Statement of

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On

Mobility, the Tax System, and Budget for a Declining Nation

Finance Committee
U.S. Senate

July 10, 2012

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He is indebted particularly to Adam Carasso, Linda Giannarelli, Elaine Maag, Caleb Quakenbush, Gillian Reynolds, and Katherine Toran for past and current work with him on both mobility and marginal tax rates. All opinions expressed herein are solely the author's and should not be attributed to any of these individuals or any organizations with which he is associated.

Mr. Chairman and Members of the Committee:

It is a privilege to testify before you today on one of the most important issues facing the nation and with which this Committee grapples: mobility. Nothing so exemplifies the American Dream than the possibility for each family to get ahead and, through hard work and faithful service to its members and the nation, advance from generation to generation. Mobility across generations can be both absolute and relative. By standing on the shoulders of those who have gone before us, absolute mobility and growth in our economy should always be possible if we don't squander our inheritance. But if we believe in opportunity for all, then we also seek a society that provides substantial relative mobility for those who start with fewer-than-average advantages.

Let me spend one moment on an issue of definition. Almost all studies on mobility measure the extent to which individuals increase their command over private human, financial, and physical capital, which is then reflected in private income. By contrast, many other studies, such as those on distribution, often include command over public transfers and taxes. To give a simple comparison, a study might find that a generation had higher net (after-transfer, after-tax) income than the previous one, but if those gains were due only to an increase in welfare or Social Security benefits, the study would not conclude that any positive intergenerational mobility had occurred.

This becomes important when considering tax as well as spending policy. Programs to promote consumption may indeed create higher or more even consumption levels, but, if they discourage work and saving, they can reduce relative mobility within and across generations.

Both absolute and relative mobility across generations are threatened by our current economic posture. This threat derives from three forces.

- First, we have a budget for a declining nation. Independent of deficits or government size, our budget promotes consumption ever more and investment, particularly in the young, ever less.
- Second, once households reach a poverty level of income, we provide relatively high disincentives to work and saving for those with fewer means, inducing behavioral patterns that can become reflected across generations.
- Third, while we spend substantial sums on both mobility and social welfare, we allocate these monies in ways that favor mobility for those with higher incomes, while promoting consumption but discouraging mobility for those with lower incomes. This discrepancy can be seen especially in policy toward housing and pensions and saving, where well over $500 billion a year in government asset-building subsidies are generally unavailable to lower-income households.

Budget for a Declining Nation

In many ways, we have a budget for a declining nation. Regardless of one's stance on the value of short-run stimulus during or immediately after a sharp downturn, we all agree that the long-run budget is way out of balance and that the related high debt levels threaten our nation. I'm not here to talk about deficits per se, but I do wish to make clear that deficits are merely symptoms of a larger problem that does affect

mobility: how our spending and tax policy attempts to control the future, but not in ways geared toward promoting mobility or meeting unknown future demands.

Even if we would bring our budget barely to a state of sustainability—a goal we are far from reaching right now—we're still left with a badly allocated budget oriented with at least two closely related long-term threats for both growth and mobility:

- ever-smaller shares of our tax subsidies and spending devoted to children, and
- ever-larger shares of tax subsidies and spending devoted to consumption rather than investment, almost no matter how defined.

Each of these trends negatively affects both absolute and relative mobility. To be clear, these issues are not part of the classic liberal-versus-conservative debate over size of government. For the most part, they arise more from the ingredients we put in our federal budget pie rather than its absolute size.

Spending for children and investment has been on the operating table for quite some time. Take almost any projection of where the budget is headed —for instance, the budget that President Obama proposed in March 2012. Looking out several years beyond the recent recession, its largest proposed long-term spending increases were not for education, or research or infrastructure, or any other investment that might pay off in higher living standards down the road. It was for interest on the debt that earlier generations and the recession had run up, and for retirement and health programs—the non-child portions of Social Security, Medicare, and Medicaid—that are slated to grow much faster than our incomes essentially forever.

In simplest terms, we're on track to spend about $1 trillion more annually in about a decade, if economic growth comes somewhere back toward normalcy and our incomes and revenues grow apace. Yet federal government programs that might promote mobility, such as education and job subsidies or programs for children, would get nothing at all or decline in real terms. Right now, these relative choices are reflected in both Democratic and Republican budgets.

Discouraging Work, Saving, and Other Behaviors That Promote Mobility

A difficult and controversial aspect of any social welfare budget is its disincentives to work and save. One of the main ways that part of the population rises in status relative to others is that it works harder and saves a higher portion of the returns on its wealth. Think of a simple case where a richer household has greater human and financial capital than a poorer household. How does the poorer household rise in relative status? It either must get a higher return on its assets, or it has to increase them at a faster clip than the richer household. We may wish that this weren't the way of the world, but it is. The great success of many immigrant groups in this nation is a testament to the rewards for hard—sometimes very hard—effort.

