject, it seems to me that this trend is going to continue.

Ms. WARREN. Yes.

The CHAIRMAN. What is it going to take to turn that trend around, to stop that trend? That is not very healthy.

Ms. WARREN. Senator, it is not very healthy. It is a ticking time bomb in the middle class, because it means that every other problem that we talk about here today—stagnant incomes, rising housing costs, the rising health care costs—every American family that is carrying debt is more vulnerable to everything else that goes wrong.

If we could change just one thing, if we could roll the clock back to 1970 and have these families have 11 percent of their income put away in savings and only have very tiny debt loads, they would be very much more able to withstand the shocks and bumps and things that go wrong. But as it is now, we have turned that exactly on its head.

This is the number that scares me most about American families, that they have pre-spent income they have not yet earned, and they have no prospects for increasing their earnings enough to be able to cover that debt load.

The CHAIRMAN. And I assume—perhaps I am incorrect—that since 1970 to the current date, that is a trend upwards rather than a big jump in 1 year that then stayed static across.

Ms. WARREN. Actually, Senator, I do not want to make it worse than it is. It is not just a trend upwards, it is a trend upward that is showing acceleration.

The CHAIRMAN. Accelerating.

Ms. WARREN. Yes.

The CHAIRMAN. All right.

Senator Bunning?

Senator BUNNING. Thank you.

The CHAIRMAN. You are welcome.

Senator BUNNING. Let me go back to the educational part. My older brother, myself, and my younger brother were the first college graduates in our family. That is a while back. But let us go back to the 1970s, because I have nine children, and I had the responsibility of trying to see that they got educated. None of them were under the GI bill. They were all eligible to go to college because they all made it through high school. I did not look to the Federal Government to pay for any of that. I looked to have enough income, or tried to have enough income, to help those nine children through college.

So I made a deal with my kids. I said, I will take care of your tuition, books, and your housing for 4 years. Anything you want to do after that, you are on your own. We had seven graduates from college. Two partly went, then got married while they were in college. But I was not looking for a handout from the Federal Government.

I want to tell you, the colleges my children went to were not expensive. Some were out of State. I will tell you about the last

five. We discovered that they had to go in-State because in-State tuition was a lot less expensive. I do not know what Montana in-State tuition is, but in Kentucky it is around \$6,000 per student per year for tuition. That is not counting books and extras.

So you can imagine, with three in college, three in high school, and three in grade school, there was a considerable amount of expense. We also found out that the Federal Government had a program that allowed them to go and borrow money to help out.

Now, if they wanted to do that, that was fine, but that was only fine after they got the first 4 years in. Now, not all of my children finished college in 4 years. That is not unusual nowadays. Some take 5, some take 6. But what I am trying to tell you is, the mind-set in those days was that you were responsible for educating your children to the best extent possible.

Now, I had a brother, an older brother whom I talked about, who made a deal with his kids and said, I will give you \$500 for each semester you go to college. Somehow you have to scrape and scramble and make ends meet if you are going to finish college. Now, all five of his children finished college. One played in the band. One did this. One did that. They borrowed money and they paid off their student loans. So when did this become the responsibility of the Federal Government, or for that matter the State government?

Now, in Georgia it is completely different because, if you want to go to college in Georgia and you are a Georgian, the State government will pay for it if you keep a B average in college. They will pay for your entire education, higher education. That is not the same in other States.

So I am trying to get to the mind-set where we are now having the Federal Government responsible for paying for education. You, Ms. Warren, said it is the primary concern of the mothers and fathers of students because they know the income differences if you do not go to college than if you are a drop-out in high school or you just finished high school.

So when did the mind-set or when did it come into being that the Federal Government was responsible for educating all of our children?

Ms. WARREN. Senator, I would start by saying that I do not think we are talking about handouts here. I went to public schools from first grade through twelfth grade and I never thought I got a hand-out. That was the education——

Senator BUNNING. No. That is in the constitution in Kentucky.

Ms. WARREN. And I will point out that at that time, when I graduated from high school, most Americans believed that was it. The State had just offered me all of the education I needed to be middle-class. That has changed dramatically in a generation, but we have not expanded. We have expanded the amount of education we think you need, but we have not expanded the amount of education that we collectively are willing to offer our children.

I will also point out that a program that I was talking about, like Service Pays, is not about children expecting to be born into families where they are going to have enough wealth that someone else could pay for their college, but what it is about, is about students who would like to be able to pay for college——

Senator BUNNING. Public service, and all those things. I agree with that.

Ms. WARREN. Public service. But without the government to stand behind that and to make that loan money available and to be willing to forgive that loan money when students get their college education and then go out and work collectively on behalf of all of us, whether they are in the military, whether they are in domestic programs, that is a way to say to America's children, yes, you need education, but unlike a generation ago where we will pay for all of it, you have to take care of it yourself, but here is the mechanism for doing that.

You can borrow the money from us, from the Federal Government, and then if you want to work you can be paid off, and at 26 you can be a college graduate, you could have 4 years of experience, and you could have no debt. Now you are ready to launch into the middle class. I think it is an investment in our young people that we—

Senator BUNNING. Does anybody else have a thought about that?

Mr. BURTLESS. The gains from attending college have gone way up. This is pretty well-known. I think some people even mentioned it this morning. The cost of college, if you are a poor student in the United States, if you come from a low-income family, is also very low.

I know, I was from a poor family and went to a very expensive college, and they gave me a free education to go to college. Many colleges still do that. At Harvard, I think you are considered poor if your family has less than \$60,000 in income, in which case Harvard gives you a free education.

Now, of course, you have to be good enough to get into that college or into some other institution around the country. You have to be good enough to qualify to be in the university that offers this kind of aid. So if you are poor, actually, the cost that you face is low if you disregard the cost of giving up earned income while you are in college.

The mystery is why, facing this cost schedule, so many youngsters from low-income families pass up the opportunity to go to college.

Senator BUNNING. But is that because the parents are not insisting and understand the fact—

Mr. BURTLESS. Undoubtedly that is true. If you are a child in a low-income family, your parents have less persuasive power to get you to do the things that will help you to become much better off when you are 35 years old. Better-off parents like myself, we have a lot of influence to get our children to study hard and persuade them to invest in hard work to get into college.

Given the fact that the pay-off to go to college has gone up so much, one of the mysteries for the United States is, why has the fraction of youngsters attending college and completing college by the time they are 30 years old risen so much less over the last 20 years than it has in other rich countries? Korea has more youngsters reaching age 30 with a college diploma than the United States does, and Korea is a relatively poor country.

The CHAIRMAN. Wait. I am sorry. What is the answer to your own question? What do you think?

Mr. BURTLESS. I think it is that parents of youngsters from lower-income families do not have the influence on their kids that more affluent parents do to get them to work hard and strive to go to college. That is, I think, the basic answer.

The other answer is that many people think the price of going to college is the posted price. When you read about the price of going to Harvard, for example, most people mention that it is \$40,000 or \$44,000 a year. (You might know; I do not know exactly what it is.) And so that seems like a Mt. Everest to many parents and youngsters in the United States.

What very few people seem to add is, "Oh, by the way, if you are from a household that has less than \$60,000 in income, Harvard waives those costs. It is free." The same is true if you go to Berkeley and other great institutions around the country. These very demanding places make available positions for people with limited means and poor backgrounds. I speak from experience as somebody who benefitted from that favoritism.

Senator BUNNING. Well, I understand the benefits. I hope that some of the parents of our young people are better able to influence their decision and make available those things that are available now to get to college and get through it. Thank you.

The CHAIRMAN. Thank you, Senator.

Mr. Hodge, do you agree or do you not, generally, with the other three panelists who are basically saying that the so-called middle-income in America feel squeezed, that they are having a tougher time perhaps than, say, 20, 30 years ago? The data certainly shows that. That is, the polls show that. Do you generally agree or not? That is my first question.

Mr. HODGE. Well, Senator, I think that we are—

The CHAIRMAN. I am not getting into solutions, prescriptions, but just the general proposition.

Mr. HODGE. No. I think we are a bit like the eight blind men trying to describe the elephant, and a lot of us are using the same data to draw different conclusions. I think that the middle class is doing a whole lot better than it did 30, 40 years ago.

If we want to go back to the 1970s before mom entered the workplace, before the Women's Lib movement I think wonderfully brought more and more women into the professional workplace, that will equalize incomes. If we want to go back to a time, my grandfather's era, in which everyone was high school educated and they were all equal, that would equalize incomes in the United States as well.

We are much better off today because the typical upper-income middle-class working family, the dual-income couple, they are college educated. They are typically older. We are seeing the top end of the baby boom generation right now hitting their peak earnings potential. No one is factoring that into any of these calculations on income disparities.

We are working better jobs. Yes, we are working longer. We have costs that are more challenging, day care, which my mom did not have because she stayed at home. We only had one car back then; we have two cars today. But all these things are improvements. We are living in much, much larger homes than we did before.

The CHAIRMAN. I do not want to put words in your mouth. So basically you think the middle class is doing pretty well?

Mr. HODGE. Well, the one thing the middle class was not paying 30 years ago is the AMT. They were not paying property taxes that were spiraling out of control.

The CHAIRMAN. I've got you. All right.

I would like anybody to respond to Mr. Hodge if anybody wants to on his basic assertion that things are pretty good.

Ms. WARREN. Well, I would just say, let us look at that dual-earning college educated couple. I have the data here. They are spending three-quarters of that new higher salary to cover the same basic expenses that that one-income family 30 years ago covered with half of their income.

Mr. HODGE. But as you argue in your book, that family is competing against other dual-income working families to buy their way into the better school districts, and that if we had something like universal school choice we would relieve some of that pressure by allowing people to live where they want to live, but still be able to send their kids to the better schools. Choice, the fact that we do not have choice today, is part of the problem.

The CHAIRMAN. All right. All right. Good.

Ms. Warren, go ahead, briefly.

Ms. WARREN. The only question I was raising, you said the middle class is better off because they are earning more money as dual-income couples. All I am pointing out is, the economic data do not bear that out. They show families who, after they account for their basic fixed expenses, have less cash left over than their one-income counterparts had a generation ago.

That means they have put more people into the workforce, they are working harder than ever before, they are struggling to try to get children into pediatricians' appointments at 7:30 in the morning so they can still get to work on time, and at the end of the month they actually have less money than a generation ago had.

The CHAIRMAN. I want to get past this argument, because I tend to agree with the three basically. I think it is tough. It is tough for an awful lot of hardworking families. It is very tough.

Mr. BURTLESS. May I make one point?

The CHAIRMAN. Yes. Sure.

Mr. BURTLESS. I think that the elephant in the room, of course, is the medical care system. That has come up over and over among things that people have said this morning. On the one hand, the medical care system can deal with things today that it could not deal with 30 years ago. We heard about the terrible position faced by people whose children have some terrible illness.

Well, when I grew up, if you were 12 years old and you got leukemia, you died. Now your parents get a very big bill if you have terrible insurance. Now, think of those two outcomes. Which is preferable? You have a living child, but you have huge medical bills. So that is the difficulty in thinking about this problem from the point of view of American living standards.

The parent whose 12-year-old is stricken by leukemia who has a healthy 21-year-old child 9 years later is better off, in spite of the fact that they may have gone through bankruptcy.

The CHAIRMAN. That is an interesting assertion. It is also true that we spend much more per capita on health care in America than do other countries.

Mr. BURTLESS. Absolutely.

The CHAIRMAN. And we are not more healthy.

Mr. BURTLESS. I agree. I think our medical insurance system is terrible. I completely agree. This is the challenge here. We have a misbegotten health insurance system. It is the single-biggest threat to financial security for the country's working-age population.

Everybody knows, even if you have a good health insurance plan right now, you are a job dismissal or a serious illness away from not being able to afford medical care. That is a terrible way to run a health insurance system. No other rich country does it. And this is a horrible threat looming over the heads of middle-income families.

We have heard stories about how some families deal with it. It is a terrible problem for these people. And to pretend otherwise, to say that, no, the middle class has no problems because average income statistics for the country as a whole have shown that there is a rise in real incomes, I think completely loses sight of this human side of making ends meet in this country.

Mr. HODGE. Well, Mr. Burtless, I acknowledge that these families are having trouble purchasing certain things, but they are things in which the government has been most involved in trying to micromanage these mini economies, being health care, housing, and education. You cannot deny the fact that health care costs are rising out of control because there is not a competitive marketplace. People are one paycheck away from—

Mr. BURTLESS. Excuse me. I can certainly deny it, and I do.

The CHAIRMAN. Yes. I am sorry, I do not want to get into an argument here between you two witnesses. This is getting a little out of hand here. I appreciate each of you giving your personal views, and that is why you are here. I deeply appreciate that.

But I tend to think that we have a problem here, a real problem in this country. I am trying to figure out what we do about it. The problem I am facing right now is, anything we do here, this year and next, or let us say this year in this committee, is really only on the margin. A lot of folks are almost dying from a thousand cuts. Anything we do here, maybe we can put a Band-Aid on a little bit here, a little bit there.

The solution is really some paradigm shift in this country. I do not know what that paradigm shift is, but it is going to have to be here at some time or this problem is not going to get better, it is going to get worse. I think a major part of it is our health care system. That is clearly part of it. There are a lot of other parts, too. Housing has been talked about here, education.

A lot of this is caused by globalization, too. The world is so complex, and globalization has caused a lot of angst in this country and a lot of dislocations in this country, and this country tends to deal not as well with the dislocations of globalization than, say, do other industrialized countries. Certainly in Europe that is the case.

This has been a very helpful hearing. Very helpful. There was a lot of very, very good testimony here from all of you. I encourage you, when you leave, if you would keep thinking of what the follow-

up might be. Ms. Warren, you had a very interesting idea on service, with education, paying it back with service, kind of a GI bill, if you will. But I encourage you to give us ideas. Keep giving us ideas, because this is a big problem and we are going to have to collectively deal with it very, very aggressively.

Thank you very much. I appreciate it. The hearing is adjourned.
[Whereupon, at 11:50 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of Sarah Blackburn

Thank you Senator Baucus and members of the Senate Finance Committee for the opportunity to testify both personally and professionally on an issue that is very important to me, to a great many people of Montana, and to the rest of the country. For lack of a better term I refer to this issue as the "Middle Class Crunch." As you know, wages in our country have remained stagnant while costs of living have increased exponentially.

When we start out, we consider building a life and shooting for the American dream as an adventure. We attend college, graduate, marry, find a job and begin our families. My husband and I married 24 years ago hoping to raise successful educated children much like ourselves. For brevity's sake I will not take you through the years of diaper changes, skinned knees and broken hearts.

After high school graduation, college was the next step for our oldest who attended Montana State University of Bozeman for two years. The value of higher education is priceless but the cost of higher education is next to impossible.

In-state tuition makes no difference to those of us who have worked hard for so many years to provide the same opportunity to our children that our parents did. Prices have risen to the point that we can no longer even consider paying for everything involved in the starting of a new life for our children. The prices of housing, books, etc. are sky high; extracurricular activities are out of the question. We have had to more than just dip into our savings and our retirement, to pay the price of providing our daughter the education she has earned. We have since had to move her to a college in Wyoming that allows substantial discounts to surrounding states. Sadly, our son will pay the price as well. Education has become a luxury of the wealthy.

As a social worker for the Billings Clinic in Montana, I and my colleagues across the country have far too often seen the toll that a catastrophic illness takes on our families. No matter that many of them have excellent insurance; the cost of medications with co-pays can be counted in the thousands. One story I know of through a colleague is that of a 16 year old girl with cancer being treated in Missouri. Her family has insurance through the University of Missouri-Columbia but is unable to afford the medication to quell her nausea because the 20% co-pay for 20 tablets is \$1200. Another example of the problem is a 6-year old girl in Montana who was unable to take a medication for her cancer as the medication was experimental and the insurance would not pay for it. The cost of the medication was staggering and would have had to be paid out of pocket. Her parents who are hard working and self-employed could not afford the cost. Their daughter has since died.

Hundreds of families across the United States are required to travel outside their areas for treatment as resources are not available. Children in Montana diagnosed with cancer and other life-threatening diseases must travel to Denver, Seattle, Phoenix, Salt Lake City, or other large areas with the appropriate medical services. Insurance does not cover the cost of wear and tear to vehicles, gas, lodging, and meals. The majority of our families do not qualify for government programs as they make too much money. Yet once faced with the added expenses of such a situation they find themselves getting further and further behind. They must rely heavily on charitable organizations just to keep their heads above water. At our clinic we have a fund which we have tapped into in order to help our patients make car payments, house payments and to simply put food on their families' tables.

Those children diagnosed with such chronic illnesses as diabetes are also affected. Even with insurance, the necessary supplies, meters and often unexpected hospitalizations can become tremendous financial burdens. Many of our parents with healthy children have to forego routine medical care for them as the parents are self-employed, cannot afford the cost of insurance, yet do not qualify for Medicaid or SCHIP. These children are going without medications that would aid them in focusing better at school or that would clear up a bacterial infection far sooner than letting it run its course.

In summary, we as middle class citizens are no longer finding that to get a good education, work hard and pay our taxes is as much the American dream as it used to be. With the rising costs of education and health care, and wages staying the same, it is becoming more and more difficult to maintain a life style commensurate with our education and work ethic.

Thank you.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
“Can the Middle Class Make Ends Meet?
Economic Issues for America’s Working Families”
May 10, 2007

Thank you, Mr. Chairman.

I welcome the opportunity to hear from this distinguished panel about recent economic developments affecting America’s working families.

In the near future, this Committee will have the opportunity to extend the tax cuts that several experts on this panel agree have added to our prosperity, or to allow those tax cuts to expire. Do we need to ask whether knocking out one of the foundation pillars of our growing economy—a blessing that has been shared across all income groups—will help our working families? Clearly, it will not.

We all want to help working families, but the various opinions we will hear today show that there is widespread disagreement on how to define the middle class. In the past, this Committee has divided taxpayers into five quintiles, based on adjusted gross income in a particular year. This approach always has had serious deficiencies, and the testimony we will hear today shows that these deficiencies have grown worse over time.

The quintile approach fails to take into account the taxpayer’s lifetime income, for example. Individuals often move into a higher quintile when they enter the job market, when they sell a home, or when they receive a windfall gain, and it does not make sense to punish these individuals with a higher tax rate. By the same token, it makes little sense to tax dual income married couples more heavily than unmarried individuals, even if their adjusted growth income places them in a higher quintile.

Few topics are more important than how to design our tax code to enhance economic growth and improve the well being of our constituents, and I welcome the opportunity to participate in this debate during the coming months.

I thank the Chairman for holding this important hearing and I look forward to the testimony and discussion today.

Thank you.

Income Progress across the American Income Distribution, 2000-2005

GARY BURTLESS
The Brookings Institution

Summary

Since the end of the last recession the American economy has grown at a moderate pace. Standard measures of income progress show decent levels of overall improvement. GDP per capita measured in constant prices increased 1.5% a year from the end of the most recent business cycle peak in 2000 through 2006. In the same six-year period real disposable income per person rose 1.4% a year, and real personal consumption per person increased even faster – 2.1% a year. Of course, income gains were considerably faster in other recent periods, including the late 1980s and late 1990s. Those periods did not include a recession, however. If we look at income gains at the same point in the last economic recovery, the gains of the past six years look reasonably good. Between 1989 and 1995, for example, real GDP per capita increased only 1.1% a year and real disposable personal income rose just 0.8% a year.

The recent gains in average income and consumption do not seem to be making much impression on average Americans. A CBS News poll in mid-April 2007 shows that large majorities of adults believe the U.S. middle class is falling behind. When asked whether life for the middle class over the past 10 years has gotten better, worse, or remained the same, 59% of respondents said the situation of the middle class has worsened. Only 30% thought life for the middle class has gotten better. (CBS News, “CBS Poll: The Middle Class Squeeze,” <http://www.cbsnews.com/stories/2007/04/15/opinion/polls/printable2684929.shtml>, downloaded May 8, 2007).

