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INNOVATIVE IDEAS TO STRENGTHEN AND EXPAND THE MIDDLE CLASS

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INNOVATIVE IDEAS TO STRENGTHEN AND EXPAND THE MIDDLE CLASS

THURSDAY, MARCH 13, 2014

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

The hearing was convened, pursuant to notice, at 10:09 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Ron Wyden (chairman of the committee) presiding.

Present: Senators Stabenow, Carper, Brown, Bennet, Casey, Warner, Hatch, Grassley, and Thune.

Also present: Democratic Staff: Adam Carasso, Senior Tax and Economic Advisor; Joshua Sheinkman, Staff Director; Michael Evans, General Counsel; Laura Berntsen, Senior Domestic Policy Advisor; and Todd Metcalf, Chief Tax Counsel. Republican Staff: Mark Prater, Deputy Staff Director and Chief Tax Counsel; Chris Campbell, Staff Director; Jeff Wrase, Chief Economist; Preston Rutledge, Tax Counsel; and Jim Lyons, Tax Counsel.

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The Finance Committee will come to order.

A century ago, shortly after the Ford Motor Company introduced its Model T, Henry Ford shocked the business world by increasing his workers' pay to $5 a day. It was more than double the going rate, but Ford knew it would guarantee he would have the best workforce in Detroit. It also meant his employees could afford to buy the cars that they built with their own hands. It ensured that they could own homes, send their kids to schools, and accumulate wealth.

It was the birth of the middle class in the United States. And in the 100 years since then, that middle class has defined the strength of America. Yet today, the middle class is under siege. In spite of the work ethic, ingenuity, and productivity of millions of Americans, globalization, technological change, and flawed tax policies have contributed to a steep decline in manufacturing jobs and wages.

Since 2000, employment in manufacturing has dropped by nearly a third, and those same forces are putting pressure on service industries. The portion of our economy made up by wages and salaries, the lifeblood of the middle class, is now at the lowest level on record, leaving many hardworking families struggling from paycheck to paycheck. And because consumer spending drives 70 percent of the American economy, that is a prescription for slower economic growth.

Today, this committee is going to begin, on a bipartisan basis, a drive to develop policies that get more Americans inside the middle-class winner's circle. And we need to focus on this, because the alternative is unacceptable. If working families fall further behind now, fewer will be able to climb America's ladder of economic mobility and secure better futures for their kids.

As those who fight our wars, educate our children, and hold our communities together, the middle class deserves better. I believe this committee, working on a bipartisan basis, has the ability to produce policies that can help buck those trends, build new pathways into the middle class, and expand the winner's circle for all.

And here are just several ideas for getting started. First, America has to find fresh policies to improve education and lifelong learning and use them as springboards to economic opportunity. It is critically important that our students not only have access to higher education, but also the ability to prosper once they have gotten in the door.

Senators Warner, Rubio, and I have offered a bipartisan proposal that would get up-to-date and accurate information to students, allowing them to compare schools and programs based on completion rates, debt, employment, and earnings.

With today's technology, it seems almost unbelievable that students are being denied access to that information. And, in addition to that step, additional efforts need to be launched to improve the rigid structure of Federal aid so that students can put that information to good use.

It has been said that one of the best ways to raise wages for the middle class is to have businesses compete for skilled, educated workers. Our bipartisan bill helps promote that.

Any effort to improve education also has to include people outside the school system, such as workers who want to learn new skills and find unique pathways to new careers. In my home State, I often talk with small business owners who want to hire carpenters or electricians, but cannot find people with the skill sets that are needed. So there is real potential here for apprenticeships to help bridge that gap as a pathway to the middle class. Our colleague, Senator Cantwell of Washington, here on the committee, has done good work on this issue, and I look forward to bipartisan efforts to partner with her on that.

A second boost for the middle class would be finding policies that encourage people to save and especially get started saving early in life. I have been struck by the interest conservatives and liberals have shown in creating child savings accounts, and I am interested, again, in working with colleagues on both sides of the aisle to explore that.

What is indisputable is that giving everybody in America the opportunity to save and get ahead—and especially those who are struggling today—is something that will help sustain and expand the middle class.

Our third focus is going to be retirement security. Too often, our families save money for a lifetime only to have it wiped away by chronic conditions like diabetes, cancer, and heart disease. Millions of Americans of all generations suffer from these conditions, and it is not just the government that bears the cost.