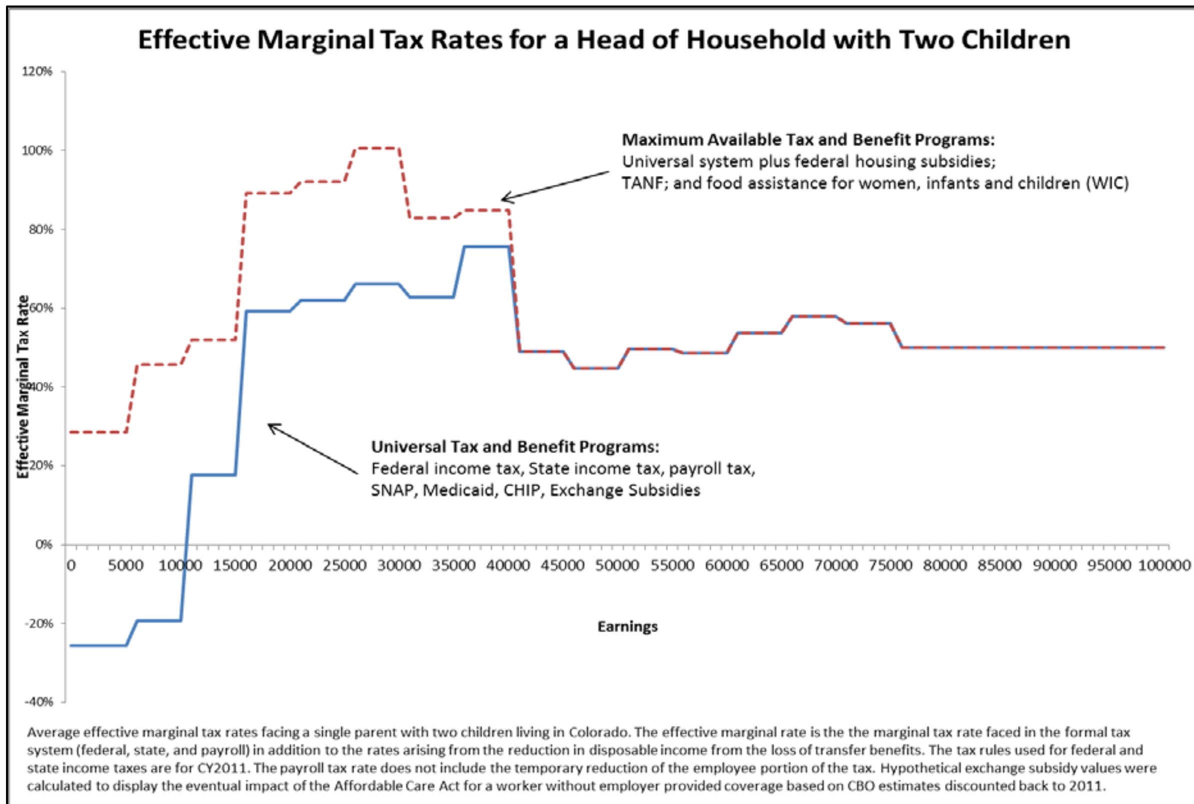
Tax and spending policy can help or hinder that effort. Higher levels of welfare are more likely to discourage work, for instance, than are higher amounts spent on education or job subsidies, although these, too, must be carefully designed. This is especially true after a base level of consumption is established—for example, after a nutritional diet and good preventive health are established. Some effects

can be quite unintended. For instance, as health costs rise, lower-income families face greater disincentives for work since a larger portion of their paycheck might go to buy health insurance they could otherwise receive from government programs.

One way to look at the disincentives facing lower-income households is to consider the effective tax rates they face, both from the direct tax system and from phasing out benefits from social welfare programs. Right now our combined tax and spending systems encourage labor force participation up to about the poverty level. After that, low- to moderate-income households often face marginal tax rates of about 50 or 60 percent if they participate in universally available programs like SNAP (formerly food stamps), the EITC, and the new exchange subsidies, while some households face rates of 80 percent or higher if they participate in programs with limited enrollment, like TANF or housing subsidies.