There are three main reasons economy-wide income gains in the current recovery do not translate into an impression of improved well-being for most members of the middle class. One reason is that in a dynamic economy many individuals experience income reverses even when the economy is growing. Millions of workers lose their jobs or see their real wages fall every year, though the economy may be expanding. The income reverses of some Americans should be more than counterbalanced by income gains experienced by prospering families, however. A second reason respondents may be gloomy about their income progress is that some income gains or improvements in consumption are not very obvious. For example, a large part of the gain in consumption and a portion of the recent rise in labor compensation has been fueled by rapid increases in medical consumption and employer-paid health insurance premiums. These consumption gains are reflected in aggregate consumption statistics, and the premium increases are reflected in statistics on real compensation. Since we do not see this consumption reflected in our money incomes and because workers seldom know how much their employers are paying for insurance premiums, most of the consumption and income gains arising from health care are invisible to most Americans. Indeed, many people are increasingly fearful about their ability to obtain good insurance if they lose their jobs or become seriously ill.

Finally, incomes are growing less equal. Over the past quarter century Americans at the top of the income distribution have seen much faster income growth than people in the middle class. If average income grows 1% a year and top earners enjoy gains of 2% a year, many people in the middle and bottom will see their incomes grow much more slowly than 1% a year. Top income earners experienced sharp income declines in the last recession, but in the last couple of years their incomes have rebounded strongly. This reinforces the impression that the gains from prosperity have flowed disproportionately to people at the top rather than in the middle of the distribution. On an after-tax basis, however, Americans across the distribution have derived notable benefits from recent tax cuts. For many middle class families the cuts have made the difference between suffering a loss and experiencing a gain in spendable income.

Income trends

The United States entered recession in early 2001. Not surprisingly, the recession slowed the robust income growth the nation enjoyed in the late 1990s. Chart 1 shows trends in real income and real consumption over the full business cycle in 1989-2000 and during the partial business cycle from 2000 to 2006. Real income and consumption are measured using the Bureau of Economic Analysis's National Income and Products Accounts (NIPA) data (last updated by BEA on April 27, 2007). The BEA's best known measure of income is personal disposable income, that is, personal income after tax payments are subtracted. Its best known measure of consumption is personal consumption expenditures. In order to estimate income and consumption in constant prices, BEA constructs a deflator based on chained prices. The inflation-adjusted estimates are then divided by the number of U.S. residents to determine real income and real personal consumption per capita. Chart 1 shows trends over the 1989-2006 period using per capita income and per capita consumption in the year 2000 as benchmarks.

Disposable income per person rose 8.9% (or 1.4% a year) in the six years after 2000, and personal consumption expenditures per person increased 13.1% (or 2.1% a year). Consumption rose faster than income because households reduced their saving rate or sold some of their assets in order to pay for part of their consumption. Although income and consumption growth after 2000 are slower than they were in the late 1990s, they are faster than they were in the first five or six years after 1989, a period that also included a recession.

The data in Chart 1 are featured prominently in the nation's newspapers and business magazines, and they provide timely information about income and consumption changes in the aggregate. They do not tell us how incomes or consumption are changing for individual households, however. The best known statistics on progress in living standards for individual households are based on the Census Bureau's annual income survey, conducted as part of its Current Population Survey (CPS). The Census Bureau uses income reports from the survey to estimate the poverty rate and the distribution of personal and household incomes. The income reports from household surveys show much less improvement in income than the BEA estimates. In fact, the Census estimates through 2005 show real household money income actually fell after 2000.

Chart 2 shows trends in the total amount of money income reported in the Census household survey divided by the number of persons represented in the survey. The Census Bureau converts incomes reported in different years into constant dollars by deflating each year's incomes using the CPI-U-RS deflator. This price deflator is constructed using consistent methods that reflect those currently used by the Bureau of Labor Statistics to measure consumer inflation. For purposes of comparison, Chart 2 also shows the trend in real personal disposable income per person as estimated by the BEA. The two income series show a similar rate of real income improvement between the business cycle peaks in 1989 and 2000. The two series show very different trends between 2000 and 2005. Whereas the BEA measure of income increased 10.2% between 2000 and 2005, the Census Bureau's measure fell 1.2%. Since average income reported in the Census survey declined, it is not surprising that the median reported income shrank as well. Bear in mind that the Census Bureau's household income survey is the main source of information about how middle class Americans are faring. Unlike the NIPA data compiled by the BEA, the Census data reflect the experiences of individual households.

Part of the difference between the BEA and Census Bureau estimates of average income growth can be explained by the differences in the income concepts the two agencies use. The Census Bureau's best known measure of household income, "money income," includes gross earnings, income from investments (except capital gains), pensions, Social Security payments, and other government cash benefits. Nearly all of these income components are also included in the BEA estimate of disposable personal income. However, in addition the BEA counts non-cash benefits, such as food stamps, housing subsidies and medical care received from the government, as well as employer contributions to health and pension plans, and it subtracts payroll and personal tax payments.

The last of these elements – personal taxes – has been particularly important since 2000. Congress and the Administration reduced federal taxes after 2000, increasing disposable income as a proportion of total personal income. Contributing to this trend, a sharp decline in capital gains income after 2000 reduced income tax collections relative to total personal income. In combination, these two developments reduced households' personal tax payments and social insurance contributions from 18.9% of personal income in 2000 to 15.1% of personal income in 2004.¹ The share of personal taxes and household social insurance contributions in total personal income has recovered somewhat, reaching 16.1% in 2005 and 16.9% in 2006, but it remains well below the level in 2000. This means, of course, that the Census Bureau's standard estimate of income improvement based on the concept of money income understates the after-tax income gains enjoyed by Americans.

In addition to the tax cuts, there have also been notable changes in other income components that affect the difference between disposable personal income and average money income. The BEA's estimate of personal income includes employers' contributions for health insurance and pension plans. These items are excluded from the Census Bureau's money income measure. Indeed, few American workers probably know how much their employers contribute to these welfare plans. Both kinds of contributions have risen much faster than money wages since 2000.

Estimates by both the Bureau of Labor Statistics, using employer surveys, and the BEA show that average real compensation and wages increased between 2000 and 2005. Compensation per hour and for a full-time equivalent worker increased slightly faster than 1.1% a year. Money wages, which is the most important component of compensation, increased only 0.4% a year. Chart 3 shows why the growth in wages was so much slower than the growth in total compensation. The calculations are based on BEA estimates reported in the NIPA. Measured in 2005 prices, the real compensation of an average full-time equivalent employee rose \$2,975, or 5.6%, between 2000 and 2005. Only 29% of the increase, or \$849, was received by workers in the form of higher money wages. One quarter was paid out by employers as higher contributions to pension and profit-sharing plans, and slightly more than one third was paid as higher contributions to employer-sponsored health insurance plans. The remaining 12% of employer compensation costs was paid out as higher social insurance contributions and other miscellaneous costs. From the point of view of income measurement, less than a third of the increase in employer compensation payments is reflected in the Census Bureau's measure of

¹ BEA, NIPA Table 2.1, lines 1, 8, 24, and 25, downloaded May 7, 2007.

money income. Nearly 60% of the increase in employee compensation is included in the BEA's estimate of disposable personal income but is not reflected in the Census Bureau estimate of money income.

We do not have information on how hourly compensation gains varied up and down the household income distribution, but we do have good estimates of the pattern of real wage changes across the wage distribution. Every month the Bureau of Labor Statistics asks one quarter of wage earners interviewed in the Current Population Survey to report their hourly pay.² The Economic Policy Institute tabulates and publishes a distributional analysis of workers' responses. Chart 4 shows estimates derived from the EPI analyses. Both panels in the chart show annual rates of real wage growth at selected points in the hourly earnings distribution. The top panel shows estimated wage changes between 2000 and 2005. For comparison purposes, the bottom panel shows similar estimates for the last full business cycle, 1989-2000. While annual wage growth has slowed since 2000, the slowdown has been greater at the bottom of the distribution than in the middle or at the top. The 10th percentile wage increased 1.1% a year between 1989 and 2000 but only 0.1% a year between 2000 and 2005. Workers earning the median wage saw their hourly earnings climb about as fast between 2000-2005 as in the 11 years before 2000. Both in the 1990s and in the years after 2000, wage gains were faster among the top 10% of wage earners than they were among workers earning lower pay. In the most recent period, however, total compensation – including employer contributions for pensions, health insurance, and social insurance – increased much faster than money wages. In both periods, workers near the middle of the wage distribution obtained hourly wage gains averaging about 0.5% a year.

The wage changes shown in Table 1 reflect rates of change in hourly earnings. Family living standards are determined by employment and paid hours of work as well as the hourly wage rate. The recession reduced employment rates, and employment and labor force participation have not yet returned to their 2000 peaks. Between 2000 and 2005 the percentage of adults who are employed dropped 1.7 percentage points (2.7%). Even if real money wages per hour or per full-time equivalent worker continued to rise, the fall in the employment-population ratio will tend to reduce the living standards of families that now lack a working breadwinner. A small part of the decline in employment is due to population aging, which increases the proportion of adults in age groups where employment is less common. Another part is due to higher involuntary unemployment. Finally, some adults, especially those less than age 30, have withdrawn from the active labor force. It is unclear whether their withdrawal from the labor force indicates dissatisfaction with current job opportunities or a decision to invest in more education or training. In any case, the drop in adult employment has reduced the labor earnings of many households.

In sum, Census statistics on money income offer a much more pessimistic picture of the trend in U.S. living standards than the NIPA statistics. One reason for the difference is definitional. The two income statistics cover different income components. The NIPA statistics offer a more comprehensive picture of the trend in total income and consumption, but they do

² The wage reports in this household survey will not necessarily correspond with BLS wage estimates obtained in employer surveys or BEA estimates based on wage data in the NIPA.

not allow us to measure the situation of individual households, including families near the middle of the income distribution. The shortcomings of the standard Census money income statistics are even more glaring, however. These statistics do not reflect changes in family tax burdens, and in recent years such changes have had an important effect on net household income (see below). In addition, money income statistics do not reflect the important and growing role of health insurance and medical care spending. Insurance has a major effect on household consumption, because most health care consumption is paid for with employer- or government-financed insurance. Employer premiums for this consumption are excluded from the Census Bureau's estimate of money income, and so are the government insurance payments that finance about 45% of all health consumption.

Most observers agree that tax burdens should be taken into account when measuring the distribution and trend of family well-being. There is less agreement on how we should view unrecorded income that pays for health care consumption. If higher spending on medical care produces improved health outcomes, the increase in spending should certainly be included when we measure the trend in living standards. Employers' health insurance premiums as well as public spending on health insurance must be added to other family income sources when counting up family resources, and this is not done in the standard Census Bureau measure of money income. If we made adjustments in the standard money income statistics to reflect health consumption that is not paid for out of consumers' incomes, the recent trend in U.S. living standards would look more positive.

Many people are skeptical, however, that higher medical spending has resulted in better health care or improved health outcomes. If this suspicion is correct, the NIPA measures of average income and consumption growth may overstate the improvement in average U.S. well-being. The rise in medical costs and health care spending poses another important question for measuring American living standards: How do we assess the situation of middle class families who lack health insurance or think they are at risk of losing the insurance they have? When health spending was low and insurance comparatively inexpensive, the difference between insured and uninsured families had smaller financial implications than is the case today. A middle income family without access to a group insurance plan must now decide whether to buy a very expensive non-group policy or face the risk of a serious illness without any insurance protection. Choosing to buy health insurance greatly reduces the income left over to pay for other necessities. Choosing to remain uninsured potentially exposes the family to bankruptcy if a family member becomes seriously sick or injured.

The tax cuts

Changes in tax law enacted between 2001 and 2003 reduced federal tax burdens. Many critics of the tax cuts believe that they were tilted in favor of high-income taxpayers, reducing the benefits conferred on middle class families. This may be true, but estimates by both the Census Bureau and the Congressional Budget Office show that lower tax burdens after 2000 helped boost the incomes of households in most parts of the income distribution.

One way to calculate how tax burdens changed across the income distribution is to use the Census Bureau's imputations of federal taxes on the public use versions of the household survey files. Chart 5 shows my estimates using information in the CPS files covering household

incomes in 2000 and 2005. I estimate federal taxes as a percent of personal money income. This income definition includes all the components included in the Census Bureau's "money income" definition – wages, self-employment earnings, investment income (except capital gains), and cash social insurance and government benefits. I adjust the estimate of household money income in order to obtain a more meaningful measure of living standards, one that reflects the impact of the number of family members who share the household's income.³ Every person in the population is then ranked from lowest to highest by his or her adjusted money income. The federal tax burden, which includes the federal income tax, the employee's portion of the FICA tax, and the Earned Income Credit, is calculated as a percentage of the person's adjusted money income. In the chart I show the federal tax burden for persons ranked from lowest to highest on the income scale. Since the income reports and tax imputations for people with very low and very high incomes are unreliable, these are not presented in the chart.

Chart 5 shows, as expected, that federal tax burdens are negative for Americans with limited incomes. For many breadwinners with low earnings, the refundable Earned Income Credit is bigger than the person's combined FICA and personal income tax liabilities. At higher income levels, tax burdens rise as a percentage of money income. According to the Census Bureau's imputations of federal taxes, a person in the exact middle of the money income distribution paid 12.7% of money income in federal taxes in 2000. This percentage fell to 11.1% in 2005. The fall in federal tax burdens – about 1.5% of the person's money income – helped offset some of the drop in money income experienced by middle income Americans. The Census Bureau's tax imputations show that between 2000 and 2005 the tax burden fell 1.1% of money income at the 25th percentile and 1.3% and 1.8%, respectively, at the 75th and 90th percentiles. The Bureau's calculations imply that the tax reductions typically raised net incomes more at higher income levels, but the reductions were proportionately larger when measured as a fraction of 2000 tax liabilities for people in the lower ranks of the distribution. Whether or not this pattern of tax cuts is fair, middle class Americans clearly enjoyed higher net incomes in 2005 than they would have if the federal tax code had been left unchanged.

The Congressional Budget Office has published tax burden calculations based on a more comprehensive measure of income than is possible using the Census Bureau survey files alone. The CBO analysis file combines records from the CPS files with statistically matched records from IRS tax files, permitting analysts to use much more accurate income estimates for high income tax payers and more reliable information about the actual tax liabilities faced by individual tax payers.⁴ The most recent CBO analysis ends in 2004. It shows that changes in tax

³ "Adjusted personal income" is simply the total amount of a household's income divided by the square root of the number of household members. Every person in a household is assumed to receive the identical amount of "adjusted personal income." This adjustment allows us to rank every person in the population using a meaningful measure of his or her economic well-being. The tax burden is estimated after performing the same household-size adjustment. That is, the Census Bureau's estimate of the household's federal tax liabilities is divided by the square root of the number of household members.

⁴ For a description of the methodology, see Congressional Budget Office, *Effective Federal Tax Rates, 1979–1997* (October 2001) and *Effective Federal Tax Rates, 1997 to 2000* (August 2003).

burdens between 2000 and 2004 had a noticeable effect on the trend in after-tax incomes. After-tax incomes rose faster or fell more slowly than pre-tax incomes.

Table 1 shows estimates of real income change between 2000-2004 using three different concepts of income. The top row shows the Census Bureau's estimates of average income change in different intervals of the household income distribution. These estimates are derived using the Bureau's standard measure of (pre-tax) money income. Households are not weighted according to household size, which means that a household containing a single person is treated as equivalent to a household containing six members. When households are ranked by their incomes and placed in five equal-size groups, the households with the lowest incomes are found to have experienced the largest percentage losses between 2000 and 2004. Their losses amounted to 8.1% of the average income they received in 2000. Households in the middle fifth of the income distribution experienced an income decline of 4.1%, and households in the top fifth saw real incomes fall by 3.0%. Interestingly, income losses in the top 5% of households were larger than those experienced by households in the middle.

The second row in Table 1 shows the CBO estimates of change in personal pre-tax income. Instead of estimating income changes among fifths of U.S. households, the CBO estimates changes in equal-size groups of people. Like the estimates displayed in Chart 5, the CBO estimates in Table 1 use a household-size adjustment to reflect differences in household spending needs. (Household incomes are divided by the square root of household size to derive an estimate of personal income.) The CBO income measure is also more comprehensive than the Census Bureau's money income measure. For example, it includes an estimate of the value of employer-provided fringe benefits, benefits that are excluded from money income. When estimating income changes on a before-tax basis, CBO finds smaller income losses than reported by the Census Bureau except at the very top of the income distribution. The pattern of income losses roughly mirrors the pattern found in the Census Bureau's money income tabulations. Income reductions are bigger at both the top and bottom of the income distribution than they are in the middle. However, the CBO estimates that Americans receiving incomes in the middle three fifths of the distribution experienced modest gains or only small reductions in income between 2000 and 2004. This highlights the importance of employer fringe benefits and insurance in assessing recent trends in family well-being.

The bottom row shows CBO estimates of income change on an after-tax basis. Income losses are smaller and income gains are larger when changes are calculated using net or post-tax incomes. These estimates imply that changes in tax burdens are an important reason that income losses are smaller or income gains are bigger as a result of the tax changes. The trend in middle class living standards unquestionably looks better in the bottom row of Table 1 than in the top row.

Net income changes

I do not have access to the excellent CBO data files containing statistically matched CPS and IRS tax records. These files offer analysts the most reliable source of information about the distribution of tax burdens and after-tax incomes using a comprehensive measure of income. However, the Census Bureau has recently released a statistical file containing estimates of household tax liabilities and non-cash income sources in 2005. Using these data along with

identical information for earlier years, it is possible to estimate real income changes under the Bureau's standard money income measure and under alternative income definitions. In addition, the data can be used to examine the distribution of living standards at the person level rather than at the household level.

Chart 6 shows my estimates of 2000-2005 income changes at successive points in the U.S. income distribution using two different income measures. Income changes at a particular point in the income distribution are measured as a percentage of the income recorded at the same point in 2000. The top panel shows the percentage change in (pre-tax) money income, while the bottom panel shows the percentage change in after-tax cash plus near-cash income.⁵ In the top panel, for example, I find that a person at the 6th percentile of the 2005 pre-tax distribution received an income that was 12% below that received by a 6th-percentile person in the 2000 distribution. A person receiving the median pre-tax income in 2005 received an income that was 3% less than the median pre-tax income in 2000. Only near the top of the pre-tax income distribution were income losses smaller than 1%. Clearly, the trend in pre-tax money incomes tended to favor Americans in the upper part of the pre-tax income distribution.

The lower panel in Chart 6 shows income changes when incomes are measured on an after-tax basis and when incomes are defined to include near-cash transfers (mainly food stamp benefits and public housing subsidies). The estimates in this panel indicate that net incomes declined in the bottom 60% of the U.S. income distribution and increased in the top 40%. Although the shapes of the distributions in the top and bottom panels are similar, a close comparison of the two panels shows that income progress has been faster – or income losses smaller – when income changes are measured using a more comprehensive income definition that subtracts tax payments from income.

For purposes of comparison, Chart 7 shows percentage changes in real after-tax incomes during two long business cycles, 1979-1989 and 1989-2000. As in Chart 6, every point along the line indicates the percentage change in real income between two calendar years. In Chart 7 the two years represent cyclical peaks in successive business cycles. The dark upward-sloping line shows income gains over the 1979-1989 cycle. After-tax cash plus near-cash incomes fell in the bottom 15% of the income distribution and rose by successively larger percentage amounts at higher points in the distribution. U.S. income inequality increased dramatically over the 1980s.

The U-shaped curve in Chart 7 shows income changes in the 1989-2000 business cycle. Incomes increased at every point in the distribution, but they increased faster at the top and bottom of the distribution than they did in the middle. The proportional income gap dividing low- and middle-income Americans shrank during the 1990s, but the gap separating middle-income and very high income people widened. A common pattern in both business cycles is that high-income Americans enjoyed faster income gains than people with a lower rank in the distribution. This same pattern is repeated in the 2000-2005 period.

⁵ Once again, incomes are measured on a person-level basis using household-size-adjusted incomes. The estimates are based in household income reports in the 2001 and 2006 CPS files, which reflect annual household incomes in 2000 and 2005, respectively.

The pattern of income changes displayed in Chart 6 is more similar to changes in the 1980s than it is to changes in the 1990s. As in the 1980s, real income gains are larger in percentage terms as we move up the income distribution. At the bottom of the income distribution, real incomes have shrunk rather than grown.