I have been pleased to partner with Senator Isakson of Georgia, another outstanding member of this committee, to come up with a bill that would bring health care providers together to keep these chronic care patients as healthy as possible in their homes and in our communities.

Fourth, steps ought to be taken to make the tax code more friendly to the middle class and not put up barriers to its growth. Right now, a nurse who is married to a police officer in Medford, OR could be paying a higher tax rate than someone who makes a living entirely off investments. Any tax reform plan needs to narrow that gap.

Over the years, I have had a bipartisan proposal with Senator Gregg, Senator Begich, and Senator Coats, and we would do just that. And, on a bipartisan basis, we have sought to triple the standard deduction to put more money into the pockets of our families.

A bedrock principle for tax reform ought to be to give the middle class and everybody else in America the chance to get ahead. Right now, despite good intentions, it does not always work that way. Take, for example, the child and dependent care tax credit. Because of the way that credit is structured, a young family just starting out might not get any meaningful benefit. Even with a meager level of assistance, child care could still be unaffordable, and a parent might have to sacrifice a career to stay at home. It is an obvious flaw in tax policy that, again, prevents our families from climbing up America's economic ladder.

Our people have proven time and time again that they are an almost endless fountain of ingenuity and innovation. American ideas and the businesses built on them have transformed the world.

Mr. Packer, who will be here with us shortly, writes about Americans like Dean Price and Peter Thiel, who want nothing more than to build a business from the ground up and nourish its growth. Our tax code should create a pathway for innovators and entrepreneurs and not erect barriers to their success. Millions of Americans dream of being the next Elon Musk or Mark Zuckerberg, and our focus should be on policies that lay the groundwork for bringing those dreams closer to reality.

And too often, tax policies that should encourage innovation and entrepreneurship do not deliver. Far too often, conversations about tax reform focus on the big businesses, the big, successful businesses, and ignore the rest. But economic growth and the jobs that follow so often flow from our small businesses. So, as this committee continues to consider the best ways, again, on a bipartisan basis, to fix this broken tax code, let us ensure that young startups and green-shoot entrepreneurs have the opportunity to succeed.

Working taxpayers, I would also point out, face an obvious double standard with respect to enforcement of the tax law. It is more likely that people working their way out of poverty will have their Earned Income Tax Credits reviewed and denied than wealthy tax-dodgers will have their tax shelters audited.

Finally, the government has an obligation to maintain and strengthen the social safety net. The promise to hardworking

Americans ought to be twofold. Just as it helps them climb into the middle class when times are good, let us also take steps to prevent our people from falling into poverty needlessly when times are bad. That means boosting the minimum wage, extending unemployment insurance, and updating the workforce programs that connect our people with the jobs of the future.

The safety net needs to be strong and modern in order to sustain a thriving middle class. The best way to reinvigorate the American economy is with a thriving, educated middle class that can find good-paying jobs, afford homes and cars, and be able to accumulate wealth over a lifetime. That is the ideal Americans have aspired to since, in effect, the middle class was born in Detroit a century ago.

Our challenge is to take the policies I have mentioned—education, savings, retirement savings, taxes, and a strong safety net—and come together as a committee and help retool these policies into a stronger economic engine for lasting economic prosperity.

I am going to turn it over to Senator Hatch now. I also want to thank our panel. We have a superb panel of witnesses. And, Senator Hatch and Senator Grassley, both of whom I have had the pleasure of working with often, I look forward to pursuing innovative ideas with you on these issues in a bipartisan way.

[The prepared statement of Chairman Wyden appears in the appendix.]

The CHAIRMAN. Let me recognize Senator Hatch.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. I do want to thank you for holding today's hearing. I also want to thank our witnesses for being here. It is really important that you took time out of your busy schedules to be with us and help us to understand these issues better.

Now, this hearing is on ideas to strengthen and expand the middle class, and focusing on the middle class is, of course, always a safe political landing spot. A host of surveys reveals that many Americans see themselves as residing in the so-called "middle class," including those who, to an outside observer, would appear to reside elsewhere.

That being the case, when politicians say they are working for the middle class, there is clearly a large constituency. Yet I do not believe that the motivation for today's hearing is politics or class warfare, at least I hope that is not the case, and I am quite sure it is not, with our distinguished chairman. The motivation, I trust, is to explore the evolution of middle-income families in America over the past few decades, to discuss what can be done to enhance their prosperity in the future, and to find ways to allow lower-income Americans to climb into the middle class or beyond.