Figure 1 below comes from a recent testimony before two Ways and Means subcommittees, where more detail is provided. The figure shows the effective marginal tax rate that derives from income, Social Security, and state taxes, combined with the phase-out of various benefits. As can be seen, tax rates begin to spike somewhere above $10,000 or $15,000. Also, the Urban-Brookings Tax Policy Center and the Urban Institute's Income and Benefits Policy Center have just released a net income change calculator that anyone can use to measure the rate facing many different types of low-income households in all 50 states.[1]

Figure 1



Average effective marginal tax rates facing a single parent with two children living in Colorado. The effective marginal rate is the the marginal tax rate faced in the formal tax system (federal, state, and payroll) in addition to the rates arising from the reduction in disposable income from the loss of transfer benefits. The tax rules used for federal and state income taxes are for CY2011. The payroll tax rate does not include the temporary reduction of the employee portion of the tax. Hypothetical exchange subsidy values were calculated to display the eventual impact of the Affordable Care Act for a worker without employer provided coverage based on CBO estimates discounted back to 2011.

Promoting Mobility

When it comes to the budget for mobility programs, the story is more complicated. Unlike the children's and investment budgets, portions of which can affect mobility and are scheduled for fairly significant decline, the mobility budget is not so foreordained. A few years ago, I led a team of researchers in a study for the Pew Economic Mobility Project[2] that examined whether our tax and spending programs were aimed at promoting mobility.

We looked at both federal government spending and tax subsidies,[3] and we separated them into three categories: (1) those designed at least partly to promote mobility through subsidies for private education, saving, investment or work; (2) those designed to boost consumption and maintain income (e.g., Social Security, Medicare, cash welfare, or Supplemental Security Income); and (3) those designed largely to promote public goods (e.g., highways).[4]

As it turns out, a sizable slice of federal funds goes to programs that arguably try to promote mobility. In 2006, about $212 billion (or 1.6 percent of GDP) in direct spending, and another $534 billion (or 4.1 percent of GDP) in tax subsidies, went to programs at least partially designed to promote mobility (Table 1).[5] That translates to about $7,000 on average per household in America in 2006 and perhaps $8,000 today.

Unfortunately, 72 percent of this $746 billion, or $540 billion, comes mainly through programs such as tax subsidies for homeownership and other saving incentives that flow mainly to middle- and higher-income households. In absolute dollars, the subsidies increase on average as the household's income increases. These vehicles often provide little for lower-income households or exclude them completely. Only about 28 percent comes through programs that favor lower- to moderate-income individuals, such as the earned income tax credit.

Table 1. A Very Approximate Distribution of Mobility Spending between Lower-Income and Higher-Income Households, 2006 (billions of 2006$)

	Lower-income	**Higher-income**
Employer-related work subsidies	$ -	$242.4
Homeownership	$3.0	$154.5
Savings and investment incentives	$ -	$104.3
Education and training	$53.3	$34.0
Child health and nutrition	$72.7	$ -
Work supports	$57.6	$ -
Other child well-being	$15.4	$ -
Business incentives and development	$0.2	$5.3
Citizenship services	$2.3	$ -
Equal opportunity services	$0.7	$ -
Total	***$205.2***	***$540.4***

Source: The Urban Institute, 2007. Estimates developed using the *Budget of the United States Government FY2008*, CBO's *The Budget and Economic Outlook: Fiscal Years 2008-17*, and *Health Care Financing Review 2005*.
Notes: Spending on mobility includes programs aimed at least partly at increasing the acquisition of private income and assets, including human capital and education. Mobility spending and income maintenance spending include tax expenditures (tax provisions that increase net income by reducing tax liability). As tax expenditures are not strictly additive, all totals should be regarded as approximate.

Moreover, some of these programs inflate key asset prices such as home prices. That puts these assets further out of reach for poor or lower-middle-income households, or young people who are just starting their careers. Thus, programs not only neglect the less well-off, they undermine their mobility.

Unlike funds for children and investment, most funds for mobility fall into a general category of permanent programs (sometimes called "tax entitlements") that avoid the budget squeeze. But the scheduled increases in the cost of these subsidies aren't allocated any better than the subsidies already in place. Thus, the largest of these mobility subsidies (such as the tax deduction for mortgage interest to promote homeownership) are designed to grow automatically over time, regardless of changes in national priorities and needs. Most of this growth, just like the base level of subsidies provided, does not benefit households of modest means.

A Note about Current Opportunities to Promote Better Homeownership and Pension Policy

The median wealth household accumulates assets over a lifetime mainly in two ways: paying off mortgages, and having a steady flow of compensation flowing into pension and retirement accounts. Consider: in a typical year, someone with an initial mortgage of $100,000 ends up saving thousands of dollars in real terms in the first year alone. Similar savings occur for a worker who has at least a small percentage of earnings put aside every year into pension and retirement accounts, where the returns on such saving compound over time.