One mystery in Chart 6 is why average income gains have been so slow and why people in so many parts of the income distribution have seen a decline in real average incomes. Chart 1 shows that *average* income and consumption has increased at least moderately since 2000. Why have after-tax incomes in the middle and at the bottom of the distribution shrunk?

Wider income inequality tends to increase the proportion of people who experience below-average gains in income. If overall income rises 1% a year and Americans in the top one-fifth of the income distribution receive income gains of 1.5% a year, there would be very little income growth left to share among the Americans in the bottom four-fifths of the distribution. Under these assumptions, incomes in the bottom four-tenths of the income distribution could only rise 0.5% a year. (This calculation assumes the distribution of income follows the pattern of household money income reported by the Census Bureau for 2005.) Even though average income growth is 1% a year, four-fifths of the population will experience income growth that is only half as fast as the average rate of growth for the population at large. Income growth in the first half of this decade, and especially in the past three years, has displayed a pronounced pattern of unequal income gains. Unfortunately, this is the same pattern of income change we saw in the 1980s, a period when inequality widened and living standards at the bottom of the income distribution fell.

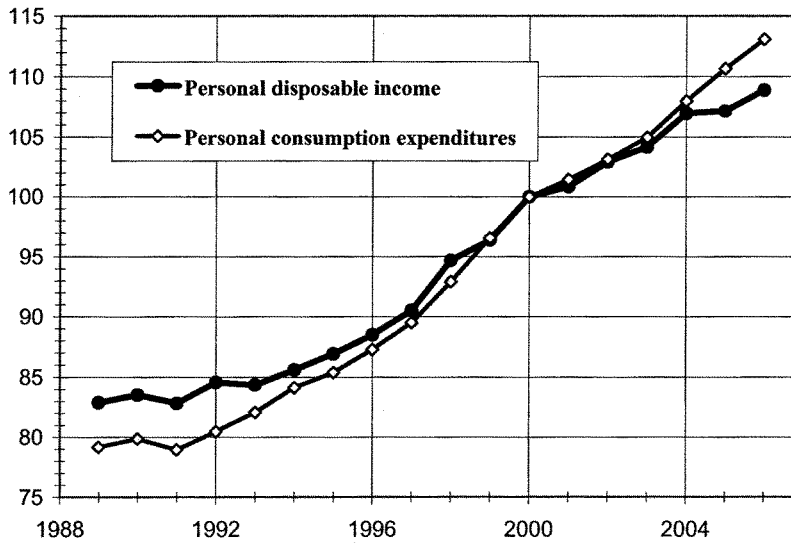
Table 1. Percent Change in Real Income at Different Positions in Income Distribution, 2000-2004

Percent	Interval in the income distribution					
	Bottom fifth	Second fifth	Middle fifth	Fourth fifth	Top 5%	
Census Bureau - Households						
1. Money income	-8.1	-5.8	-4.1	-2.8	-3.0	-4.7
CBO - Persons						
2. Comprehensive, before-tax	-4.3	-0.5	2.0	0.0	-3.8	-6.8
3. Comprehensive, after-tax	-2.0	2.8	5.4	4.0	0.0	-3.5

Source: Author's tabulations of U.S. Census Bureau data on household incomes (<http://www.census.gov/hhes/www/income/histinc/h03ar.html>) and CBO data on pre- and post-tax incomes (<http://www.cbo.gov/ftpdocs/77xx/doc7718/SupplementalTables.xls>, Table 1C.)

Chart 1. Trends in Real Disposable Income and Real Personal Consumption Expenditures Per Person, 1989-2006

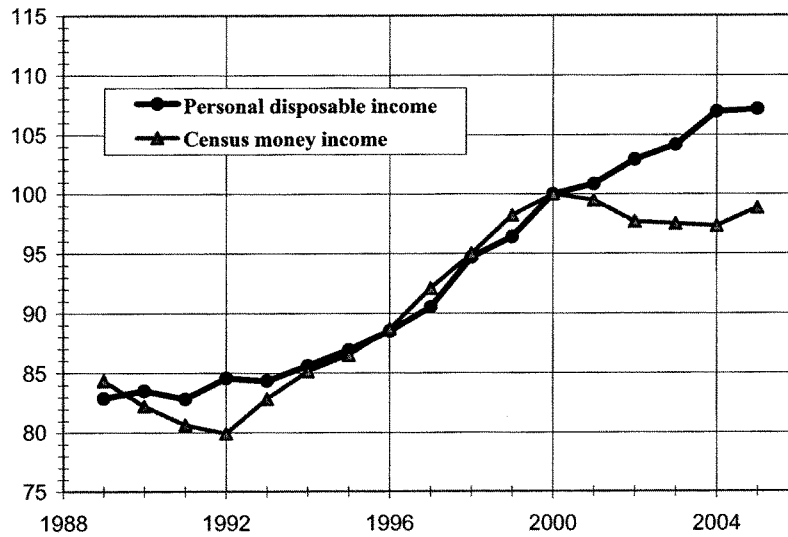
Level in 2000 = 100



Source: Author's tabulations of U.S. National Income and Product Account (NIPA) data from Bureau of Economic Analysis, downloaded May 5, 2007.

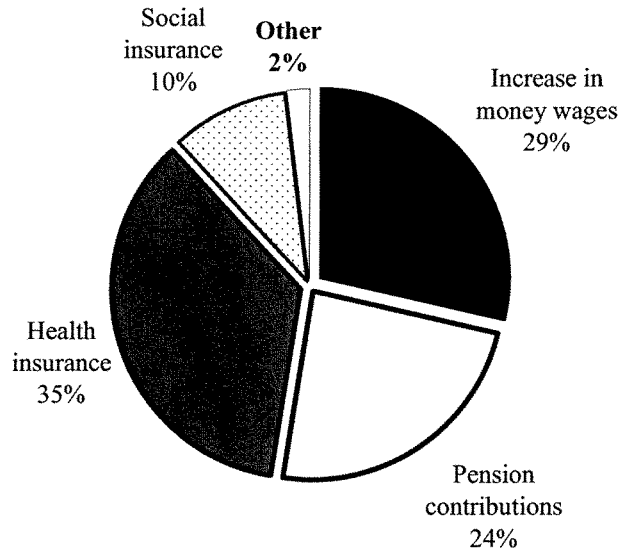
Chart 2. Trends in Real Disposable Income and Real Money Income Per Person, 1989-2005

Level in 2000 = 100



Source: Author's tabulations of U.S. National Income and Product Account (NIPA) data from Bureau of Economic Analysis, downloaded May 5, 2007, and U.S. Census Bureau household money income statistics.

Chart 3. The real average compensation paid to a full-time U.S. worker increased almost \$3,000 between 2000 and 2005. Where did the increase go?

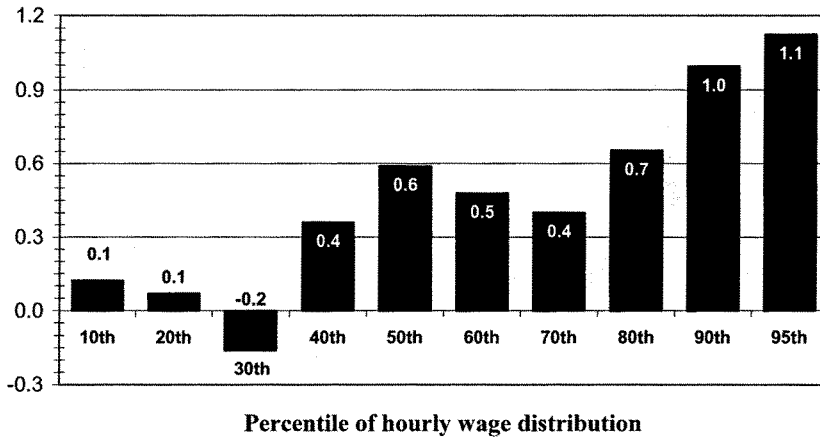


Note: Between 2000 and 2005 money wages increased \$849 (or 1.9% of real wages in 2000); employer pension contributions increased \$710 (34% of pension contributions in 2000); employer health insurance premiums increased \$1,061 (35% of premiums in 2000); and employer social insurance contributions increased \$293 (9% of contributions in 2000). Real compensation per worker, deflated using the CPI-U-RS, increased \$2,975 (5.6% of compensation in 2000).

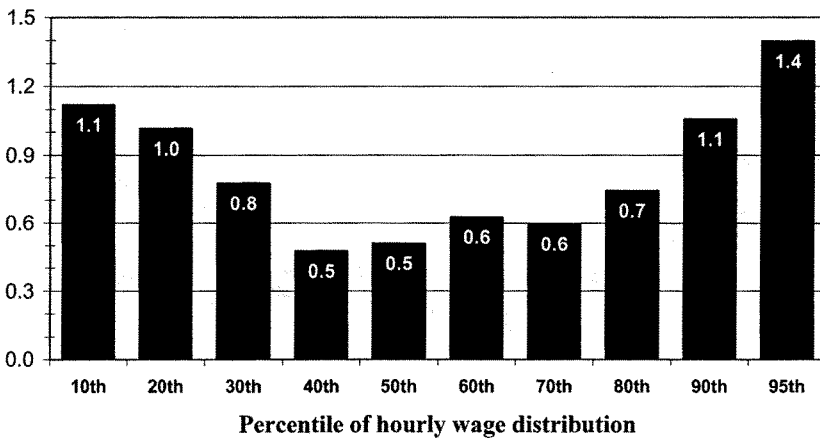
Source: Author's tabulations of Bureau of Economic Analysis, national income and product accounts data (NIPA Tables 2.1, 6.6, and 7.8, downloaded May 6, 2007).

Chart 4. Trends in Real Hourly Earnings at Selected Points in the Wage Distribution, 2000-2005 and 1989-2000

**Annual percent change in
real hourly wage, 2000-2005**



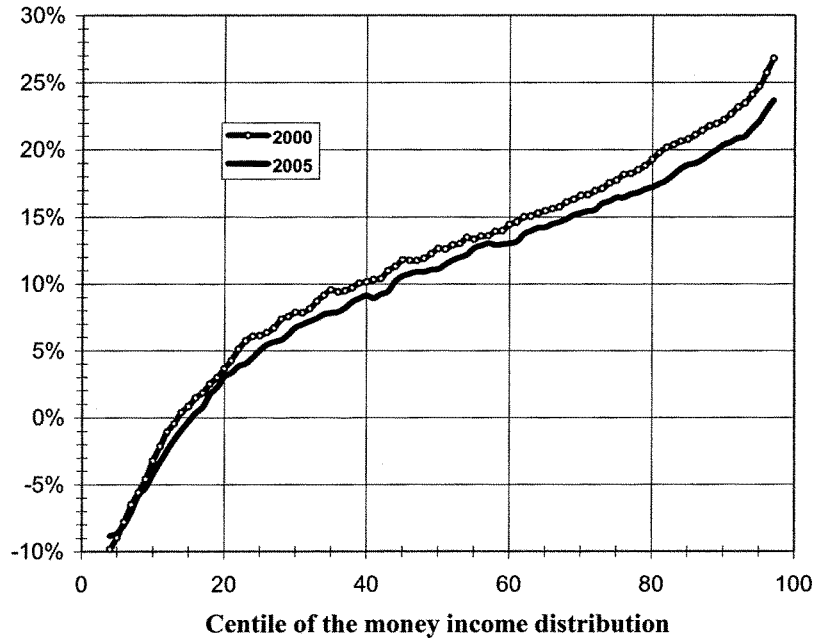
**Annual percent change in
real hourly wage, 1989-2000**



Source: Author's tabulations of Economic Policy Institute estimates of hourly earnings based on the monthly Current Population Survey files (http://www.epi.org/content.cfm/datazone_dznational).

Chart 5. Federal Tax Burden as a Percent of Adjusted Personal Money Income by Position in Income Distribution, 2000 and 2005

Percent of adjusted personal money income

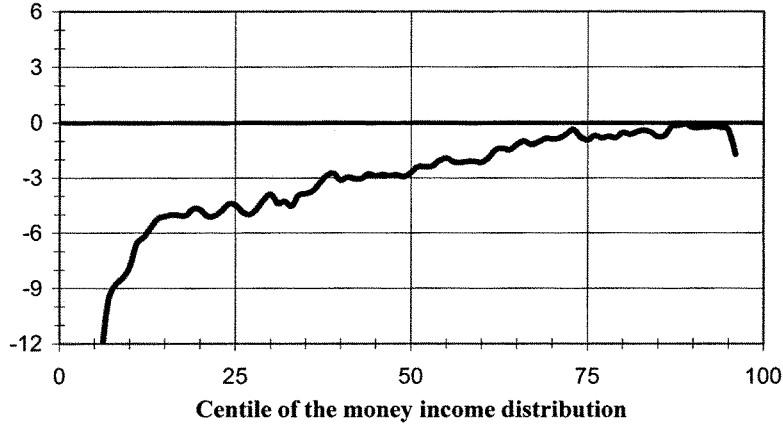


Note: Persons are ranked by their adjusted personal money income. "Adjusted personal income" is calculated using total household money income adjusted to reflect the number of persons in the household. The adjustment used is the square root of the number of household members.

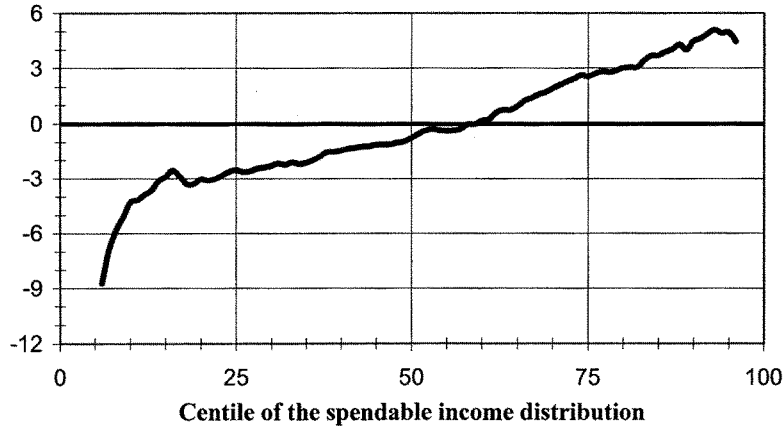
Source: Author's tabulations of U.S. Census Bureau Current Population Survey (CPS) files.

Chart 6. Change in Real Money Income and Real Spendable Income by Position in Income Distribution, 2000-2005

Percent change in real pre-tax money income, 2000-2005



Percent change in real net cash + near-cash income, 2000-2005

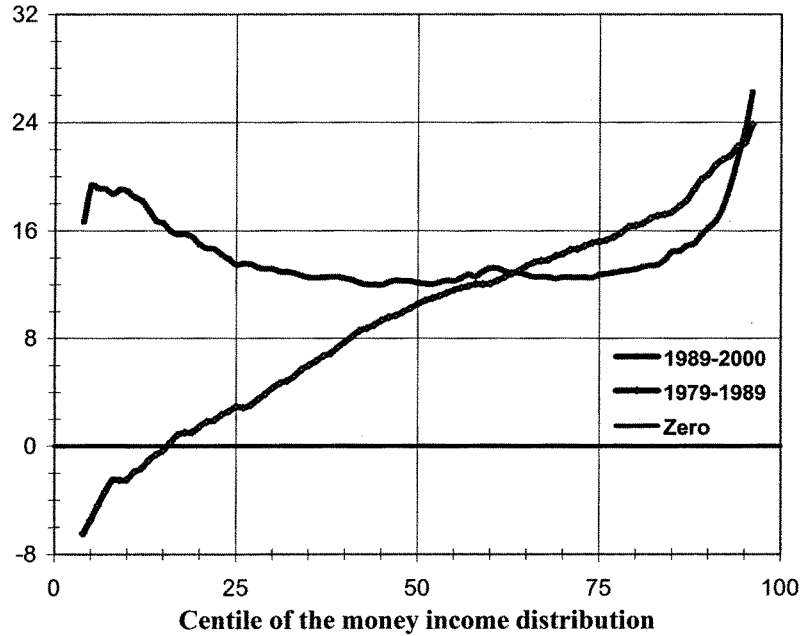


Note: Persons are ranked by their adjusted net or spendable income. "Adjusted spendable income" is calculated using net household cash plus near-cash income adjusted to reflect the number of persons in the household. The adjustment used is the square root of the number of household members (see text).

Source: Author's tabulations of U.S. Census Bureau Current Population Survey (CPS) files.

Chart 7. Change in Real Net Income in Two Business Cycles by Position in Income Distribution, 1979-2000

**Percent change in real net income,
1979-1989 and 1989-2000**



Note: Persons are ranked by their adjusted net or spendable income. "Adjusted spendable income" is calculated using net household cash plus near-cash income adjusted to reflect the number of persons in the household. The adjustment used is the square root of the number of household members (see text).

Source: Author's tabulations of U.S. Census Bureau Current Population Survey (CPS) files.

**Senate Finance Committee Hearing
“Can the Middle Class Make Ends Meet?”
Questions for the Record**

**Answers prepared by Gary Burtless
The Brookings Institution, Washington, DC
May 31, 2007**

Question: The data that we have for total incomes for the middle-class stop at 2004 or 2005 at the present time. Do we have other information on hand today that can suggest what the data for total income for 2006—relative to 2000—are likely to look like? (Chairman Baucus)

Answer: My testimony contained four kinds of data. The first is from the national income and product accounts (NIPA) as published by the Bureau of Economic Analysis, U.S. Department of Commerce. Data from this source are updated every calendar quarter. They now give us preliminary data through the end of March 2007. However, these data only provide us with evidence on aggregate or total income growth, not on income gains or losses experienced by middle-income families.

The second kind of data are from my own tabulations of the U.S. Census Bureau’s Current Population Survey (CPS) files. These data permit us to examine income gains and losses up and down the U.S. income distribution (though the CPS data are probably not very reliable in the case of households with incomes in the top 1% or 2% of the distribution). The most recent data published by the Census Bureau cover calendar year 2005. The data covering calendar 2006 were collected by the Census Bureau in February through April 2007, but these data have not yet been tabulated and will not be published by the Bureau until August or September 2007.

A third source of information about the trend in living standards of *working-age* families is the wage information collected from about one-quarter of respondents in the monthly CPS surveys. These data are tabulated and published by the Economic Policy Institute (see for example http://www.epi.org/datazone/06/wagecuts_all.xls). Unfortunately, the EPI tabulations only extend through 2005. I believe, however, that analysts could probably extend the EPI tabulations through the first quarter of 2007.

Finally, I mentioned estimates of a comprehensive measure of income compiled by the Congressional Budget Office (CBO). As noted in my testimony, these estimates have only been published up through 2004. One advantage of the CBO calculations is that they combine data from the Census Bureau’s CPS files with data from IRS income tax records. Even though the CBO has not yet performed calculations for 2005 or 2006, the IRS has published preliminary income tax distributional statistics covering calendar year 2005. These have been summarized and placed in historical context by University of California, Berkeley, economist Emmanuel Saez. His tabulations of IRS data, including

estimates of income at the top of the distribution, may be found at URL <http://elsa.berkeley.edu/~saez/TabFig2005prel.xls>. Professor Saez's tabulations cover the period through 2005.

Based on the most recent IRS income tabulations and the most recent Social Security Administration tabulations of W-2 wage records, which extend through 2005, my guess is that Americans with very high incomes continue to receive an exceptionally large share of the total income gains received by all Americans. Although we cannot yet be sure, it seems likely that middle-income families have recently obtained smaller average income gains than those implied by the NIPA data referred to in the first paragraph above. In contrast, households with very high incomes have probably obtained income gains that are proportionately larger than those implied by the NIPA income statistics.

