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Hearing on "Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve the American Dream."

It is my pleasure to share a few thoughts with you regarding intergenerational income mobility and policies that Congress can enact to ensure that all of this nation's young people can fulfill their potential.

In the United States, a ten percent wage disadvantage in a father's long term income translates into roughly a six percent wage disadvantage in a son's long term income (See Mazumder, 2005). This suggests that the son of a poor father will have a strong tendency to have a low income himself. Estimates from other developed countries imply much less persistence in income levels from father to son.[1]

These results have caused consternation because they appear to refute the premise of the "American Dream" that anyone can be successful. Indeed, if a person's economic position was determined entirely by the economic position of one's parents, independent of that person's skill or potential, there would be nearly universal condemnation of the institutions that led to such an unfair outcome. Furthermore, it would lead to a poorer society as the mediocre children of wealthy parents were promoted to jobs beyond their capabilities while the brightest children of the poor languished in occupations that failed to harness their full potential.

[1] See Solon (2002) for a cross-country comparison of intergenerational income inequality.

It would be equally symptomatic of poor labor market institutions, however, if there was no correlation between parents' income and that of their children. Because capable parents tend to have capable children,[2] a zero correlation between the incomes of children and parents suggests that our labor market fails to reward skill. Rewards for skill and hard work are essential signals for sorting our most talented workers to the fields and occupations in which they produce the most value. When we fail to allocate skill to its highest productivity use, we become poorer as a society.

I will now compare the special cases of Sweden and the United States. These countries represent the extremes of observed intergenerational income inequality in the developed world. The comparison highlights the tension between economic efficiency and equality as well as the importance of human capital investments. The degree to which paternal income difference persist to the next generation is about 26 percent in Sweden (see Björklund, Roine, and Waldenström, 2012) compared to 61 percent in the United States.[3] While Sweden is a more egalitarian country, Swedish citizens have lower incomes on average than Americans. Once one adjusts for how much more goods cost in Sweden than the United States, per-capita GDP is nearly twenty percent less in Sweden.[4]

Sweden achieves this level of equality in several ways. Generous wages for many occupations are collectively bargained at the industry level and assume the role of the mandated

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[2] To illustrate this point, it is useful to consider that the heritability of IQ is on the order of .7. In other words, if the average IQ of two parents is 10 points above the norm, a child will tend to have an IQ about 7 points higher (see Bowles and Gintis, 2002). Using Swedish data, Lefgren, Lindquist, and Sims (2012) show that the majority of intergenerational income inequality comes about through the heredity and family culture as opposed to the direct impact of financial resources.

[3] The cross-sectional distribution of incomes is also substantially more egalitarian in Sweden where the top ten percent of individuals in the income distribution earn 22.9 percent of total income. In the United States the corresponding figure is 29.9 percent. See United Nations *Human Development Report, 2009*. Accessed at http://hdr.undp.org/en/media/HDR_2009_EN_Complete.pdf on July 6, 2012.

[4] See United Nations *Human Development Report, 2009*. Accessed at http://hdr.undp.org/en/media/HDR_2009_EN_Complete.pdf on July 6, 2012.

minimum wage in other countries. A large public sector provides many individuals with a middle class lifestyle. High taxes substantially reduce differences in take home pay across workers. Aronsson and Walker (1995) discuss how these labor market institutions create incentives to limit work hours and educational investments. These institutions also dull incentives for individuals to enter demanding occupations where the value of their work product is high as opposed to pleasurable, but potentially less useful, occupations. High quality public preschools as well as primary, secondary, and college education are provided to all citizens at little or no cost.

Conversely, in the United States levels of unionization are low and dropping (see Farber, 2001). The minimum wage is low and binds for only a small fraction of the population.[5] Tax rates and the size of the public sector are both low relative to other developed countries.[6] The financial return to education is quite high. Collectively, the tax code and labor market institutions in the United States do relatively little to equalize incomes at a point in time or across generations. They do, however, provide an efficient environment for individuals to undertake educational investments and employ their skills in the setting in which they are most highly valued.

In the United States, primary and secondary school is provided free of cost, though the quality of education is more variable in the United States than in Sweden (See Nicaise et al. 2005). Access to publicly provided preschool through programs such as Head Start is available to some, but not all, families. Individuals have access to low cost community and state colleges

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[5] See http://www.bls.gov/cps/minwage2010.htm accessed on July 6, 2012.
[6] See Handler et al. (2005).

and also have access to loans and grants to cover remaining expenses. For well-prepared students, the United States has the best university system in the world.[7]

The United States does not, however, provide a strong educational foundation to disadvantaged children. In Chicago, where I went to graduate school and conducted my early education research, only 56 percent of students graduate from high school.[8] Most of those who drop out, and many who graduate, have substandard numeracy and literacy skills. Too many of our disadvantaged young men end up in trouble with the law and experience the resulting adverse labor market consequences. While existing programs such as No Child Left Behind and Title 1 have had some mixed success in increasing student achievement (see, for example, Dee and Jacob, 2011 and Weinstein et al., 2009), improvements in education policy should be an ongoing congressional priority. Research by Heckman[9] and many others underscores the importance of early childhood education in the formation of the soft skills required for success in school, life, and the workplace.[10]

In conclusion, it is unclear what the right level of intergenerational income mobility ought to be. Tax and labor market policies designed to foster an egalitarian wage distribution and high levels of intergenerational mobility distort incentives for efficient educational investments, occupational choices, and effort levels. In this regard, congress must thoughtfully consider the tradeoffs between economic efficiency and inequality. However, the failure to foster the educational development and success of all of America's children stunts the economic potential

[7] Times Higher Education, a London based organization, reports that seven of the top ten universities in the world are located within the US. See http://www.timeshighereducation.co.uk/world-university-rankings/2011-2012/top-400.html accessed on July 6, 2012.

[8] See http://www.catalyst-chicago.org/notebook/2011/07/14/record-high-school-graduation-rates accessed on July 6, 2012.

[9] Heckman et al. (2010) is just one of many examples.

[10] See Johnson (2012) for research on the long term effects of Head Start.

of many citizens, lowers our collective national wealth, and increases intergenerational inequality in a manner that most Americans, I believe, would consider unfair.

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