There are two ways to analyze the condition of middle-income Americans. One way is to cherry-pick economic data that conform to the policy or political points that one wants to make without checking to see if the position is also supported by other evidence. The other way is to analyze data to see if they are consistent with one's position and to compare the findings with different measurements, datasets, or economic models.

If you are only interested in making a political point, you are likely to choose the first option. But if you really want to see what is happening with the middle class, the second option is the better one.

I mention this because, in debates concerning things like inequality and middle-class incomes, people often tend to choose the first option, utilizing only the data that confirms their preconceived notions. For example, if you try to measure median income using a measure that is pre-tax and pre-transfer, and with the tax unit as the unit of measurement, you find growth of only around 3 percent between 1979 and 2007, which is consistent with the common claims of middle-class stagnation.

However, if you look at post-tax, post-transfer income data that includes valuation of health insurance benefits and take a size-adjusted household as the unit of measurement, you find that, over the same period, median income has grown by close to 40 percent, which is decidedly less stagnant. There are similar measurement issues when it comes to data commonly used to analyze income inequality.

Mr. Chairman, I know that I make these observations at great risk of being accused of denying stagnation, inequality, or any number of struggles facing the middle class. However, given what I think is the spirit of this hearing, I believe that we should fully examine the issues and measures surrounding the middle class, including income growth and income inequality. That is the only way we can get to the heart of the problems that exist. And we should be addressing these problems, and we should be addressing what our priorities should be.

Mr. Chairman, I can point to positive examples very close to home. The latest data from Harvard's Equality of Opportunity Project ranked Salt Lake City as the number-one city in America in terms of upward mobility.

Keep in mind that, in terms of policy, the vast majority of Utahans support a vibrant private sector. We seek lower taxes, individual responsibility, and less intrusive government, and we take a backseat to no one in terms of caring for the less fortunate in our communities. The means by which we care for the less fortunate is, by and large, through strong charitable institutions. I think Utah's story is instructive on what we can do to help grow the middle class.

Finally, Mr. Chairman, I must say that, while there has been a lot of rhetoric in recent years about the middle class, I believe that the Obama administration's focus has been misplaced and that its policies have actually been hurting the middle class. Four and a half years after the end of the recession, economic growth remains sluggish, and the labor market remains depressed. Yet, in all that time, what has the administration been focused on?

We have seen a massive expansion of our national debt due to policies like the failed stimulus. What little deficit reduction we have seen has been, by a factor of 9-to-1, due more to increased taxes than reductions in spending. And to date, the administration is unwilling to do much of anything else unless there is yet another tax hike attached.

We have seen the effort to pass and implement the Affordable Care Act, which further increased taxes and health care costs for middle-class families and is, according to the Congressional Budget Office, having an adverse impact on labor market incentives. We have seen a vastly expanded Federal bureaucracy through the Dodd-Frank Act, which has failed entirely to address known significant contributors to the recent financial crisis. And we have seen a regulatory effort from the EPA to the Department of Labor to the NLRB that has imposed costs on American businesses that will surely be passed along to employees and consumers in the middle class.

I do not see a laser focus on job creation or growing the middle class anywhere in these policies.

Now, Mr. Chairman, if we are serious about helping and expanding the middle class, and I think we should be, it needs to be more than just a slogan. Sadly, I believe that over the last 5 years, the talk about helping the middle class has not translated into policies that would actually do the job.

I look forward to working with you, Mr. Chairman, to explore other ideas that will lead to a strong middle class and an economy with robust growth in jobs, private investments, and prosperity for all American families. And I think you are on the right track in raising these issues, but I hope that today's hearing will provide us with some insights on how we can do better. I appreciate your efforts in having this hearing and creating this dialogue and discussion that I think may be very beneficial to our country.

The CHAIRMAN. Thank you, Senator Hatch. I thank you for your kind words about me. And without making this a bouquet-tossing contest, let me just say how much I have appreciated your leadership on several of the issues that really undergird this topic.

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

The CHAIRMAN. As you know, we have the CHIP bill for our kids coming up. That would not have become law if it were not for your leadership. And the reality is, every year in America, there are millions of visits to community health centers now that are not costing taxpayers an additional penny because you are willing to work with me on a bipartisan basis to get those community health centers out from under needlessly excessive liability costs.

So I thank you for it, and I appreciate having you and Senator Grassley and Senator Stabenow here. We have worked together in a bipartisan fashion in the past, and we are going to do so again.