Question: In your testimony, you note that CBO adjusts its income data for family size and that you do the same with your own data sets. How important is it to do so? Which income data sets are not so adjusted? (Chairman Baucus)

Answer: The importance of making adjustments to reflect differences in household or family size depends crucially on the time span of the analysis. If we are comparing incomes in two years that are not far apart, such as 2003 and 2004 or 2000 and 2003, we can usually make fairly reliable comparisons between the years without making any adjustment for family size. For example, suppose we want to know whether middle-income households or families experienced an income gain between 2003 and 2004. In that case, we can use the Census Bureau's estimates of average income in the middle one-fifth of households to make a reasonable calculation. While the size and composition of middle-income households undoubtedly changed between 2003 and 2004, the importance of those changes is likely to be small relative to the change in unadjusted incomes.

When making comparisons over a longer span of years, however, it can be risky to ignore the effects of changes in the average size of households or families. The average American family had 3.6 members in 1947, 3.4 members in 1973, and 3.1 members in 2001. Because family size shrank about 0.3 percent a year, income per family member would have increased 0.3 percent a year even if families' average income *had not changed at all* between 1947 and 2001.

In addition, a growing percentage of Americans lives alone or with someone who is not a relative. The incomes of these unrelated individuals are excluded from the Census Bureau's tabulations of family income. Of course, one-person households are included in the Bureau's tabulations of *household* income, but the increasing proportion of one-member households in the total population means that household size has also shrunk over time. In order to take these changes into account when measuring changes in real living standards, I believe that we must make some adjustment in a household's income so we can fairly compare the living standards of a household containing, say, two members and another household that contains, say, six members. The adjustment that I made in my testimony is the same as the adjustment made by the CBO. I believe this adjustment yields a tolerably accurate indicator of long term trends in living standards.

United States Senate
Committee on Finance



Sen. Chuck Grassley · Iowa
Ranking Member

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Statement of Senator Chuck Grassley
Hearing, “Can the Middle Class Make Ends Meet?”
Economic Issues for America’s Working Families”
Thursday, May 10, 2007

One of the many challenges presented by today’s hearing is the difficulty of defining the middle class. While visions of married couples with children often come to mind, such families have never comprised a majority of U.S. households. According to the Census Bureau, married couples with children account for 24 percent of all households. That’s down from 35 percent in 1974. Most households are comprised of single parents, childless couples or empty nesters, and unrelated individuals. Thus, analyzing the state of America’s middle class often involves an apples-to-oranges comparison of ever-changing households.

Aside from the problem of identifying the middle class, there is the problem of measuring their well-being. The typical approach of sorting them into groups based on income without regard to any other factors is highly misleading. Median household income varies by a factor of nearly two-to-one (\$62,000 in New Jersey vs. \$33,000 in Mississippi). But, if the citizens of New Jersey are so much better off than everyone else, why doesn’t everyone move there? The answer of course is that income alone doesn’t tell you everything there is to know.

Much of the variation in household income is related to regional differences in the cost-of-living. There are also differences based on quality-of-life factors such as crime rates, traffic congestion, access to arts and culture, health care and education, and even the weather. When choosing between income and amenities, many people believe a better lifestyle is worth more than a bigger paycheck. Despite the difficulties of defining the middle class and measuring their well-being, many people contend the typical American family is struggling to make ends meet. To the extent this might be true, the question is, what can Congress do about it?

Given the fact that the government is already heavily involved in the three areas most often identified as problematic – housing, health care, and education – additional efforts to expand the role of government in these areas should be viewed with caution.

Moreover, an examination of the historical record suggests the ability to tax and spend our way to greater prosperity and income equality is extremely limited. According to the Census Bureau, the direct net effect of current government tax and income transfer policies is to shift roughly eight percent of total income from the top 40 percent of households to the bottom 60 percent of households. This figure has remained virtually unchanged for the past 27 years.

By most measures, the vast majority of Americans have a higher standard-of-living today than ever before. History shows this success was not the result of government efforts to redistribute income. If our goal is to help future generations achieve the American dream, we must not let good intentions cloud our judgment and cause more harm than good.

Testimony of Scott A. Hodge¹
President
Tax Foundation

Submitted to the Senate Committee on Finance
“Can the Middle Class Make Ends Meet?
Economic Issues for America’s Working Families”
May 10, 2007

Mr. Chairman, I’m honored to have the opportunity to speak with the members of the Finance Committee about the economic challenges facing working families in America today.

The Tax Foundation is the nation’s oldest tax research organization. This year, we are celebrating our 70th anniversary. The Tax Foundation is non-profit, non-partisan and accepts no government funding. Our mission is to educate taxpayers about sound tax policy and the size of the tax burden borne by Americans at all levels of government.

Before we can consider what measures the Congress should take to help working families, we must first understand how different today’s families are from those of 40 or 50 years ago and how demographic changes have affected the notions of who is “middle-class” and who is upper-income in America.

Next, we also need to understand who is benefiting from government tax and spending policies and who is not. I think the results of this assessment will surprise the members of this committee and the general public.

Lastly, the pending expiration of the so-called Bush tax cuts has prompted many discussions about the relative progressivity and distribution of the nation’s tax burden. As we’ll see, allowing those tax cuts to expire will effectively raise taxes on the same people we’re talking about today, working families. If members of Congress believe our fiscal system should be more progressive, there are less economically damaging ways to achieve that goal. Indeed, progressivity and tax simplicity are not necessarily contradictory concepts.

Not Your Father’s Middle Class

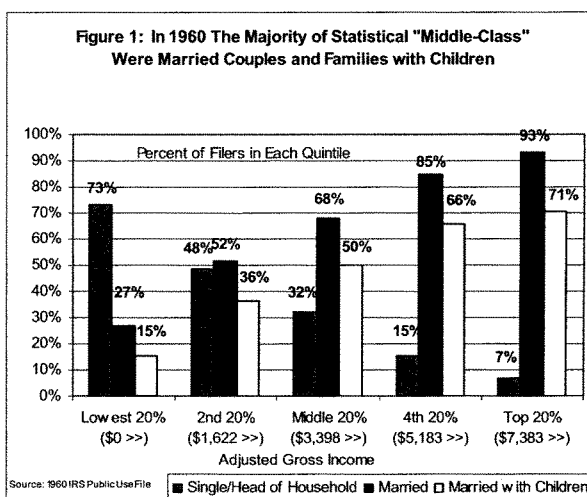
Most tax discussions begin with the premise that tax policies should either help or at least protect the “middle class.” However, we must be careful about mistaking middle-income taxpayers or the median taxpayer with the “middle class.”

¹ Scott A. Hodge, Tax Foundation, 2001 L Street, NW, Suite 1050, Washington, DC, 20036.

If by "middle class" we mean intact families with children (the stereotypical family of four), then these families no longer comprise the majority of the statistical middle 20 percent of taxpayers. The majority of families with children now populate the wealthiest 40 percent of Americans, in part because of the growth in dual-earner households. So if members of Congress focus too much on the "median family" or "median taxpayers" they will not be accurately portraying the economic status of today's working families.

Figure 1 below looks at the composition of taxpayers in 1960, back in the days of "Leave it to Beaver." The

population of taxpayers is divided evenly into five equal parts, or quintiles, each with 20 percent of taxpayers. Focusing specifically on the middle quintile, we can see that the stereotype was true: nearly 70 percent were married couples, most of whom were raising children. Indeed, in 1960, married couples comprised the majority of every group of taxpayers except for the lowest 20 percent. Of that low-income group, 73 percent were single filers.



Over the past four decades, demographic changes have dramatically altered the picture of the statistical middle and contributed to the perception of widening income disparity in America. One of the biggest of these changes has been the rise of dual-income families. In the mid-1960s, less than half of all working-age families – 38 percent – had both spouses in the workforce. Today, some 67 percent of families have both spouses in the workforce and only 21 percent have only one spouse working.

As Figure 2 shows, three things are immediately clear about today's society:

- (1) There are vastly more single taxpayers than ever before and they comprise the majority of the populations of the first three quintiles.
- (2) Because of the rise in dual-earner families, married couples are mostly found in the two highest quintiles.
- (3) A greater percentage of taxpayers in the top two quintiles are married couples without dependents; no doubt many are "empty-nest" Baby Boomers in their peak earning years.

Phoebe and Joey Have Replaced Ozzie and Harriet

Today, the composition of taxpayers in the statistical "middle class" is completely reversed from what it was in 1960. More than two-thirds of modern middle-income taxpayers are single, or single-headed households, while just 36 percent are married. In other words, the statistical middle now looks more like the cast of the TV program "Friends," not the "June and Ward Cleaver" notion that many of us grew up with.

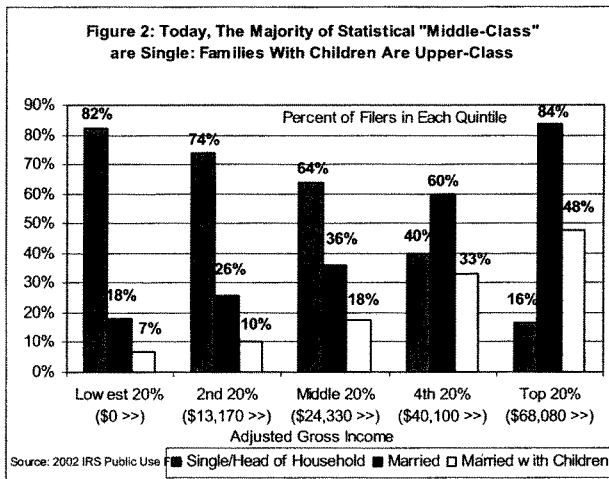
Moreover, while half of the middle-income taxpayers in 1960 were couples with children, today only 18 percent of these taxpayers are couples with children. The majority of couples with children are now clustered in the top two quintiles.

These demographic shifts have no doubt contributed to the perception of rising income inequality. When the so-called rich are increasingly couples with two incomes, they will naturally look wealthier than the vast number of single taxpayers who now populate the statistical middle.

However, when two single workers get married, they may immediately move from the statistical middle to the so-called "rich" simply by saying, "I do."

For example, a young school teacher earning \$40,000 per year clearly falls into the statistical middle. But if she marries a man earning the same amount as a computer technician, their combined income of \$80,000 is enough to qualify them to be in the top 20 percent of tax returns. Thus a family can have two "middle-class" jobs with two middle-income salaries, but still be considered statistically high-income according to sterile IRS data.

Taxes are stressing these dual-earner families from all sides. Many of these families live in high-cost urban and suburban areas and have incomes commensurate with the cost of living. Because of the progressive rate structure of the federal tax code, these couples end up facing the highest federal income tax rates even though they live distinctly "middle-class" lifestyles. For example, a couple earning \$150,000 may be considered rich in



Lincoln, Nebraska, but are considered middle-income in Westchester, New York. They both, however, are theoretically taxed at the same marginal tax rate.

These dual-income couples also tend to live in communities with high state and local taxes – especially property taxes. As a result, they are increasingly subjected to the Alternative Minimum Tax, which increases their federal tax bills.

As lawmakers look for solutions to the economic challenges facing today's "middle-class" but upper-income families, they would do well to consider the way in which taxes – federal and local – are contributing to their economic problems.

America's Growing Entrepreneurial Class

One other important characteristic of these high-income families is that they are fast becoming the nation's entrepreneurial class. Over the past 25 years, the number of individual taxpayers reporting business activity on their tax returns has grown at a rapid rate. When we look carefully at the distribution of these tax returns a clear picture emerges: as taxpayers' incomes rise, so too does the likelihood that they have some form of business income (schedule C, E or F) reported on their tax return.

Between 1980 and 2004, for example, the total number of sole proprietorships, partnerships, farms, and S-Corporations doubled, from 13.3 million in 1980 to 27.5 million in 2004. S-Corps alone grew 560 percent, from 545,389 in 1980, to roughly 3.5 million in 2004, and now far exceed the number of conventional C-Corporations.

Overall, 43 percent of taxpayers in the top quintile have business income – twice the percentage of business activity in the middle-income group. Of those taxpayers subject to the highest marginal tax rate of 35 percent, 77 percent have business income.²

The lesson here is that today's so-called "rich" are the nation's entrepreneurs and business owners. In part, the explosion in non-corporate business forms has been made possible by tax law changes that Congress has made since the 1980s expanding pass-through business entities such as S-Corporations and Limited Liability Corporations. As a result, more and more business income is now being taxed under the individual tax code rather than the traditional corporate tax code.

Forty years ago, the income from these entrepreneurial endeavors would have been taxed under the traditional corporate tax code. Some scholars have suggested that "the observed growth in the income of the richest individuals relative to the rest of the population may, at least in part, be a fiction, reflecting simply a shift in their form of compensation."³

² Tax Policy Center, Table T07-0131, April 27, 2007.

³ Roger H. Gordon and Joel Slemrod, "Are 'Real' Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?" National Bureau of Economic Research, *Working Paper 6576*, May 1998, <http://www.nber.org/papers/w6576>.

Working Families Bear the Nation's Tax Burden

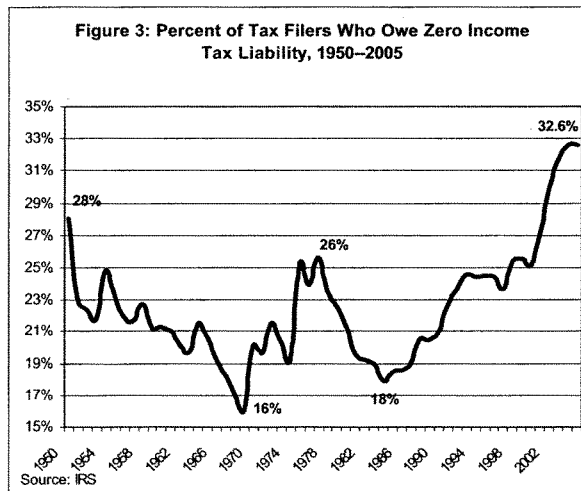
One of the most important things that Washington can do for today's working families is to demand less of them. Upper-income working families are now paying the lion's share of the nation's tax burden and getting little in return. Indeed, a new Tax Foundation study shows that these taxpayers are not only paying their share of the tax burden but they are pulling the wagon for millions of their fellow Americans.

Over the past quarter-century, federal tax policy – and income tax policy in particular – has shifted the burden of taxation to upper-income Americans even as overall tax rates have been cut substantially. While cutting top rates, lawmakers enacted numerous measures that have effectively knocked millions of taxpayers off the rolls entirely.

Today, some 44 million Americans, one-third of all tax filers, file a tax return but have no income tax liability after taking advantage of credits and deductions such as the Earned Income Tax Credit and the \$1,000 child credit. The number of non-payers has increased by 50 percent since 2000 when the number of filers with zero tax liability stood at 29 million. Added to these non-payers are 15 million people who have some income but not enough to file a tax return. This brings the total of households outside of the income tax system to 58 million.

Moreover, lawmakers are increasingly involving the IRS in the distribution of benefits to low-income taxpayers. Last year, the IRS sent out \$50 billion in refundable credits through the Earned Income Tax Credit program (\$35 billion) and the child credit (\$15 billion). These payments effectively offset other taxes that these low-income families pay, such as payroll and excise taxes.

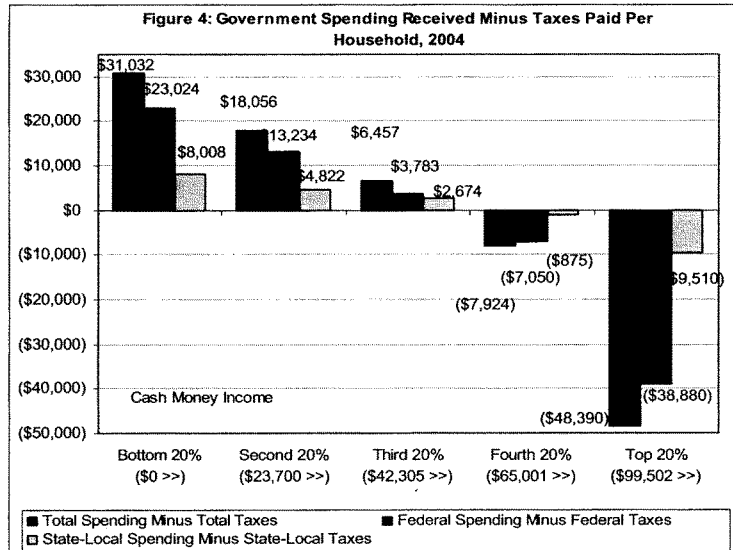
As the result of so many taxpayers being knocked off the bottom, the top 20 percent of taxpayers – which is largely composed of dual-income families – now pay 84 percent of the federal income tax burden. The top 10 percent (those earning over roughly \$99,000) pay about 68 percent of income taxes.



Indeed, the income tax code has become so progressive that the top 1 percent of taxpayers alone – largely the nation’s entrepreneurs – now pay 37 percent of income taxes even though they comprise 19 percent of the nation’s income. This is a greater share of the income tax burden than is borne by the bottom 90 percent, representing about 115 million taxpayers. This means that the top 1.5 million taxpayers pay a greater share of income taxes than everyone earning under \$100,000 per year combined.

Who Pays and Who Receives?

What is more surprising is the amount of income that is being redistributed from upper-income households to lower-income households. A new Tax Foundation study, "Who Pays America's Tax Burden, and Who Gets the Most Government Spending?" compares the amount of taxes paid by households to the amount of spending they receive from government.⁴



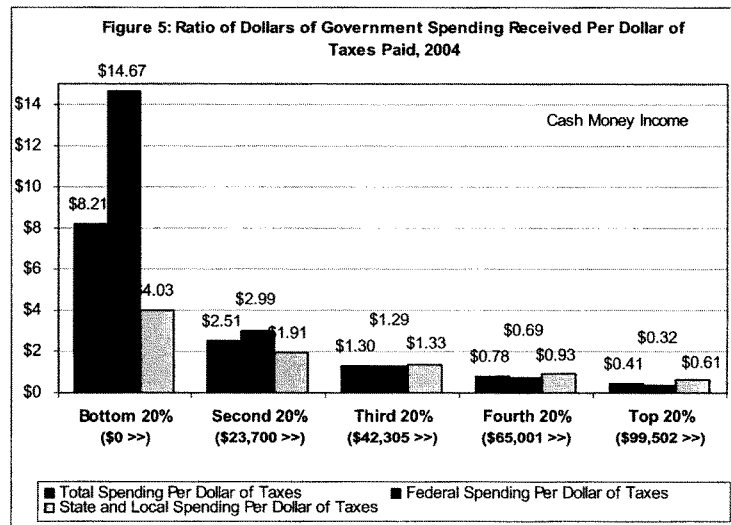
The Tax Foundation study shows that the spending side of the government ledger, especially federal spending, is also quite progressive or “pro-poor.” In 2004, governments at all levels spent roughly \$3.5 trillion on American households – or roughly \$31,108 for every household in the country. Of that amount, \$2.2 trillion was spent by the federal government and \$1.3 trillion was spent by state and local lawmakers.

⁴ Andrew Chamberlain and Gerald Prante, “Who Pays Taxes and Who Receives Government Spending? An Analysis of Federal, State and Local Tax and Spending Distributions, 1991 – 2004,” *Tax Foundation Working Paper, No. 1*, March 2007. <http://www.taxfoundation.org/files/wp1.pdf>

Just as taxes fall more heavily on some Americans, dollars of government spending don't flow to all Americans equally. Government transfer payments such as aid to needy families, veterans' benefits and Social Security payments benefit some Americans and not others. Similarly, government spending on public universities, airports and highways routinely benefit some Americans more than others.

Using official survey data from the federal government, Tax Foundation economists were able to determine which households in America are most likely to use all the different government programs on the books – from local roads to federal tuition subsidies – and allocate the costs to those who use them.

The spending received by each household was then compared to the total amount of taxes it paid – from local property taxes to federal income taxes. If a household receives more in government spending than it pays in taxes it is considered a net consumer of government, while households who pay more in taxes than they receive in spending are considered to be net payers.



The result of this comparison may surprise many on this committee. Figure 4 shows the net amount of spending households receive compared to the taxes they pay. Overall, households in the bottom 20 percent receive \$31,032 more in government spending than they pay in taxes. Households in the middle 20 percent, or middle-income households, receive \$6,457 more in spending than they pay in taxes, while households in the top 20 percent pay an average of \$48,390 more in taxes than they get in government spending.