Outside education and early childhood health, if Congress wishes to promote mobility of lower-income households, as well as protect the past gains of moderate- and middle-income households that are now threatened, almost nothing succeeds more than putting them onto a path of increasing ownership of financial and physical capital that can carry forward from generation to generation.

Two opportunities, largely neglected in today's policy debates, may be sitting at our feet. I hope you will give them some consideration.

First, rents have now moved above homeownership costs in many parts of the country.[6] Unfortunately, we seem to have adopted a buy high, sell (or don't buy) low homeownership policy for low- and moderate-income households. Not everyone should own homes, of course, but federal homeownership policy seems to discourage ownership at the very times when it becomes optimal.

Second, pension reform is a natural accompaniment and add-on to the inevitable Social Security reform that is around the corner. Private pension reform is not the individual account debate of the last decade, which focused on reallocating Social Security taxes, but about providing greater protection and wealth-building for the substantial portion of our population that has little today.

Such efforts increase intergenerational mobility not simply by adding to assets that can be passed onto children and grandchildren but also by helping inculcate the habits of saving that can carry forward from generation to generation.

Conclusion

The hard future ahead for programs that help children, invest in our future, and promote mobility for low- and moderate-income households does not necessarily reflect the aspirations of our people or of either political party. Instead, the automatic features of our budget increasingly favor

- end-of-life support over beginning-of-life support — that is, more support to help each person retire early and consume than to help the next generation build productive lives;
- consumption over investment, including social consumption (Social Security, Medicare, and food assistance) over social investment (children's health and education); and
- for poor and moderate-income households, adequate consumption, especially for those who do not work, but exclusion from mobility-enhancing programs.

I should be clear. I am not making a judgment that programs that promote consumption or that provide public goods are without merit. Nor am I claiming that every government program that at least partially intends to promote mobility is effective. I simply note that the ever-increasing emphasis on consumption and adequacy has come at no small costs to programs that might be more likely to promote mobility.

Similarly, though I do note that most mobility programs generally are not available to low- and moderate-income households, I am not claiming that government neglects them. I am simply noting that it often serves these households in ways that do little to promote mobility and sometimes work against it.

There are limits to how much government generally, or the Senate Finance Committee more specifically, can do to increase intergenerational mobility. However, a good place to start would be to do just as you are doing today: consider how well the automatic growth in many types of tax subsidies, as well as other programs under its jurisdiction, promote or hinder such mobility.

Notes

[1] The Urban-Brookings Tax Policy Center and the Urban Institute Income and Benefits Policy Center have collaborated with governments and foundations to produce a net income calculator (NICC), which can be found at http://nicc.urban.org/netincomeCalculator/. It allows individuals to generate a state-by-state analysis of tax and transfer benefits available to individuals and families as income, weekly hours, wage levels, and program participation varies. The calculator does not currently include a calculation for various health care programs, in part because of the complex issues related to their valuation. Nonetheless, it is especially useful in developing specific state data for those who are interested.
Initial development of the NICC was funded by the Annie E. Casey Foundation as part of the Low-Income Working Families Project. Funding for the update of the 2008 rules was provided, in part, by HHS/ASPE. Additional funding came from the John D. and Catherine T. MacArthur Foundation. NICC's development built on an earlier tool, the Marriage Calculator, developed at the Urban Institute under contract with HHS/ACF. NICC's calculations are performed by an adapted version of the TRIM3 microsimulation model. The standard version of TRIM3 is funded and copyrighted by HHS/ASPE and developed and maintained by the Urban Institute. My colleague and I are

further working with the TRIM3 model to try to determine just how many households are subject to these high rates, which depend upon both family structure and participation levels.

[2] For more information on this project, see http://www.pewstates.org/projects/economic-mobility-project-328061.

[3] Because these tax subsidies are not formally in the expenditure budget, but operate very much like expenditures, they are sometimes labeled tax expenditures.

[4] The distinctions between mobility versus consumption and individual versus public goods are, like all budgetary classifications, somewhat blurred. No judgment was made that any particular purpose was without value. Budget classifications, however, help us sort out and account for the nation's established priorities—particularly in this case to tease out how much of the federal budget is directed toward improving individual economic mobility.

[5] Adam Carasso, Gillian Reynolds, and C. Eugene Steuerle, *How Much Does the Federal Government Spend to Promote Economic Mobility and for Whom?* (Washington, DC: The Urban Institute, 2008), http://www.urban.org/publications/411610.html.

[6] Robert I. Lerman, C. Eugene Steuerle, and Sisi Zhang, *Homeownership Policy at a Critical Juncture: Are Policymakers Overreacting to the Great Recession?* (Washington, DC: The Urban Institute, forthcoming).