We are going to call a little bit of an audible, since Mr. Packer is still on the train, and I thought we might begin, if we could, with you, Ms. Swonk. You are the chief economist and senior managing director of Mesirow Financial, and I think it would be ideal if you could, in your testimony, give us a sense of the lay of the land, the challenges for middle-class people.

We have an excellent panel. And why don't we begin with you, Ms. Swonk?

STATEMENT OF DIANE SWONK, CHIEF ECONOMIST AND SENIOR MANAGING DIRECTOR, MESIROW FINANCIAL, CHICAGO, IL

Ms. SWONK. Thank you so much for having me here, both Chairman Wyden and Ranking Member Hatch. I am honored to be here with my colleagues, who have incredible expertise behind them, and, looking over their testimonies, I am humbled and, again, honored.

I really thought what I could do best and most prudently in this hearing is to provide some sense of the direct result of the Great Recession and the subpar recovery that followed on the middle class, and where I think things are likely to get worse before they get better with regard to income inequalities and the potential for growth in the United States.

I will not read any notes I have, because I am dyslexic. So I apologize in advance for that. I also flip numbers. So I will try not to——

The CHAIRMAN. God has a special place in Heaven for those who do not read their statements. [Laughter.]

Ms. SWONK. There you go. It means that sometimes things come out of my mouth that probably should not, as well, but I am sure you are all familiar with that too.

The crisis has revealed and exacerbated income and wealth inequalities and set in motion some shifts that I think, if unaddressed, are likely to compound the problems and undermine potential growth in the U.S. economy.

We have seen substantial healing in the aggregate in credit markets. We have seen things like the debt-to-income ratio get down to 2003 levels, which is a great improvement, prior to the housing market boom, but still well above the already-elevated levels of both the 1980s and 1990s, which were both debt decades for the U.S. consumer.

We have seen debt service burdens and debt financial obligation ratios fall to record lows in recent years, although I would argue, and the data supports it, that we have seen homeowners more than account for all that improvement as they have restructured their debt either by force or by choice. And, on the flipside of it, renters have seen an increase in their financial service burdens. And, as we know, we have seen more people move into the rental category in recent years, and I think that is going to continue. There are reasons for that, but it is something that disturbs me all the same.

Wealth, net worth, has hit new highs both in absolute and nearly relative terms. Of course, that is concentrated, depending on what studies you look at, in the top 7 percent of households, while the bottom 93 percent are still trying to regain ground lost to the Great Recession.

Now, home values have come back, but not to the previous equity we held in our homes prior to the housing market bust; not that that is what it should be, but clearly people measure themselves on a relative basis.

Also, median income, as you noted—there are problems with the data—has stagnated and declined since 1999 and continues to decline. I think there are some real issues in that, although I do recognize, Senator Hatch, your important issues on data, and I will address those in a minute.

One of the things that also is very important is that income inequalities within the top echelons of income have also intensified. And you are seeing in many areas what would be considered very high income households actually having to pay up and compete with the uber-wealthy in the .01 percent, say, and they are finding that their pace of spending has slowed and their living standards have been compromised.

So “middle-income” is kind of a relative term. I am always amazed at people who think they are middle-income where I would look on the numbers charts and say, “Boy, you are at the very top, in the top 5 percent or at least the top 10, if not the top 1.” But it is interesting to see how those stresses are distributed.

I would also argue—and this is one of the more important issues—that the stresses that these households are seeing are being intensified. Student debt is one of my greatest concerns, something I have been noting for many years, the rapid rise in student debt. I followed consumer credit markets and the banking industry—thank God, I am out of it now—for 19 years, and I was in the middle of it, and I watched this happen. And I warned people that the best way to die is in debt, and that was the incentive, because they died above their means, living above their means their whole lives.

And now we have student debt as the fastest-growing component of consumer debt, with default rates at 11.5 percent, which grossly understates the defaults. Now, some of this is because some of those students—and you noted them earlier, Senator Wyden—many of these students should not have gone to college or did not know what their earnings potential was.

They turned around and tried to sue their colleges because they could not earn enough to pay for it when they came out. Also, a lot of these people maybe should not have been in college in the first place, but they were given access. They should have been in training programs or in what I consider more 18-month training programs with community colleges. Where the labor shortages are now, particularly in construction, that is a difficult thing to do, because the employers are very diverse and cannot pair up with community colleges to create the kind of apprenticeship programs that are necessary.