Figure 5 displays the ratio of how much government spending households receive compared to the amount of taxes they pay. Looking specifically at the ratio of federal taxes and spending shows that the lowest 20 percent of Americans receive \$14.67 in spending for each \$1 they pay in taxes. Households in the middle-income range receive \$1.29 per tax dollar, and America's highest earning households receive \$0.32 per tax dollar.

Clearly, the bottom 60 percent of households on average get more government spending than they pay in taxes. And this is funded entirely by households in the top 40 percent. In all, government in 2004 redistributed \$1 trillion to \$1.5 trillion from the top 40 percent to the bottom 60 percent of households through taxes and spending. That's between 9 percent and 13 percent of the total GDP in that year.

The fact that the majority of Americans are now net consumers of government spending while a minority are net funders of government should be a cause for alarm, especially since that tax-funding minority is largely comprised of dual-income working families and entrepreneurs. Not only are we asking too much of them, but we are setting the stage for social conflict between those who consume government and those who pay for government.

Help Working Families by Doing Less

While it is tempting for lawmakers to try to do more for working families through new tax and spending initiatives, Washington can actually do more for them by doing less. Frankly, we are already asking too much of the IRS and the tax system and neither one is functioning very well.

Lawmakers are increasingly asking the tax code to direct all manner of social and economic objectives, such as encouraging people to: buy hybrid vehicles, save more for retirement, purchase health insurance; buy a home, adopt children, put them in daycare, take care of Grandma, hire the unemployed, spend more on research, purchase school supplies, take out huge college loans, invest in historic buildings, and the list goes on. The point is that we have so carved up the tax base that trying to accomplish more social goals via the tax code will be like pushing on a string.

Interestingly, the issues that are most troubling for working families – health care, housing, education, and property taxes – are the areas in which government is already the most involved.

For example, the tax preference for employer-provided health insurance creates a classic third-party payer problem in which patient-consumers are disconnected from the cost of service. The cost of health care is soaring because we have an unlimited demand for health care because someone else is paying the bills. The market forces that deliver quality goods at low prices for everything from toasters to automobiles have been disrupted in the health care system because it is tax preferred.

Higher education suffers a similar problem because of the plethora of tax and spending subsidies for college costs. Universities don't have an incentive to control costs because they know students aren't bearing the full cost. And efforts to help students with tax credits backfire because the credits ultimately get capitalized into the price of tuition in the same manner that the Mortgage Interest Deduction gets capitalized into the price of homes.

The deduction for state and local taxes allows local governments to raise taxes and pass as much as one-third of those costs to Uncle Sam. This is especially true for high-cost, high-tax suburban communities. Ironically, the state and local tax deduction is the primary reason more and more taxpayers in these high-tax urban areas – largely in so-called Blue States – are being ensnared in the Alternative Minimum Tax. The AMT is not an issue for taxpayers in lower-tax states and communities.

For those who are concerned with equity issues, these tax preferences tend to benefit upper-income taxpayers, not those in the middle or bottom. For example, IRS data indicates that 64.5 percent of the benefits of the state and local tax deduction are claimed by taxpayers earning more than \$100,000 per year, while 37 percent of the benefits of the Mortgage Interest Deduction are claimed by these taxpayers. The state and local tax deduction effectively subsidizes high-tax communities at the expense of low-tax communities while the Mortgage Interest Deduction subsidizes home owners at the expense of renters.

As an aside, the state and local deduction may also contribute to the inequality of local education spending. Since the majority of taxpayers who take the state and local tax deduction live in upper-income communities and the majority of local property taxes are for education spending, it is logical to conclude that these communities can spend disproportionately more on education than lower-income communities.

Taxpayers Support Simple System and Low Rates

Progressivity and tax simplification are not necessarily contradictory goals. Indeed, simplifying the tax system and broadening the tax base by eliminating preferences in the tax system that disproportionately benefit higher-income taxpayers will achieve both goals. Moreover, the benefits of eliminating the economic distortions caused by these tax preferences will not only accrue to the overall economy but also to the working families that lawmakers want to help.

Ideally, eliminating these preferences should be accompanied by an across-the-board reduction in tax rates. A bit of sugar always helps the medicine go down and polls show that taxpayers are largely supportive of this approach to tax reform.

The most recent Tax Foundation *Annual Survey of U.S. Attitudes on Taxes and Wealth*, conducted by Harris Interactive®, finds that the majority of U.S. adults believe the federal tax code is complex, the federal income tax taxes they pay are too high, and the

federal tax system needs major changes or a complete overhaul. Surprisingly, half of those surveyed would give up some tax deductions in exchange for lower tax rates.

As a thought experiment, Tax Foundation economists used our microsimulation model to calculate how low tax rates could be cut by broadening the tax base through the elimination of various tax preferences. These include the preference for state and local bonds, the Mortgage Interest Deduction, the state and local tax deduction, and the tax exclusion for employer-provided health care. While seemingly painful, eliminating these preferences allows for a 32 percent across-the-board cut in every marginal tax rate. This means the 10 percent rate would fall to 6.79 percent and the top rate would fall to 23.76 percent.

Avoid Policies that Are Harmful to Working Families

The so-called Bush tax cuts expire at the end of 2010 and many in Washington are of the opinion that most of the provisions – especially the top tax rates – should be allowed to expire and return to their higher 2000 levels. For example, the top individual rate of 35 percent would increase to 39.6 percent. Our research suggests that raising the top income tax rates would be a very poor way to increase progressivity.

First, raising the top tax rates will not likely stop the vast demographic changes that are affecting the distribution of income and taxes in America. We know that taxpayers affected by the highest tax rates are largely dual-income, college educated, older and in their peak earning years, and have business income. Are these not qualities we want to encourage, not discourage?

One could make the case that boosting the top rates would, at the margin, discourage high-income people from marrying, encourage Baby Boomers to retire early, and encourage entrepreneurs to reform their businesses as traditional C-Corps. All of these consequences would cause a reduction, not an increase, in overall tax revenues and would have severe economic consequences.

Similarly, there is growing sentiment that the lower rates on capital gains and dividend income should be raised to the level of the individual rates. Proponents of this view argue that (1) capital income should be taxed at the same rate as wage income and (2) the wealthy disproportionately benefit from the lower rates on capital income.

But the evidence suggests that boosting capital gains and dividend income would harm American competitiveness and well as the growing number of retirees who depend upon this income.

Those who maintain that capital income and wage income are not taxed at the same rate forget that capital income is taxed twice, once at the corporate level – at which the top corporate rate of 35 percent is the same as the top personal rate for the first time in the history of the tax code – and then again at 15 percent at the individual level. Capital taxes at the state level add yet another layer.

Data from the OECD shows that the U.S. has a combined rate of 50.8 percent on dividend income, ranking our rate as the eighth highest among developed countries and six percentage points higher than the OECD average. Boosting our rate not only flies in the face of global trends in capital taxation, but it will make U.S. companies less competitive in the global capital market by encouraging investors to put their money in lower-tax countries.⁵

While upper-income Americans currently earn the bulk of dividend and capital gains income, America's investor class – those claiming dividends or capital gains income – is becoming increasingly middle-class. Based on IRS data, Tax Foundation economists estimate that more than 80 percent of taxpayers who claim dividend income earn less than \$100,000 and 76.4 percent of those who claim capital gains earn less than \$100,000.

Among taxpayers with dividend income, roughly 23 percent are over age 65 while nearly 36 percent are over age 55. Among taxpayers with capital gains income, nearly 26 percent are over age 65 and more than 38 percent are over age 55.

Within these figures lies a more interesting story of how dependent older Americans are on capital gains and dividend income. The data shows that capital gains realizations clearly increase with age. Some 30.2 percent of taxpayers between age 65 and 74 claim capital gains income, while 27.6 percent of taxpayers over age 75 have capital gains income. The percentage of taxpayers over age 65 with capital gains income is higher than any other age group, and is more than twice the national average of 12.9 percent.

Older Americans are even more reliant on dividend income than capital gains. Among taxpayers between age 65 and 74, a remarkable 51.3 percent claim dividend income while 50.4 percent above age 75 have dividend income.⁶

Considering America's demographic changes, raising the capital gains and dividend taxes at this time would have a severe impact on the soon-to-be-retiring Baby Boom generation in addition to current retirees.

Lastly, some are suggesting that the revenue generated by increasing the rates on capital gains and dividend income could be used to offset the cost of fixing the Alternative Minimum Tax. It is interesting to note, however, that the majority of taxpayers affected by the AMT also claim capital gains or dividend income, meaning that such a measure would not make these taxpayers any better off in the long-run.⁷

⁵ <http://www.oecd.org/dataoecd/26/51/33717596.xls>

⁶ Scott A. Hodge, "Majority of Seniors Benefit from Reduced Capital Gains and Dividend Rates," *Tax Foundation Fiscal Fact, No. 42*, December 6, 2005.

<http://www.taxfoundation.org/research/show/1236.html> See also: Gerald Prante, "The Importance of Dividend Income for Low-Income Seniors," *Tax Foundation Fiscal Fact, No. 50*, February 8, 2005.

<http://www.taxfoundation.org/research/show/1354.html>

⁷ Gerald Prante, "Majority of Taxpayers Affected by AMT Also Claim Capital Gains or Dividend Income," *Tax Foundation Fiscal, Fact No. 51*, February 26, 2006.

<http://www.taxfoundation.org/research/show/1372.html>

Cut the Corporate Tax Rate

To the surprise of many, our research shows that cutting the corporate tax rate will help the poor. Most economists agree that the economic burden of corporate taxes is eventually borne by either workers (through lower wages), shareholders (through lower dividends), or consumers (through higher prices). Therefore, lowering corporate income taxes should benefit each of these groups.

When Tax Foundation economists estimated the distribution of the federal corporate income tax, they used two different approaches to see what the outcomes would be. First, based on the findings of a Congressional Budget Office study, they assumed that 70 percent of corporate income taxes are ultimately borne by workers. Next, they conducted the same calculation but assumed that shareholders bear the ultimate cost of corporate income taxes.

Interestingly, in both cases they found that the bottom 20 percent of Americans pay more in corporate income taxes than they do in personal income taxes. In the first case, they found that low-income workers pay \$171 in personal income taxes and \$271 in corporate income taxes. Even more remarkably, when we assumed that shareholders bear the burden of the corporate tax, the results hardly changed. This demonstrates the extent of stock ownership among low-income seniors.

Since 44 million tax filers pay no income taxes at all and millions pay next to nothing, this profound finding suggests that cutting the corporate income tax will do more to help low-income Americans than any additional cuts in the individual income tax.

Such a move would also make the U.S. vastly more competitive in the global economy. Currently, the U.S. has the second-highest overall corporate tax rate among OECD countries, at 39.3 percent. Only Japan, with an overall rate of 39.4 percent, has a higher rate among industrialized countries. Indeed, the average corporate tax rate among European Union countries is roughly 25 percent, putting our rate way out of step with our major economic competitors.

Thus, cutting the corporate tax rate would be a twofer – it would help the poor and American competitiveness.

Conclusion

Public opinion polls universally indicate that the vast majority of Americans view themselves as “middle-class.” Indeed, a recent Tax Foundation public opinion survey found that only 2 percent of adults identified themselves as “upper-class.” These surveys make it clear that most Americans see the concept of “middle-class” as a value system, not a point on the income scale.

The key to helping the so-called middle-class while solving the inequality problem is to implement policies that make all Americans richer, not try to bring the top back down to the middle. Our attempts to promote equality should not produce mediocrity.

Today's middle-class families are not our fathers' middle class. Today's working couples with children are increasingly dual-income, educated, older, and business owners – all traits we should value and not punish through punitive tax rates and redistribution.

Our government's attempt to use tax policy to promote certain sectors of the economy over others has not only produced a Byzantine tax system, but it has also created economic distortions in the very areas we have tried to help, such as housing, health care, and education.

The way to help middle-class families is to do less. Greatly simplifying the tax code while cutting tax rates across the board would boost economic growth and, most likely, also boost the progressivity of the nation's fiscal system. This is an outcome that should have bi-partisan support.

Thank you very much Mr. Chairman. I look forward to answering any questions you may have.

Appendix

Average Dollar Tax Burdens by Type of Tax Per Household, Calendar Year 2004

	Quintiles of Household Cash Money Income, Calendar Year 2004				
	Bottom 20 Percent	Second 20 Percent	Third 20 Percent	Fourth 20 Percent	Top 20 Percent
Total Tax Burden	\$4,325	\$11,932	\$21,194	\$35,288	\$81,933
Federal Taxes					
Income	\$171	\$1,431	\$3,720	\$7,973	\$29,257
Payroll	\$917	\$3,656	\$6,788	\$10,737	\$18,470
Corporate Income	\$271	\$999	\$1,734	\$2,894	\$6,597
Gasoline	\$69	\$138	\$202	\$286	\$493
Alcoholic Beverages	\$34	\$52	\$75	\$102	\$141
Tobacco	\$51	\$67	\$73	\$68	\$59
Diesel Fuel	\$10	\$38	\$65	\$109	\$248
Air Transport	\$22	\$51	\$81	\$147	\$312
Other Excise	\$43	\$66	\$89	\$124	\$177
Customs, Duties, etc.	\$96	\$147	\$200	\$279	\$396
Estate & Gift	\$0	\$0	\$0	\$0	\$1,362
Total Federal	\$1,684	\$6,644	\$13,028	\$22,719	\$57,512
State and Local Taxes					
Income	\$75	\$583	\$1,341	\$2,598	\$7,197
Corporate Income	\$48	\$176	\$306	\$510	\$1,163
Personal Property	\$16	\$36	\$49	\$69	\$108
Motor Vehicle License	\$66	\$106	\$134	\$156	\$175
Other Personal Taxes	\$8	\$19	\$32	\$48	\$99
General Sales	\$853	\$1,498	\$2,188	\$3,211	\$4,606
Gasoline	\$97	\$192	\$283	\$399	\$689
Alcoholic Beverages	\$19	\$28	\$41	\$56	\$77
Tobacco	\$87	\$116	\$126	\$118	\$102
Public Utilities	\$123	\$167	\$199	\$234	\$280
Insurance Receipts	\$66	\$105	\$131	\$166	\$223
Other Selective Sales	\$121	\$185	\$252	\$350	\$498
Motor Vehicle (Business)	\$8	\$31	\$54	\$90	\$205
Severance	\$22	\$40	\$57	\$79	\$139
Property	\$961	\$1,773	\$2,580	\$3,839	\$7,104
Special Assessments	\$19	\$35	\$51	\$76	\$140
Other Production Taxes	\$53	\$197	\$342	\$571	\$1,300
Estate & Gift	\$0	\$0	\$0	\$0	\$316
Total State and Local	\$2,642	\$5,288	\$8,166	\$12,570	\$24,421

Source: Tax Foundation

**Detail of All Federal Government Spending Received Per Household,
Calendar Year 2004**

	Quintiles of Household Cash Money Income, Calendar Year 2004				
	Bottom 20 Percent	Second 20 Percent	Third 20 Percent	Fourth 20 Percent	Top 20 Percent
Federal Spending					
General Public Service					
Executive and Legislative	\$506	\$506	\$506	\$506	\$506
Tax collection and financial management	\$109	\$109	\$109	\$109	\$109
Interest payments	\$159	\$327	\$572	\$1,067	\$3,662
Other	\$0	\$0	\$0	\$0	\$0
National defense	\$4,295	\$4,295	\$4,295	\$4,295	\$4,295
Public order and safety					
Police	\$219	\$219	\$219	\$219	\$219
Fire	\$3	\$3	\$3	\$3	\$3
Law courts	\$61	\$61	\$61	\$61	\$61
Prisons	\$41	\$41	\$41	\$41	\$41
Economic affairs					
Transportation					
Highways	\$2	\$5	\$7	\$9	\$16
Air	\$29	\$69	\$109	\$196	\$417
Water	\$85	\$85	\$85	\$85	\$85
Transit and railroad	\$5	\$10	\$14	\$24	\$47
Space	\$135	\$135	\$135	\$135	\$135
Other economic affairs					
General economic and labor affairs	\$17	\$69	\$131	\$209	\$437
Agriculture	\$7	\$80	\$148	\$249	\$741
Energy	\$44	\$80	\$114	\$159	\$278
Natural resources	\$152	\$152	\$152	\$152	\$152
Postal service	\$0	\$0	\$0	\$0	\$0
Housing and community services					
Disaster relief	\$175	\$175	\$175	\$175	\$175
Other	\$613	\$137	\$40	\$12	\$4
Health					
Medicaid	\$3,151	\$1,494	\$962	\$584	\$378
Medicare	\$4,262	\$3,321	\$2,205	\$1,557	\$1,387
Veteran's health benefits and services	\$116	\$235	\$270	\$385	\$293
Other miscellaneous health	\$585	\$585	\$585	\$585	\$585
Recreation and culture	\$41	\$41	\$41	\$41	\$41
Education					
Elementary and secondary	\$225	\$277	\$321	\$343	\$335
Higher	\$117	\$127	\$174	\$213	\$313
Other	\$124	\$124	\$124	\$124	\$124
Income security					
Disability	\$484	\$882	\$1,271	\$1,277	\$1,426
Retirement	\$4,780	\$4,676	\$3,346	\$2,435	\$2,226
Welfare and social services	\$2,929	\$1,064	\$384	\$171	\$54
Other	\$1,390	\$505	\$182	\$81	\$26
Total Federal Spending	\$24,860	\$19,889	\$16,781	\$15,502	\$18,573

Source: Tax Foundation

Overall Effective Statutory Tax Rate on Dividend Income (CIT + PIT)			
Country	2005	2000	Percentage Point Change 2000 to 2005
Japan	63.7	64.5	-0.8
Denmark	59.0	59.2	-0.2
Canada	56.1	62.5	-6.4
France	55.9	63.2	-7.2
Switzerland	54.7	56.5	-1.8
Germany	52.4	60.9	-8.5
Netherlands	52.1	74.0	-22.0
United States	50.8	58.9	-8.1
Spain	50.0	52.7	-2.7
Sweden	49.6	49.6	0.0
Ireland	49.3	57.4	-8.2
Korea	48.7	44.6	4.1
Australia	48.5	48.5	0.0
United Kingdom	47.5	47.5	0.0
Hungary	45.4	55.7	-10.3
Italy	44.8	45.9	-1.1
Turkey	44.0	65.0	-21.0
Luxembourg	44.0	52.2	-8.3
Belgium	43.9	49.1	-5.3
Austria	43.8	50.5	-6.8
Portugal	42.0	51.4	-9.4
New Zealand	39.0	39.0	0.0
Finland	37.8	29.0	8.8
Czech Republic	37.1	41.4	-4.3
Poland	34.4	44.0	-9.6
Greece	32.0	40.0	-8.0
Mexico	30.0	35.0	-5.0
Norway	28.0	28.0	0.0
Iceland	26.2	37.0	-10.8
Slovak Republic	19.0	39.7	-20.7
Average	44.3	50.1	-5.8
Source: http://www.oecd.org/dataoecd/26/51/33717596.xls			



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**The New Economics of the Middle Class:
Why Making Ends Meet Has Gotten Harder**

by

**Elizabeth Warren
Leo Gottlieb Professor of Law
Harvard Law School**

**Testimony Before
Senate Finance Committee
May 10, 2007**

America's strength comes from her middle class. These are the people who drive the economy, who teach the children, who police the streets and fight the wars, who vote in large numbers and who pay billions in taxes.