I also think it is very important—we talk a lot about labor force participation. And a lot of people want to discount this, but when it comes to our young people, labor force participation rates have fallen precipitously, and not just on the soft skills among our teenagers. I do worry about my own daughter, who is 19 years old and in college right now. She has had unpaid positions, which I encouraged her to do, but not many paid positions. She thinks she can go out and earn a good paycheck. She wants a good job with good hours. I say, get in line, there are another 115 million people in the labor force, but anyways——

I think it is important, this decline in labor force participation among, not just teens but those into their 20s, what I call our learners and our earners, those who are 35 to 44 years old. We are losing people in that bracket. And guess where they are living? They are living at home with their parents in multigenerational households. Some research by the Pew Research Institute suggests it is the worst situation since 1940 on multigenerational families living within a household, causing economic stresses there, with many people not fully employed and grandparents taking care of their grandchildren, as well as their adult children.

Over 31 percent of 18- to 34-year-olds are currently living with their parents. Again, the data is a little bit elusive on that, because some of those people are just still in college. They are not actually living at their parents' home continuously, but their parents presumably are having to deal with the overhang of that debt.

The result has been dramatically reduced pools of both current and future first-time home buyers and vehicle buyers. And why is this so critical? In January, first-time home buyers, as existing home sales plummeted, that was not the weather in January.

The important point is that we are seeing that these people are diminishing the current pool of first-time buyers, just 26 percent in January. Forty percent is the norm on the existing home market. Without first-time buyers, you do not have trade-up buyers to trade up. They cannot sell their home to trade up. You do not have churn in the housing market, and you also do not have the path to saving and wealth that has been long considered the American dream. I hate to use the term. It is a little trite. But let us face it, we are losing some of the pathways that we once saw to generating wealth and saving in the United States, which means we are undermining the actual backbone of our future and potential growth going forward.

I will end my comments. I know I speak quickly, but I know that I also am longer-winded on time. You give an economist a minute, we will take 10, and I am supposed to take 5. I apologize.

But we have seen an extraordinary bifurcation of consumer spending in the United States. Initially in the Great Recession, nobody escaped. Everybody was hit, and we saw consumer spending across income strata and across business lines hit all the way across the board, and an extraordinary migration down what I call the retail food stream. Now we see divisions, the hollowing out of what were previously middle-market retailers. We are now seeing more and more middle-income households searching for value and not allowing any price increases.

One of the most disturbing trends is the pooling at the very top. Actually, as I came here yesterday through O'Hare and all the delays that were present because it snowed in Chicago—of course, they do not know how to deal with that there—one of the things that came through on my e-mail was a bubble in the luxury market, that everybody is trying to feed off of this very small percentage and very small number of consumers, and they have bid up these prices very high.

In the rest of the economy, you are not seeing any pricing power. And one of the things that I find most striking is sales in grocery stores. Today's retail sales data showed we have seen some weakening, particularly since some of the food subsidies have been lifted as well, but some weakening in spending at grocery stores.

There is a difference between the cost of healthy and hungry spending. It strikes me that during the polar vortex, which I lived through and you had to live through here, some of the biggest worries were about children missing their one meal a day that they were going to get in school and, also, those people who use school as day care who could not work.

I believe weather has redistributive effects. But clearly those waitresses and waiters and people who are hourly who are getting the influx of people migrating rather than hibernating from the cold weather to ski resorts and sunny locations are not the same people losing it, as those are the people who lost it to the weather in this particularly harsh winter.

But the issue in grocery stores, I think, really does highlight this. Dominick's, a mid-market store chain in Chicago, went bust. Mariano's, which wants to be the new Nordstrom's of the grocery world, is growing right now. I have my doubts. Whole Foods has seen increased competition. You are going to see a lot more competition at the high end as well. And what you are seeing is the lack of pricing power at the low end, which is exacerbating the slowdown in inflation, which some would say is welcome. But if it becomes deflationary, that is a spiral we do not want to get into in any way.

The CHAIRMAN. Ms. Swonk, I am reluctant to stop you, because I think not only has this been good, but you are going to probably get conscripted to come before a lot of other committees, because it has been that good.

Could you perhaps——

Ms. SWONK. I have a last sentence, and I will finish it up.

The CHAIRMAN. Great.

Ms. SWONK. I apologize. I told you, if you give me a minute, I do not keep time either. I apologize.