The definition of the middle is always elusive, but my focus today is on the middle, those with household incomes from about \$20,000 to \$100,000.¹ In fact, most of my testimony will be about the millions of households who live on incomes close to the exact middle in the US, or about \$46,300.²

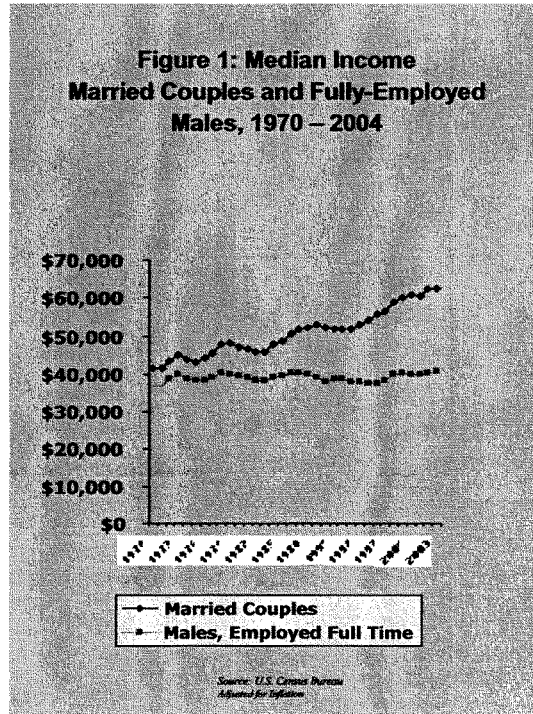
In the last generation, middle class families have undergone a powerful economic transformation that has attracted little attention, but that is quietly reshaping the face of

America. America's middle class is struggling, caught in a vise of stagnant incomes and rising costs and set upon by a largely-unregulated consumer credit industry that has reaped billions of dollars in profits from families' troubles. The economic rules have changed, leaving millions of hard-working, play-by-the-rules families caught in a battle for economic survival.

Higher Incomes, But at a Price

Over the past generation, new economic forces have reshaped the middle class. The most profound changes have taken place in family income.

As Figure 1 shows, today's median-earning family is making a lot more money than their parents did a generation ago. (Throughout this discussion, all dollar figures will be adjusted for the effects of inflation.)³



But there are two lines on Figure 1. The second line shows what has happened to the wages of a fully-employed male over the same time period. As the data show, the typical man working full-time today, after adjusting for inflation, earns about \$800 less

than his father earned back in the early 1970s. After decades of rising incomes earlier in the 20th Century, about thirty years ago wages for middle class men flat-lined.

When wages quit increasing, how did family incomes rise? The answer is all around us. Mothers of minor children went back to work in record numbers, and many increased the hours they worked. In the early 1970s, the median family lived on one paycheck. Today the family in the middle brings home two paychecks.

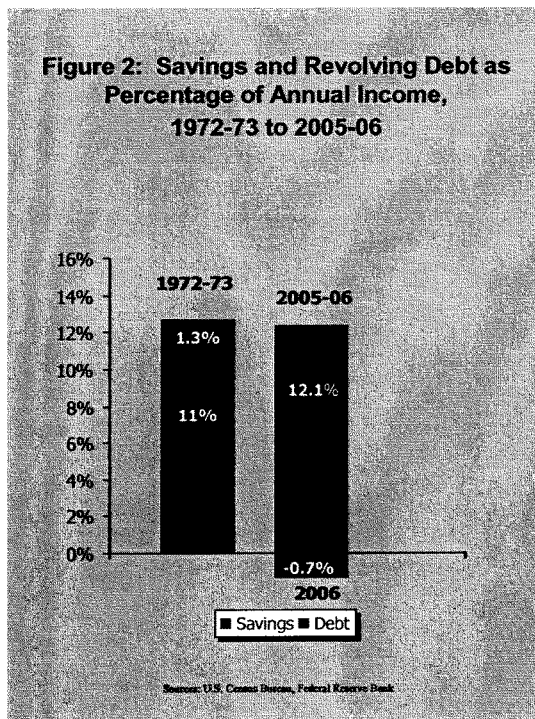
The shift from one income to two has had seismic implications for families across America. It means that all the growth in family income came from adding a second earner. Among two-paycheck families, median income is now \$76,500, but the middle one-paycheck family now earns only \$42,300.⁴ This means that one-income households—whether they are couples in which one works and one stays at home or they are households with only one parent—have fallen sharply behind. A generation ago, a one-earner family was squarely in the middle, but now that average one-earner family has slipped down the economic ladder. Over the past generation, this is only the first of many critical economic divisions that have begun to emerge within the middle class.

Savings and Debt

While not every family brought home two paychecks, by the early 2000s a substantial majority of families sent both parents into the workforce. For those two-income families, an outsider might predict that the economic picture would be rosy. Not so.

In the early 1970s, the typical one-income family was putting away about 11% of its take-home pay in savings.⁵ In addition to its mortgage and car loan, that typical family also carried credit cards and other revolving debt that, on average, equaled about 1.3% of its annual income.⁶

By 2005, that picture had shifted dramatically. The national savings rate dropped below zero.⁷ Revolving debt—largely credit cards—ballooned, topping 12% of the average family's income.⁸



In a single generation the family had picked up a second earner, but it had spent every dollar of that second paycheck. Worse yet, it had also spent the money it once saved and it had borrowed more besides.

By the most obvious financial measures, the middle class American family of the 21st Century is beginning to sink financially.

Over-Consumption—The Standard Story

There is no shortage of experts who are willing to explain exactly where the money went. The story is all about over-consumption, about families spending their money on things they don't really need. Economist Juliet Schor blames "the new consumerism," complete with "designer clothes, a microwave, restaurant meals, home and automobile air conditioning, and, of course, Michael Jordan's ubiquitous athletic shoes, about which children and adults both display near-obsession."⁹ Sociologist Robert Frank claims that America's newfound "Luxury Fever" forces middle-class families "to finance their consumption increases largely by reduced savings and increased debt."¹⁰ John de Graaf and his coauthors claim that the "urge to splurge" is an affliction affecting millions of Americans who simply have no willpower.¹¹ The distinction is critical: According to these critics, over-consumption is not about medical care or basic housing, and it isn't about buying a few goodies with extra income. It is about going deep into debt to finance consumer purchases that sensible people could do without.

The beauty of the Over-Consumption story is that it squares neatly with many of our own intuitions. We see the malls packed with shoppers. We receive catalogs filled with outrageously expensive gadgets. We think of that overpriced summer dress that hangs in the back of the closet or that new power drill gathering dust in the back of the garage. The conclusion seems indisputable: the "urge to splurge" is driving folks to spend, spend, spend like never before.

But is it true? Deep in the recesses of federal archives is detailed information on Americans' spending patterns going back for more than a century. It is possible to analyze data about typical families from the early 1970s and from the early 2000s, carefully sorting spending categories and family size.¹² If today's families really are blowing their paychecks on designer clothes and restaurant meals, then the expenditure data should show that they are spending more on these frivolous items than their parents did a generation earlier. But the numbers point in a very different direction.

Start with clothing. Everyone talks about expensive sneakers, designer outfits, and the latest fashions. How much more is today's typical family of four spending on clothing than the typical family spent in the early 1970s? They are spending *less*, a whopping 32% less today than they spent a generation ago.¹³ The differences have to do with how people dress (fewer suits and leather shoes, more T-shirts and shorts), where they shop (more discount stores), and where the clothes are manufactured (overseas). Compared with families a generation ago, today's median earners are downright thrifty.

How about food? People eat out now more than ever before, and bottled water turns something that was once free into a \$2 purchase. How much more is today's family of four spending on food (including eating out) than the typical family in the early 1970s? Once again, they are spending less, about 18% less.¹⁴ The reasons are that people eat differently (less meat, more pasta), shop differently (big discount super-centers instead of corner grocery stores) and agribusiness has improved the efficiency of food production.

What about appliances? Families today have microwave ovens, espresso machines and fancy washers and dryers. But those appliances aren't putting a big dent in

their pocketbooks. Today's family spends about 52% less each year on appliances than their counterparts of a generation ago.¹⁵ Today's appliances are better made and last longer, and they cost less to buy.

Cars? Surely luxury vehicles are making a difference. Not for the median family. The per-car cost of owning a car (purchase, repairs, insurance, and gas) was on average about 24% lower in 2004 than in the early 1970s.¹⁶

That is not to say that middle-class families never fritter away any money. A generation ago no one had cable, big-screen televisions were a novelty reserved for the very rich, and DVD and TiVo were meaningless strings of letters. Families are spending about 23 percent more on electronics, an extra \$225 annually. Computers add another \$300 to the annual family budget.¹⁷ But the extra money spent on cable, electronics, and computers is more than offset by families' savings on major appliances and household furnishings alone.

The same balancing act holds true in other areas. The average family spends more on airline travel than it did a generation ago, but it spends less on dry cleaning. More on telephone services, but less on tobacco. More on pets, but less on carpets.¹⁸ And, when it is all added up, increases in one category are pretty much offset by decreases in another. In other words, there seems to be about as much frivolous spending today as there was a generation ago.

Where Did the Money Go?

Consumer expenses are down, but the big fixed expenses are up—way up. Start at home. Style Section headlines are all about McMansions, granite countertops and media rooms. But today's median family buys a three-bedroom, one-bath home—statistically speaking about 6.1 rooms altogether.¹⁹ This is bigger than the 5.8 rooms the median family lived in during the early 1970s, but only modestly so. At the same time, the price tag—and the resulting mortgage payment—is much bigger. In 2004, the median homeowner was forking over a mortgage payment that was 76% larger than a generation earlier.²⁰ The family's single biggest expense—the home mortgage—had ballooned from \$485 a month to \$854. (Remember that all the numbers have already been adjusted for inflation.)

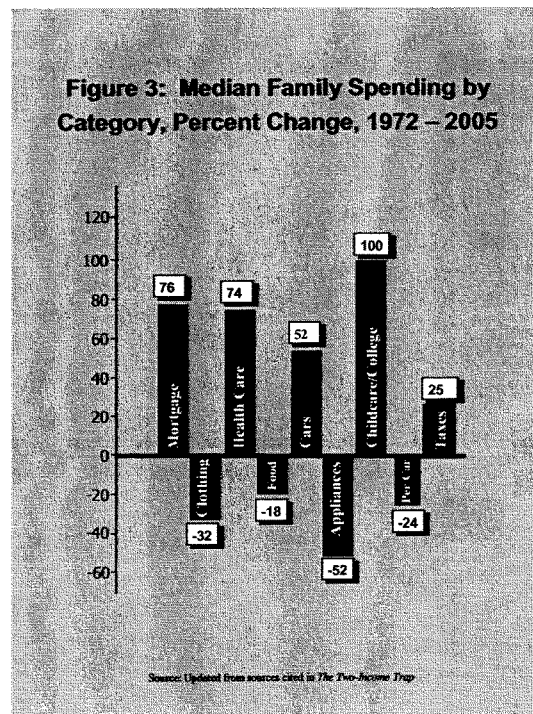
Increases in the cost of health insurance have also hit families hard. Today's family spends 74% more on health insurance than their earlier counterparts—if they are lucky enough to get it at all.²¹ Costs are so high, that 48 million working-age Americans simply went without coverage last year.²²

The per-car cost of transportation is down, but the total number of cars is up. Today's family has two people in the workforce, and that means two cars to get to work. Besides, with more families living in the suburbs, even a one-earner family needs a

second car for the stay-at-home parent to get to the grocery store and doctors' appointments. Overall transportation costs for the family of four have increased by 52%.

Another consequence of sending two people into the workforce is the need for childcare. Because the median 1970s family had someone at home full-time, there were no childcare expenses for comparison. But today's family with one pre-schooler and one child in elementary school lays out an average of \$1048 a month for care for the children.²³

Even when the children are past the daycare years, the costs keep multiplying. Ask any parent about how much it costs to send a child to public school—band, sports, fees, fund raisers—as well as the costs of after-school care. For parents facing the college years, the news is even worse. The cost of sending a child to college has doubled in twenty years, at the same time that a family's ability to save for college continues to fall.²⁴

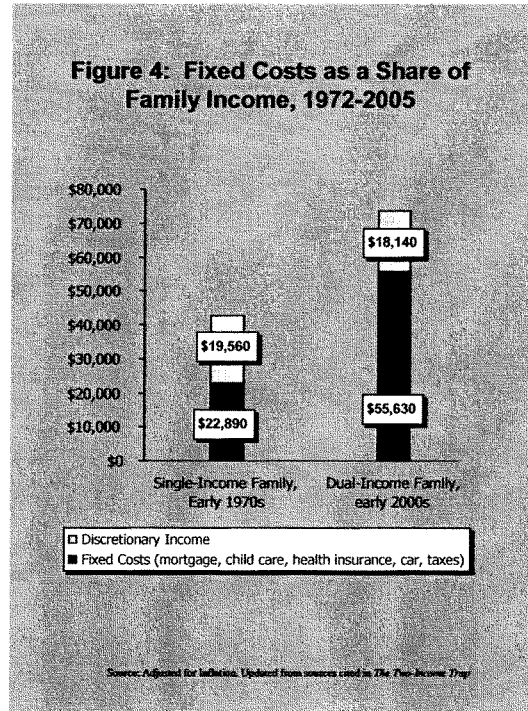


Taxes also take a bigger bite from the two-income family of 2004. Because their second income is taxed on top of their first income, the average tax rate is 25% higher for a two-income family in 2004 than it was for a one-income family in 1972.²⁵

The ups and downs of family spending over the past generation are summarized in Figure 3. Notice that the biggest items in the family budget—the mortgage, taxes, health insurance, child care are all on the up side. Reduced spending—food, clothing, and appliances—are all relatively smaller purchases.

Also notice that the items that went down were more flexible, the sorts of things that families could spend a little less on one month and a little more on the next. If someone lost a job or if the family got hit with a big medical bill, they might squeeze back on these expenses for a while. But the items that increased were all fixed. It isn't possible to sell off a bedroom or skip the health insurance payment for a couple of months. If both parents are trying to work, childcare costs will go on even during a job search. The increases occurred among expenses that a family must meet month after month, in good times and in bad.

When it is all added up, the family in the 2000s has a budget that looks very different from that of its early 1970s counterpart. As Figure 4 shows, there is more income, but the relationship between income and fixed expenses has altered dramatically.



The family of the 1970s had about half its income committed to big fixed expenses. Moreover, the typical 1970s family had one stay-at-home parent, someone who could go to work to earn extra income if something went wrong. By contrast, the family of 2004, has already put everyone to work so there is no extra income to draw on if trouble hits. Worse yet, even with two people in the workforce, after they pay their basic expenses, today's two-income family has less cash left over than their one-income parents had a generation ago.

New Risks for the Middle Class

The numbers make it clear that the cost of being middle class is rising quickly—much more quickly than wages. Many families have tried to cope by sending both parents into the workforce. But that change has helped push up costs, and it has increased the risks these families face. They now have no backup worker. Instead, they now need both parents working full-time just to make the mortgage payment and keep the health insurance. And when they need twice as many paychecks to survive, they face

twice the risk that someone will get laid off or become too sick to work—and that the whole house of cards will come tumbling down.

The new two-income family faces other risks as well. Back in the 1970s, when a child was ill or grandma broke her hip, there was a parent at home full-time to deal with the needed care, to administer medications and drive to doctors' appointments. But someone in the family with no parent at home must take off work whenever anyone else in the family has a serious problem. As a result, problems that were once part of the ordinary bumps of life today have serious income consequences.

New risks keep multiplying. A trip to the emergency room can easily cost \$10,000. A child who needs tutoring or car that needs significant repairs can put an already strained budget into the red zone. Savings have fallen and families are in debt even before something goes wrong. Retirement presents another risk, as generous pensions disappear and even the social security back up system looks shaky.

Some will read these data and conclude that one parent should just stay home. Whatever the advantages and disadvantages of that idea from a social or psychological perspective, it is clearly a losing proposition from an economic perspective for all but the most well-to-do families. Go back to the first graphic and look at what a fully employed male can earn (and remember that a fully-employed female will earn even less). Then look at the big, fixed expenses. Sure, the family can save on childcare and taxes will be lower, but the house payment and the health insurance stay the same, and car expenses are unlikely to drop by much. That leaves the median one-income family with a 71% drop in discretionary income compared with a one-income family a generation ago. In other words, today the two-income family can barely afford the basics, and the median one-income family is simply out of luck.

What do these data say to one-parent families? These families get the worst of both worlds. They have no partner to provide childcare every day and no back-up earner when something goes wrong. In those ways, they look like the typical two-income family—except that they don't have that second income either. A typical one-parent household cannot cover even the basic expenses that would put that family squarely in the middle of American economic life.

It is no surprise that an increasing number of middle class families turned to bankruptcy. From 1980 until federal law was changed in 2005, the number of households filing for bankruptcy quadrupled.²⁶ By 2004, more children were living through their parents' bankruptcy than through divorce.²⁷ In fact, households with children were about three times more likely to file for bankruptcy than their childless counterparts. What were the main reasons cited for these bankruptcies? About 90% of the families cited some combination of job loss, medical problems or family breakup.²⁸

Thinking About Solutions

The pressures on the middle class have come from many sources, which is both the good news and the bad news. It is bad in the sense that no single silver bullet will fix everything. But it is good in the sense that many different approaches can make things better—much better—for families across the economic spectrum.

There are five areas where Congress could make changes that would have a powerful impact on the economic security of middle class families.

- Health care and disability protection
- College
- Pre-school education
- Public schools
- Credit safety

Each of these areas has its own experts, and policy changes are justified on a number of grounds. But I want to put the focus today on middle class family economics.

Health Care and Disability Protection.

Finding better health care solutions in America is not simply about bringing the uninsured under the tent of insurance. That is an important goal, but it does not address a far more profound point: Even insured families are getting squeezed. The extraordinary rise in the costs families pay for health care has been exceeded by the amounts that employers are paying—for the lucky people who have access to employer-sponsored health care. For many employees, what might have been a rise in wages has been siphoned off to ever-increasing health insurance costs.

As insurance becomes more expensive, many companies cut costs by providing less and less coverage. Recent research revealed that about half of all the families in bankruptcy were filing in the aftermath of a serious medical problem.²⁹ The more shocking finding, however, was that three-quarters of those who described their bankruptcies as related to medical problems had health insurance at the onset of their illnesses or accidents. Health insurance is not an on-off switch, providing adequate coverage to every person who has it. There is much room for improvement.

Disability insurance has also been overlooked in our national discussion of health insurance. In the age of families living close to the economic edge, disability insurance can be all that stands between them and financial ruin. Unfortunately, a majority of workers do not have any private long-term disability insurance, and only a handful of states provide coverage for their residents.³⁰ Unemployment insurance offers no relief because most states require that an individual be “able” to work in order to qualify for benefits.³¹ Fortunately, there is some good news here. Fixing the disability coverage problem may be easier than solving the health insurance crisis, because the apparatus already exists. Virtually every worker in America has long-term disability coverage through the Social Security Disability Insurance (SSDI) program. All that remains is to

close the holes in the SSDI safety net, many of which are big enough to drive a truck through.

The uninsured were once only the very poor and the very young. Today, middle class families with decent jobs are increasingly counted among those with no insurance. Why? Because they cannot afford the premiums. Health insurance is becoming a luxury item, and hard-working families are forced to make choices between mortgage payments and health insurance premiums. Fixing a broken health care system is no longer about benefits for the poor. It is now about survival for the middle.

College

Americans see a college degree as the single most important determinant of a young person's chances of future success, their ticket to the future.³² But it is becoming harder than ever for families to pay for that ticket. Costs are rising and family savings are falling, and that leaves many middle class families deeply worried. And as students increasingly try to shoulder the burden, many are graduating deep in debt—tempering the good news of higher earning potential with the higher risks associated with debt. Many others, including almost 20 percent of low-income high school graduates with high test scores, do not manage to enroll in college at all within two years of graduation.³³

The high costs of college have hit middle class families especially hard. As a group, these students are unable to rely on family income or savings to pay for college, so they shoulder large debt loads. Every cut in the federally funded student loan program is a cut felt directly by middle class families. Policy tradeoffs pit low-income students, eligible for grants, against moderate-income students who must rely on loans, leaving both groups scrambling to try to find a way to pay for the college educations they need.

Underfunding grant programs for low-income students is a mistake, but making middle class students pay for increases in grant programs by cutting their access to loan programs is a bigger mistake. College is the ticket to security and success. A new financing mechanism is essential, one that lets students take responsibility for the cost of their own educations without burdening their families unduly, forcing them to make career choices that push them out of public service, or taking on so much debt that their economic futures look bleak.

Any person—regardless of income—who is willing to work hard should have a realistic chance to get a college education and to pay for it without mortgaging the future. Adequate federal loans should be made available to every student in the country, with enough money to cover four years of room, board, tuition and books (pegged to state university costs). After graduation, repayment options should include public service, as well as dollar repayment.³⁴ A year of college expenses could be forgiven for each year the graduate works in public service.³⁵ With such a program, typical students could begin adult life debt-free at age 26, with a college diploma and four years of work experience already in hand. Those who go to college later in life would also have the opportunity to

participate in the loan forgiveness program. Equally important, giving college students an opportunity to repay loans through public service would provide an opportunity for young Americans to contribute vital services to their nation and their communities.

Pre-School Education

Over the past generation, the image of preschool has transformed from an optional stopover for little kids to a prerequisite for elementary school. Parents have been barraged with articles telling them that early education is important for everything from “pre-reading” skills to social development. As one expert in early childhood education observes, “In many communities around the country, kindergarten is no longer aimed at the entry level. The only way parents can get their child prepared is through a pre-kindergarten program.”³⁶

Middle-class parents have stepped into line with the experts’ recommendations. Today, nearly two-thirds of America’s three- and four-year-olds attend preschool, compared with just 4 percent in the mid-1960s.³⁷ This isn’t just the by-product of more mothers entering the workforce; nearly half of all stay-at-home moms now send their kids to a pre-kindergarten program. As *Newsweek* put it, “The science says it all: preschool programs are neither a luxury nor a fad, but a real necessity.”³⁸

But the costs are staggering. In 2002, a full-day program in a pre-kindergarten offered by the Chicago public school district costs \$6,500 a year—more than the cost of a year’s tuition at the University of Illinois.³⁹ According to one study, the annual cost for a four-year-old to attend a child care center in an urban area is more than double the price of college tuition in fifteen states.⁴⁰ Today’s middle-class families simply spend and spend, stretching their budgets to give their child the fundamentals of a modern education.

This problem can be fixed by extending the scope of public education. If Americans generally believe that educational programs should begin at age three, why should public education wait to kick in at age five or six? The decision about how old children should be when they start school was made more than a century ago, when views about the learning capacity of young children were very different. The absence of publicly funded preschool is an anachronism, one that could easily be remedied.

Preschool and college, which now account for one-third (or more) of the years a typical middle-class kid spends in school, are paid for almost exclusively by the child’s family. Helping families with these expenses would give them much-needed relief.

Public Education

Failing public schools have an impact on the children trapped in them, but they also impose a terrible burden on the families struggling to escape them. Failing public schools translate directly into higher housing costs for middle class families as they try to escape those school. Home prices have grown across the board (particularly in larger urban areas), but the brunt of the price increases has fallen on families with children. The home value for the average childless couple increased by 58 percent between 1984 and 2004—an impressive rise in less just twenty years.⁴¹ (Again, these and all other figures are adjusted for inflation.) For married couples with children, however, housing prices shot up 145 percent during this period—nearly three times faster.⁴² To put this in dollar terms, in 1984 the average married couple with young children owned a house worth about \$77,000 in today's dollars. Less than twenty years later, a similar family bought a similar house worth \$188,000—an increase of more than \$110,000, and mortgage costs shot up at the same time.

Homes can command a premium for all sorts of amenities, such as a two-car garage, proximity to work or shopping, or a low crime rate. A study conducted in Fresno (a midsized California metropolis with 400,000 residents) found that, for similar homes, school quality was *the single most important determinant of neighborhood prices*—more important than racial composition of the neighborhood, commute distance, crime rate, or proximity to a hazardous waste site.⁴³ A study in suburban Boston showed the impact of school boundary lines. Two homes located less than half a mile apart and similar in nearly every aspect, will command significantly different prices if they are in different elementary school zones.⁴⁴ Schools that scored just 5 percent higher on fourth-grade math and reading tests added a premium of nearly \$4,000 to nearby homes, even though these homes were virtually the same in terms of neighborhood character, school spending, racial composition, tax burden, and crime rate.

This phenomenon isn't new, but the pressure has intensified considerably. In the early 1970s, not only did most Americans believe that the public schools were functioning reasonably well, a sizable majority of adults thought that public education had actually *improved* since they were kids. Today, only a small minority of Americans share this optimistic view. Instead, the majority now believes that schools have gotten significantly worse.⁴⁵ Fully half of all Americans are dissatisfied with America's public education system, a deep concern shared by black and white parents alike.⁴⁶

Parents are trying to buy safe streets and good schools, and they are doing it by bidding up prices in a shrinking number of neighborhoods. Failing schools impose an enormous cost on those children who are forced to attend them, but they also inflict an enormous cost on those who don't. Reinvigorating America's public schools is good for many reasons, but relevant to our discussion here today, such relief would take a great deal of pressure off middle class families.

Credit Safety

Stagnant incomes and escalating expenses have left Americans drowning in debt. Their difficulties are compounded by substantial changes in the credit market that have made debt instruments far riskier for consumers than they were a generation ago. The effective deregulation of interest rates coupled with innovations in credit charges (e.g., teaser rates, 2-28 mortgages, negative amortization, increased use of fees, cross default clauses, penalty interest rates) have turned ordinary purchases into complex financial undertakings.

In the mid-1980s, the typical credit card contract was about a page long; today it is more than 30 pages, often of dense legalese that even a lawyer cannot understand.⁴⁷ Small loans that may seem safe in the beginning are repeatedly rolled over in the payday loan industry, making the average effective interest rate more than 400%.⁴⁸ Credit reports, the foundation of the modern credit system, have errors of 50 points or more in 31% of all files, and consumers have little help when they try to straighten out the tangle.⁴⁹ Home mortgages are promoted by brokers who take bribes—known in the trade as yield spread premiums—to “upsell” customers into higher interest products than they qualify for.⁵⁰

Aggressive marketing, almost non-existent in the early 1970s, now shapes many consumer choices. Six billion credit card applications were mailed out in 2005, in addition to on-campus, phone, flyers, in-store, and all other sorts of other marketing. Companies hawk mortgage refinancing, promising lower payments and cash back, and without mentioning the high fees and increased odds of losing a home. Consumer capacity—measured both by available time and expertise—has not expanded to meet the demands of a far more dangerous and aggressive credit marketplace.

No one has to be an engineer to buy a toaster. No one needs to be a crash test expert to buy a car. No one needs to have a degree in chemistry to buy a prescription drug. These markets have soared with innovation over the past decades, but they have also been supported by national safety standards that kept burst-into-flames toasters, crumple-on-impact cars and poisonous pills off the markets. Government and industry joined forces to develop enforceable guidelines, and cheap short-cuts that would boost profits but leave consumers at risk have been banned from those markets. The result is intensified competition for the things consumers can readily see and evaluate, like price, convenience, and color, and safer products at lower prices. It is time for safety regulation for credit products as well.

Conclusion

The rules of the game have changed. For today’s middle class families, hard work and good intentions are no longer enough. Go to school, get a good job, do your work, don’t go crazy with spending, and everything will work out. That formula may have worked in their parents’ day, but today families face a tough, new world. There are opportunities to be sure, but there are also new costs and hidden dangers.

America was once a world of three economic groups that shaded each unto the other—a bottom, a middle, and a top—and economic security was the birthright of all those who could make it to the middle. Today the lines dividing Americans are changing. No longer is the division on economic security between the poor and everyone else. The division is between those who are prospering and those who are struggling, and much of the middle class is now on the struggling side.

The economy has changed, and middle class families are struggling to change with it. Laws like social security, Medicare, FHA, consumer product safety, fair credit reporting and a host of other statutes were designed to help middle class Americans cope with the risks in the economy of the mid-Twentieth Century. With a strong safety net to back them up, Americans innovated at a rate unparalleled in world history. Today's families face new costs and new risks, and they need help so that they too can achieve security and prosperity for themselves and a stronger, healthier economy for everyone.

¹ The lower 20% of income cuts off at \$19,000, while the top 20% starts at about \$92,000. The 60 percent in the middle are solidly middle class, although many of those with higher and lower incomes would also call themselves middle class. http://pubdb3.census.gov/macro/032006/hhinc/new05_000.htm

² http://www.census.gov/Press-Release/www/releases/archives/income_wealth/007419.html

³ Today, the two-parent family right in the middle is earning about \$66,000. Bureau of the Census, 2005 American Community Survey, S. 1901 Income in the Past 12 Months (in 2005 Inflation Adjusted Dollars), http://factfinder.census.gov/servlet/STTable?_bm=y&-qr_name=ACS_2005_EST_G00_S1901&-geo_id=01000US&-context=st&-ds_name=ACS_2005_EST_G00_-tree_id=305 Because all households include one-adult and two-adult households, any statistic confined only to two-parent families will show considerably higher earnings.

⁴ Bureau of the Census, *Historical Income Tables—Families*, Table F-13.

<http://www.census.gov/hhes/www/income/histinc/f13ar.html>

⁵ <http://www.bea.gov/bea/dn/nipaweb/TableView.asp#Mid> (savings rates reported by quarter)

⁶ Computed from data on debt, both revolving and total, from the Federal Reserve (available at http://www.federalreserve.gov/releases/g19/hist/cc_hist_sa.html), number of households and data on household income, from the Bureau of the Census (available at

http://factfinder.census.gov/servlet/ADPTable?_bm=y&-geo_id=01000US&-ds_name

http://factfinder.census.gov/servlet/STTable?_bm=y&-qr_name=ACS_2005_EST_G00

⁷ 2006 savings rate was -0.7%. Bureau of Economic Analysis, National Economic Accounts, Table 2.1, Personal Income and Its Disposition.

<http://www.bea.gov/bea/dn/nipaweb/TableView.asp?SelectedTable=58&FirstYear=2004&LastYear=2006&Freq=Qtr>

⁸ See data cited in note 8 supra.

⁹ Juliet B. Schor, *The Overspent American: Upscaling, Downshifting, and the New Consumer* (New York: Basic Books, 1998), p. 20, 11.

¹⁰ Robert H. Frank, *Luxury Fever: Why Money Fails to Satisfy in an Era of Excess* (New York: Free Press, 1999), p. 45.

¹¹ John de Graaf, David Waan, and Thomas H. Naylor, *Affluenza: The All-Consuming Epidemic* (San Francisco: Barrett-Koehler, 2001), p. 13.

¹² The Bureau of Labor Statistics maintains the Consumer Expenditure Survey (CES), a periodic set of interviews and diary entries, to analyze the spending behavior of over 20,000 consumer units. Much of the analysis compares the results of the 1972–1973 CES with those of the 2004 CES. In some instances, prepublished tables from the 1980 or the 2000 survey are used in order to use the most comparable data available. In both time periods, the data used are for four-person families.

¹³1972-1973 CES, Table 5, Selected Family Characteristics, Annual Expenditures, and Sources of Income Classified by Family Income Before Taxes for Four Person Families; 2004 CES, Table 4, Size of Consumer Unit: Average Annual Expenditures and Characteristics. See also Mark Lino, "USDA's Expenditures on Children by Families Project: Uses and Changes Over Time," *Family Economics and Nutrition Review* 13, no. 1 (2001): 81-86.

¹⁴1972-1973 CES, Table 5; 2004 CES, Table 4. See also Eva Jacobs and Stephanie Shipp, "How Family Spending Has Changed in the U.S.," *Monthly Labor Review* 113 (March 1990): 20-27.

¹⁵1972-1973 CES, Table 5; 2004 CES, Table 4.

¹⁶1972-1973 CES, Table 5; 2004 CES, Table 4.

¹⁷1972-1973 CES, Table 5; 2004 CES, Table 1400. Electronics comparison includes expenditures on televisions, radios, musical instruments, and sound equipment. Computer calculation includes computer hardware and software.

¹⁸For example, in 2000 the average family of four spent an extra \$290 on telephone services. On the other hand, the average family spent nearly \$200 less on floor coverings, \$210 less on dry cleaning and laundry supplies, and \$240 less on tobacco products and smoking supplies. 1972-1973 CES, Table 5; 2004 CES, Table 1400.

¹⁹Bureau of the Census, *American Housing Survey: 1975, General Housing Characteristics*, Current Housing Reports, H-150-75A, Table A1; *American Housing Survey, 1997*, Current Housing Reports, H150/97 (October 2000), Table 3-3, Size of Unit and Lot—Owner Occupied Units.

²⁰CES, 1984, Table 5; CES, 2004

²¹1972-1973 CES, Table 5; 2004 CES, Table 4

²²Commonwealth Fund, *Gaps in Health Insurance: An All-American Problem* (2006).

²³Day care costs are calculated from average child care costs for mothers employed full-time with a child aged five to fourteen, and preschool costs are calculated from average child care costs for mothers employed full-time with a child under five. 2004 CES, Table 1A, consumer price index for all consumers: US city average, by expenditure category and commodity and service group, 1999 annual, and 2004 annual. Preschool and daycare cost data were adjusted using consumer price index for "tuition & childcare".

²⁴In inflation-adjusted dollars, the cost of a four-year public college has increased by 134%. SANDY BAUM & KATHLEEN PAYEA, THE COLLEGE BOARD, *EDUCATION PAYS 2006*, available at http://www.collegeboard.com/prod_downloads/press/cost06/trends_college_pricing_06.pdf (last visited Feb. 11, 2007).

²⁵Claire M. Hintz, *The Tax Burden of the Median American Family*, Tax Foundation Special Report 96 (Washington, DC: Tax Foundation, March 2000), Table 1, Taxes and the Median One-Income American Family. For more details on the complex tax calculations, see *Two Income Trap*, Chapter 2, page 206-07, note 115.

²⁶Administrative Office of the United States Courts, Table F-2, 1980, 2004. In 1980, 287,570 households filed for bankruptcy. In 2004, that number had jumped to 1,563,145.

²⁷*Two-Income Trap*, page 13.

²⁸*Id.* at page 81.

²⁹Himmelstein, Warren, Woolhandler, and Thorne, *Illness and Injury as Contributors to Bankruptcy*, *HEALTH AFFAIRS* (February 2, 2005).

³⁰Only 43 percent of workers have long-term disability coverage, and only 19 percent have at least six months of short-term coverage. Helen Levy, "Disability Insurance: Where Are the Gaps in Coverage?" unpublished paper (July 2002).

³¹In Texas, for example, an individual "must be physically and mentally able to perform full time work" in order to qualify for unemployment benefits. Texas Workforce Commission, "Unemployment Insurance Benefits, Frequently Asked Questions." Available at

<http://m06hostp.twc.state.tx.us/CLAIMS/common/help.html#faq5>

³²JOHN IMMERWAHR & TONY FOLENO, CTR. FOR PUB. POLICY AND HIGHER EDUC., *GREAT EXPECTATIONS: HOW THE PUBLIC AND PARENTS—WHITE, AFRICAN AMERICAN, AND HISPANIC—VIEW HIGHER EDUCATION* 3, tbl.1 (2000).

³³DAVID ELLWOOD & THOMAS KANE, *WHO IS GETTING A COLLEGE EDUCATION? FAMILY BACKGROUND AND THE GROWING GAPS IN ENROLLMENT*, IN *SECURING THE FUTURE* 294 (S. Danziger & J. Waldfogel eds., 2000). See also SANDY BAUM & KATHLEEN PAYEA, *THE COLLEGE BOARD, EDUCATION PAYS 2004: THE*

BENEFITS OF HIGHER EDUCATION FOR INDIVIDUALS AND SOCIETY (2004), available at http://www.collegeboard.com/prod_downloads/press/cost04/EducationPays2004.pdf.

³⁴ For more details on *Service Pays*, a program to pay off college loans through public service, see, Elizabeth Warren, Sandy Baum and Ganesh Sitaramen, A Ticket to the Middle Class: Working Off College Debt Boston Federal Reserve Communities & Banking 6 (winter 2007).

³⁵ Students could opt for two years in public service, for example, and pay off the remainder of their loans in cash. This would give more flexibility to the students, and it would preserve resources for the program.

³⁶ Laurent Belsie, "Preschools Are Popping at the Seams," *Christian Science Monitor*, July 9, 2002, p. 13.

³⁷ Belsie, "Preschools Are Popping at the Seams," p. 13.

³⁸ Anna Quindlen, "Building Blocks for Every Kid," *Newsweek*, February 12, 2001.

³⁹ Kate N. Grossman, "Pre-kindergarten Lures Middle Class to Public School," *Chicago Sun-Times*, June 10, 2002; in-state tuition and fees at the University of Illinois are \$5,748. University of Illinois Web site, at <http://www.oar.uiuc.edu/current/tuit.html>

⁴⁰ Karen Schulman, *The High Cost of Child Care Puts Quality Care Out of Reach for Many Families* (Washington, DC: Children's Defense Fund, 2000), Table A-1, Comparison of Average Annual Child Care Costs in Urban Area Centers to Average Annual Public College Tuition Costs.

⁴¹ BLS, *Consumer Expenditure Survey, 1984*, Table 5, Composition of Consumer Unit. BLS, *Consumer Expenditure Survey, 2004*, Table 5, Composition of Consumer Unit, Average Annual Expenditures and Characteristics. Data are mean estimated value of owned home for "husband and wife only" consumer units (\$182,558 in 2003; \$63,667 in 1984). Similarly, the American Housing Survey shows that homeowners with no unmarried children (including both single and married homeowners) experienced a 20 percent increase in median home value between 1985 and 2001. *American Housing Survey for the United States in 1985*, Current Housing Reports, H-150-85 (December 1988), Table 3-22, Value by Selected Characteristics—Owner Occupied Units.

⁴² BLS, *Consumer Expenditure Survey, 1984*, Table 5. BLS, *Consumer Expenditure Survey, 2004*, Table 5. Data are mean estimated value of owned home for married couples with oldest child under age 6. We have focused on couples with young children because they are typically new entrants into the housing market and therefore feel most acutely increases in housing prices. Couples with the oldest child between 6 and 17 also experienced a significant (though somewhat smaller) increase in average home value during this period, of 58 percent. The American Housing Survey indicates a somewhat less dramatic rise in median home values, showing that the average homeowner with two young children saw a 37 percent real increase in median home value between 1985 and 2001, compared with a 20 percent increase for homeowners without children. *American Housing Survey for the United States in 1985*, Current Housing Reports, H-150-85 (December 1988), Table 3-22. *American Housing Survey for the United States: 2001*, Annual Survey (2001), Table 3-22. The difference between BLS and American Housing Survey data may in part be due to the fact that BLS data separates married couples, whereas American Housing Survey lumps together both married and single homeowners. AHS data may be skewed by the growing number of single mothers, who live in much smaller and less expensive homes than their married counterparts, thus reducing the average amount spent by households with children.

⁴³ David E. Clark and William E. Herrin, "The Impact of Public School Attributes on Home Sale Prices in California," *Growth and Change* 31 (Summer 2000): 385–407. "The elasticity of teacher-student ratio is nearly 8 times that of murder rate and just over 10 times that of the largest environmental quality measure [proximity to interstate]."

⁴⁴ Sandra E. Black, "Do Better Schools Matter? Parental Valuation of Elementary Education," *Quarterly Journal of Economics* 114 (May 1999): 577–599.

⁴⁵ George H. Gallup, "The Eleventh Annual Gallup Poll of the Public's Attitudes Toward the Public Schools," *Phi Delta Kappan* (September 1979), p. 37. "More Than Half of Americans Say Public Education Is Worse Today Than When They Were Students," *Public Agenda Online* (April 2000), available at http://www.publicagenda.org/issues/pec_detail.cfm?issue_type=education&list=16

⁴⁶ Black parents are almost three times more likely than other parents to report that they are "completely dissatisfied" with the quality of their children's schools. Lydia Saad, "Grade School Receives Best Parent Ratings, Education Nationally Gets Modest Ratings," *Gallup Poll Analyses*, September 4, 2002.

⁴⁷ Mitchell Pacelle, *Putting Pinch on Credit Card Users*, Wall Street Journal (July 12, 2004).

⁴⁸ Center for Responsible Lending, Support SA 4331, Consumer Credit for Service Members <http://www.responsiblelending.org/policy/congress/page.jsp?itemID=29895875> (last visited September 3, 2006).

⁴⁹ M.P. McQueen, *Credit Bureaus Create Single Rating: VantageScore to Streamline Process but Doesn't Improve Consumer Data Reliability*, Wall Street Journal Online (March 15, 2006).

⁵⁰ This practice produces what are known in the industry as "yield spread premiums." See, for example, the testimony of Martin Eakes, *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures* (February 2007) <http://www.responsiblelending.org/policy/testimony/page.jsp?itemID=31558717>.

COMMUNICATIONS

**STATEMENT OF JOHN WACHSMANN
On behalf of
THE AMERICAN PREPAID LEGAL SERVICES INSTITUTE
Before the
SENATE FINANCE COMMITTEE**

**On the subject of
Can the Middle Class Make Ends Meet?
Economic Issues for America's Working Families
May 10, 2007**

Mr. Chairman and Members of the Committee:

I am John R. Wachsmann, President of the American Prepaid Legal Services Institute. The American Prepaid Legal Services Institute (API) is a professional trade organization representing the legal services plan industry. Headquartered in Chicago, API is affiliated with the American Bar Association. Our membership includes the administrators, sponsors and provider attorneys for the largest and most developed legal services plans in the nation. The API is looked upon nationally as the primary voice for the legal services plan industry.

I offer this written testimony in support of employer-paid group legal services for working families. Employer-paid group legal services provide a vital safety net for middle-income families.

The hearing today deals with the economic challenges facing middle class families. Committee Chairman Baucus noted in calling the hearing that "Another way to look at the middle-class is to consider what happens when a calamitous event occurs to a middle-class family." He suggests expanding middle-class tax relief.

One effective and inexpensive part of middle class tax relief should be the restoration of the tax exempt status of Employer-Paid Group Legal Services. This is targeted tax relief aimed for the middle class that works two ways:

- It reduces the tax burden on working families and businesses
- It seeks to prevent or change the consequences of calamitous events that without legal assistance can quickly snowball into disaster

For example, one of the economic challenges facing working families is surviving in an increasingly complex financial environment. Currently working families are in an extremely precarious economic position. A perfect storm of adjustable rate mortgage increases, credit card interest rate increases, layoffs and cutbacks have put many families on the edge of economic collapse. Many middle income families are living paycheck to paycheck with very little cushion in the event of illness or injury.

As Chairman Baucus pointed out, a single event, such as a divorce, job lay-off or illness that interrupts cash flow is enough to trigger defaults on mortgages, evictions or collection lawsuits. Now is the time when working families need access to the legal system, through employer-provided legal plans, to save their homes, deal with debt collectors and keep their families intact.

Group legal plans help working Americans in financial distress. Plans provide preventative assistance with mortgage and refinancing document review, as well as advice on sub prime loans and exotic financing instruments. Group legal plans help American families understand the economics of their mortgages to avoid entering into transactions likely to result in future defaults.

If a default has occurred, plans will review the documents for compliance with existing laws and advise on workouts that allow reinstatement of the mortgages. The result is not only saving the family's place to live, but safeguarding the family's primary investment.

Group legal plans also provide employees with low cost basic legal services, including assistance with the preparation of a will, probate, and domestic relations issues, such as child support collection. Other issues plans address are:

- Protecting spouses and children in the event of death
- Anticipating the need for long term care, as well as Medicare and Medicaid issues
- Informing medical professionals on how they want to be treated in the event of a serious illness or a life threatening accident
- Instructing family members on how they want their property handled in the event of incapacitating illness or accident
- Addressing financial management and investment issues in the face of a decreased income
- Educating clients on how to avoid identity theft and what steps to take if a client is a victim of this crime

Legal plans provide the advice and legal documents to accomplish these tasks through wills and trusts, powers of attorney, living wills/medical directives, guardianship and conservatorships, nursing home contract review, Medicare and Medicaid appeals and home refinancing document review.

Yet now, when the need is at its greatest, fewer Americans have access to inexpensive, preventative legal assistance. Since the loss of the benefit's tax-preferred status in 1992, existing plans have been forced to cut back and few new plans have been added.

As employers seek to limit expenses by reducing or eliminating benefits in general, targeting benefits that are not tax-preferred are high on employers' lists. Recently this trend toward reducing benefits has taken a toll on existing group legal plans. Large employers such as Rouge Steel, Delphi and Visteon have either dropped the benefit entirely or created a two-tier benefit system that eliminates group legal for their newest

employees. The lack of a tax preference for group legal plans makes the benefit vulnerable for reduction or elimination by employers, effectively barring access to justice for millions of working, middle-class Americans.

Section 120 was originally enacted in 1976 and extended on seven separate occasions between 1981 and 1991. This Congress has the opportunity to reinstate Section 120 of the Internal Revenue Code of 1986 and restore the exclusion from gross income for amounts received under qualified group legal services plans. This will provide an incentive for existing plans and tax relief for working families and businesses.

Bills have been offered in the past several Congresses, including this year's bill, S 1130, introduced by Senators Smith and Lincoln and co-sponsored by 7 Senators, 6 of whom are on the Finance Committee. The identical house version of the bill, HR 1840, has similar bi-partisan support on the Ways & Means Committee.

Reinstatement of the benefit's tax preference will provide direct and immediate tax relief to employees. When this exclusion expired, it triggered a tax increase for millions of working Americans whose employers contribute to such plans. Currently more than 2 million working families with legal plans offered by such national companies as Caterpillar, J.I. Case, Mack Truck, John Deere, Ford Motor Company, General Motors, and thousands of small businesses are taxed on the employer's contribution, whether or not they use the benefit.

Businesses will also gain direct and immediate tax relief. Employers must pay an additional 7.65 percent of every dollar devoted to a legal plan as part of its payroll tax. Employees pay the payroll tax plus income tax on the cost of the benefit whether they use it or not in any given year.

Encouraging this benefit is also an efficient and low cost way of offering protections to middle class working families. Employers can provide a substantial legal service benefit to participants at a fraction of what medical and other benefit plans cost. For an average employer contribution of less than \$100 annually, employees and retirees are able to take advantage of a wide range of legal services often worth hundreds and even thousands of dollars, which otherwise would be well beyond their means.

In conclusion, reinstating Section 120 would repeal a tax increase on middle class Americans and businesses and restore equity to the tax treatment of this benefit.

Reinstatement will also insure access to the legal system for millions of middle-class families who might otherwise be priced out of our justice system. Restoring the tax-preferred status will demonstrate to millions of hard-working low and middle-income workers, not only that this Congress supports them, but that the tax code can be beneficial for them.

Respectfully,
John R. Wachsmann
President, API



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U. S. Senate Committee on Finance Hearing on
Can the Middle Class Make Ends Meet? Economic Issues for
America's Working Families
May 10, 2007

Statement of Lisa Mensah, Executive Director
The Initiative on Financial Security of The Aspen Institute

Thank you, Chairman Baucus, Ranking Member Grassley, and distinguished members of the Committee for the opportunity to submit testimony for this important hearing on the many economic issues that middle-class Americans are facing.

Among our nation's founding principles is the idea that each citizen's ability to succeed – to achieve financial security, to do better than the generation that came before – should be as limitless as individual potential. And yet, that objective is moving farther out of reach for millions of working Americans because of a deepening asset crisis that threatens the strength of our economy and undermines the ability of individuals to save, invest and own.

Nearly half of working Americans do not own any type of personal retirement account, and current federal savings policies don't reach one in three American taxpayers. Helping more Americans invest in assets like homes, education and savings is a smart, safe strategy for long-term economic growth and individual success that can put the American dream back in reach. Savings helps spark entrepreneurship, increase the GDP, build the middle class and create jobs for our future.

The Initiative on Financial Security was founded in 2003 in response to the growing asset crisis in the United States. It is the nation's leading policy program that uses a business-driven approach to create smart solutions that help Americans save, invest and own. In the following statement, we'll discuss recommendations for four programs, developed after years of work with a bipartisan group of finance sector leaders and public policy experts, that we believe can help restore savings opportunities for the middle class. Also included is the executive summary of our report, *Savings for Life: A Pathway to Financial Security for All Americans*, which we released earlier this month on Capitol Hill.

Saving: A Critical Economic Issue for America's Working Families

Policymakers have long identified saving as the key to a secure retirement, and rightly so. But the benefits of saving are much broader. The opportunity to save at every point in the life cycle drives the ability to buy a home, to get an education, to start a business – all springboards to financial security and upward mobility. It is clear that helping more Americans save, invest and own must be a major element of any serious effort to build greater household and national prosperity.

The savings picture is bleak. Too narrow in its focus on retirement, our savings system also leaves too many Americans out. The current patchwork of savings plans is often redundant and far too complex for easy, universal use. More importantly, the emphasis on promoting savings through tax relief disproportionately benefits those who already fall into higher income brackets. As income goes up, the government's subsidy goes up, too. As a result, the government now grants hundreds of billions of dollars in tax subsidies that primarily benefit those who would save even without the government's helping hand. And more and more working families are left behind.

Higher rates of saving can also strengthen the national economy. Greater savings can stimulate economic opportunity through greater investment, both at the national and household levels. That growth, in turn, can help correct America's current account deficit and decrease reliance on overseas investment. An increase in household assets should also provide our workforce with more educational and employment opportunities, a key to national productivity in our increasingly global economy. Expanding that economic potential through a stronger savings policy should be a top national priority.

Unfortunately, our personal savings rate has been declining for decades, sliding from 10.8 percent in 1984 to -1.0 percent in 2006. And our net national savings rate is the lowest among the G-20 countries. Those trends will likely lead to slowing rates of income growth and lower standards of living for the middle class, even as the gap between rich and poor grows wider.

Simplifying the savings system is a laudable, even necessary, long-term goal. But it is not enough. The government must also step up to the challenge by building durable "on-ramps" to the savings system for everyone. We need an entirely new approach that will allow all Americans – across income levels and at every stage of life – to save, invest and own.

The lack of a sensible U.S. savings policy that promotes financial security at every point in the life cycle is one important cause of the difficulty Americans have achieving social mobility. The benefits of smarter saving are both straightforward and compelling. Saving – not just for retirement, but throughout life – smoothes the path to the middle class by creating economic opportunities. The ability to buy a car can allow a person to get to a new and better job. The higher income from that job can lead to purchase of a home. Equity from that home can finance a business or a child's college tuition, and so on.

Research has also shown that higher levels of assets promote confidence, self-sufficiency and civic engagement. In particular, more saving leads to greater educational opportunity, a key determinant of financial security. Studies have shown that family assets correlate strongly with child achievement, for a number of reasons. Families with greater assets tend to own homes in better neighborhoods, rather than renting, and for longer periods of time, affording children better and more consistent educational opportunities and resources.

Families are also less susceptible to financial ruin resulting from medical or employment emergencies if they have ready access to assets. Smart saving can literally mean the difference between a temporary setback and a plunge into poverty. There is no question that saving is difficult for most people. But recent research shows that many do save when they have the right incentives and opportunities.

The IFS Approach to Saving

In 2004, led by a core group of experts in economic development, pensions and benefits, finance and government, IFS set out to create a team of bipartisan voices to fundamentally rethink the way the United States approaches savings policy. Our Advisory Board was drawn mainly from the ranks of top executives from the financial services industry. Our objective was to bring the best minds in the business and policy worlds together to identify ways to change the dysfunctional national savings dynamic and, ultimately, to recommend a set of savings products to help more of our citizens save, invest and own.

Our founding premise was that a substantial percentage of the nation's working families have been unnecessarily left out of our savings system. We believed both data and experience proved that these families can save more, and they do – when offered the right opportunities. But in order to work, savings plans need to create the right incentives, both for consumers and for the financial services industry.

Our unique mission was to bring the expertise of the financial sector to bear on the problem of helping working families save. For decades, these two indispensable players in any savings system – the public policy thinkers who provide the ideas for new savings vehicles, and the companies that must ultimately offer and administer them – have not collaborated in developing savings policy that works for industry, government, and households.

The reasons for this lack of collaboration are complex, but a few are instructive:

- The financial services industry has not been persuaded that many working families can save more than they do, even when given the opportunity.
- Industry also believed that even if more families saved more money, the number of new participants would be small, and the scale of their savings would never be large enough to achieve significant profitability.
- While savings vehicles designed to increase savings by lower-income families had been a success on a small scale, it has been difficult to extrapolate their likely success, and profitability, on a large scale.
- Policymakers have been suspicious that any solutions supported by industry would contain high and hidden fees that would unreasonably offset the potential gains of lower-income savers.

We believed that all of those premises were demonstrably wrong.

We also sought to address another basic market failure. Nearly half of the nation's households have virtually no connection to the financial services industry because they do not participate in a retirement savings plan, the most widely held savings vehicle. This lack of first-hand experience with savings products, combined with a widespread financial illiteracy, has discouraged millions of families from seeking out more opportunities to save.

What is needed is the right nexus to bring the financial services sector and low- and moderate-income Americans together. Given the right savings vehicles with the right incentives for both the public and the industry, more Americans can access the path to greater savings.

Savings for Life: A Pathway to Financial Security for All Americans

After three years of intensive collaboration between policy experts and the financial services industry, IFS has just released its report, *Savings for Life: A Pathway to Financial Security for All Americans*. Savings for Life advocates a savings policy based on five central principles:

- Savings plans should be targeted to meet the needs of working Americans at every point in the life cycle and promote saving for specific goals—education, homeownership, and retirement.
- Savings plans should be universal – available to all Americans at every income level.
- Savings plans should be simple – designed with ease of participation in mind.
- Savings plans should include a government match to provide the right incentives for saving by working families.
- Savings plans should be designed in cooperation with the private sector.

Based on those principles, IFS has developed a package of four complementary savings vehicles that can significantly improve the savings options for all Americans:

- **Child Accounts** to build savings from the beginning of life. All children born in the U.S. would receive a beginning endowment provided by the government to open an investment account. Based on the United Kingdom's Child Trust Fund, this market-based, retail-sold account product would give every child a financial jump start and help build financial literacy.
- **Home Accounts** to be used for a down payment on a home. These FDIC-insured accounts would allow more low- and moderate-income families to become homeowners by providing a government match on their savings.

- **America's IRA**—standardized, simple Individual Retirement Accounts with a government match for low- and moderate-income Americans who do not have access to retirement plans where they work. America's IRA would use existing IRA products and distribution channels and would feature a one-time incentive for opening the account.
- **Security "Plus" Annuities**—basic life annuities to provide an additional layer of lifetime, guaranteed income as a complement to Social Security. It would partner the familiar and universal Social Security program with the private market, and would provide many of the 80 million soon-to-retire baby boomers with a simple, low-cost annuity product that protects them from outliving their savings or losing them in a market downturn.

We believe these savings vehicles can serve as the first steps toward a more sensible system of saving for every American to promote the financial security and, ultimately, the economic security of America's working families.



Lisa Mensah
Executive Director
The Initiative on Financial Security
The Aspen Institute

Executive Summary

The Case for Savings for Life

Among America's founding principles is the ideal that each citizen's ability to succeed—to achieve financial security, to do better than the generation that came before—should be as limitless as individual potential.

A sound national savings policy is essential to achieving the American Dream. Policymakers have long identified saving as the key to a secure retirement. But the benefits of saving are far broader. Having the opportunity to save at every point in the life cycle enables people to get an education, to buy a home, to start a business, to sustain them in emergencies—all springboards to financial security and upward mobility.

Higher rates of saving can also strengthen the national economy. Greater household assets can lead to a more educated workforce with more employment opportunities, a key to national productivity in our increasingly global economy.

Unfortunately, the savings picture in the United States today is bleak. The U.S. personal savings rate has been declining for decades, sliding from 10.8 percent in 1984 to -1.0 percent in 2006. And our net national savings rate is the lowest among the G-20 countries.

The problem is particularly acute with regard to retirement savings, the most important asset after homeownership for most Americans. Of the bottom 20 percent of households (in terms of income), only ten percent own tax-favored retirement accounts, with a median value of \$4,500—a tiny fraction of total retirement needs. The bottom quartile of earners owns just one percent of total retirement account assets. Retirement accounts held by the top ten percent of wage earners have a median value of \$130,000—still well short of what they will require for a financially secure retirement.

Most households do not save enough to meet even half of their retirement needs. According to a Congressional Budget Office study, roughly a quarter of baby boomers are completely unprepared for retirement, and another quarter are somewhat unprepared.

A dearth of home ownership—a key means of achieving financial security throughout life and of monetizing savings in retirement—is also contributing significantly to the American asset deficit when viewed in light of racial and ethnic disparities. In 2004, 76 percent of White, non-Hispanic Americans were homeowners, compared with 51 percent of all non-White, non-Hispanic Americans, whose homes were also worth substantially less.

If the current savings situation is bleak, it will soon become much worse. The peak years for saving occur in workers' 50's and 60's, after which individual saving characteristically declines. According to the U.S. Census, the percentage of the population over 65 will grow from about 12 percent today to about 21 percent by 2050, a gradual increase in net spenders relative to net savers.

The time to change course is now. The U.S. needs a sensible savings policy that allows all Americans to save, invest and own, at every stage of life.

Today's savings system consists of a confusing patchwork of plans, most of them income-based programs that rely on tax subsidies to generate retirement savings. Unfortunately, those plans are not currently available to many Americans, and they are far too complex for easy, universal use.

More importantly, the emphasis on promoting saving through tax relief disproportionately favors those who already fall into higher income brackets. The government now issues more than \$300 billion a year in tax subsidies that primarily benefit those who would save even without the government's helping hand. And more and more working families are left behind.

Simplifying the saving system is a laudable, even necessary, long-term goal. But it is not enough. The government also must step up to the challenge by building durable "on-ramps" to the savings system for low- and moderate-income citizens.

The Unique Approach of the Initiative on Financial Security

The Initiative on Financial Security (IFS) Advisory Board is drawn mainly from the top ranks of executives from the financial services industry. Our unique mission is to bring the expertise of the financial sector to bear on the problem of helping families save. For decades, these two indispensable players in any savings system—the public policy thinkers who provide the ideas for new savings vehicles, and the private firms that must ultimately offer and administer them—have been virtual strangers to one another.

We believe that by truly engaging the best minds in finance, we can find common ground on which to build a new set of savings vehicles that would help more Americans save, invest and own. And at the same time, we can build a vibrant new market of savings product consumers.

We also seek to address another basic market disconnect. Nearly half of the nation's households have virtually no connection to the financial services industry because they do not participate in a retirement savings plan, the most widely held savings vehicle. And the business community has not adequately engaged them because it has not perceived their full potential as new consumers.

What is needed is the right nexus to bring the financial services sector and low- and moderate-income Americans together. Given the right savings vehicles with the right incentives for both individual savers and the financial services industry, more Americans can access the pathway to greater savings.

After more than two years of work, we have concluded that five principles should drive savings plans:

- **Savings plans should be targeted to meet needs at every point in the life cycle.** Savings products should promote saving for specific goals—education, homeownership, retirement—that we each face in our lifetime.

- **Savings plans should be universal.** Savings plans should be available to all Americans at every income level.
- **Savings plans should be simple.** Many potential savers stay out of current savings plans because of their complexity. Better plans would be designed with simplicity and ease of participation in mind.
- **Savings plans should include a government match.** Current savings plans rely on tax subsidies, which disproportionately favor high-income households. Better plans would include a government “match” for low- and moderate-income households to provide the right incentives for more Americans to save.
- **Savings plans should be designed in cooperation with the private sector.** The financial services industry has deep experience and knowledge about what does and doesn’t work in the real world. And they are the ones who must ultimately offer and administer the plans. The industry should play a central role in creating new plans.

Recommendations

Based on those principles, we have developed a package of four complementary savings vehicles that we believe can significantly improve the savings options for all Americans:

- **Child Accounts** to build savings from the beginning of life. All children born in the U.S. would receive a beginning endowment provided by the government to open an investment account. Based on the United Kingdom’s Child Trust Fund, this market-based, retail-sold account product would give every child a financial jump start and build financial literacy.
- **Home Accounts** to be used for a down payment on a home. These FDIC-insured accounts would allow more low- and moderate-income families to become homeowners by providing a government match on their savings.
- **America’s IRA**—standardized, simple Individual Retirement Accounts with a government match for low- and moderate-income Americans who do not have access to retirement plans where they work. America’s IRA would use existing IRA products and distribution channels and would feature a one-time incentive for opening the account.
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We believe these savings vehicles can serve as the first steps toward a more sensible system of saving, for every American.