The CHAIRMAN. It has been terrific.

Ms. SWONK. My greatest concern, as I have outlined, is that—well, I will end it on a personal note. My son is 16 years old, and I live in a highly income-diverse area. He has not bought a pair of shoes in 2 years—he is 16 years old—because his friends, who are in his honors and AP classes, cannot afford a pair of shoes, and he will not buy a pair of shoes until they can. He has grown 6 inches in those 2 years, thankfully, not in his feet. Kind of like puppies growing into their feet.

But I think the narrative of the Hartzell family that we are going to hear from Mr. Packer is, unfortunately, going to be more the norm than just a narrative going forward. And, if we do not get the money to support our statistical agencies, you are going to kill the messenger as well.

The CHAIRMAN. That was a really superb way to help us get this started, and, particularly, your message is something that I think is going to appeal to elected officials of both parties, and I appreciate it.

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

The CHAIRMAN. Mr. Packer, if you are not out of breath, because I know you have sprinted here, I think it would be very helpful to have you follow Ms. Swonk, who has really given us an overview of the challenge of Americans trying to climb the economic ladder.

Are you sufficiently situated there and not out of breath? Can we go to you next?

Mr. PACKER. Ready to go, Mr. Chairman.

The CHAIRMAN. We look forward to your testimony, and your book is spellbinding. And having a spouse in the bookstore business, I know a little bit about the challenge of writing books, and we commend you, and we are glad you are here.

STATEMENT OF GEORGE PACKER, STAFF WRITER, *THE NEW YORKER* MAGAZINE, AND AUTHOR OF "THE UNWINDING: AN INNER HISTORY OF THE NEW AMERICA," BROOKLYN, NY

Mr. PACKER. Thank you, Mr. Chairman. I apologize for being late. It was Amtrak's fault, not mine.

Chairman Wyden, Ranking Member Hatch, and members of the committee, I am honored to have been asked to testify before the Senate Finance Committee today.

I am a staff writer at *The New Yorker* magazine, and last year I published a book called "The Unwinding: An Inner History of the New America." I conceived it as a 30-year history of the political and economic upheavals that have transformed America during my adult lifetime.

I might have added another policy book to the long shelf of such tomes or written a conventional work of American history, but I did not feel very qualified to do either. I am a journalist, and I wanted to write about this generational change through the lives and stories of a handful of unknown Americans in some of the more forgotten corners of the country. So, from 2009 to 2012, I spent a lot of time in the Piedmont region of North Carolina, in Youngstown, OH, and in the unincorporated subdivisions around Tampa Bay.

Here is what I learned from some of the people with whom I spent many weeks and months. First, everywhere I went, I heard again and again there is no more middle class here. There is just rich and poor. Even if this was not statistically true, it felt true to the people I talked with.

The disappearance of jobs in manufacturing, small-scale agriculture, and construction, depending on where I was, has been going on for a long time, since the late 1970s in the case of the steel industry in Youngstown. And any long-term trend can begin to seem normal and even becomes unnoticeable.

But the financial crisis and the Great Recession seemed to focus people's minds on how far things had gone. I remember walking along Main Street in Madison, NC with Dean Price, the son of tobacco farmers and a native of the area.

He had grown up thinking of himself as middle class, but just about every store he had known as a kid was closed down. And he said, "If you think about it, the people who ran the hardware store, the shoe store, the little restaurant that was here, they were the fabric of the community. They were the leaders. They were the Little League baseball coaches. They were the town council members. They were the people everybody looked up to. We lost that."

How many Madison, North Carolinas are there around America? When you leave the more prosperous areas of the country, it becomes almost routine to see deserted Main Streets in town after town.

In Rockingham County, NC, population 93,000, three Walmarts opened up in one 6-month period a few years back, with almost 10 applicants for every position, which paid an average of $16,108 a year. Those were just about the only jobs available to workers who had once held manufacturing jobs in the textile mills and furniture factories before those moved overseas.

Dean Price told me that with the housing bust, a lot of people in his area had to choose between paying the mortgage and putting gas in the car to drive ever longer distances to ever lower-paid work.

Again, this is not the exceptional case. It felt closer to the norm. It is the economic success stories that we hear about so much in the media in Silicon Valley and on Wall Street that felt more like the exceptions. As Dean Price said to me, how many investment bankers and software designers are there around the country? Then think of how many farmers.

The second thing I kept hearing was that the game is rigged. People who were trying to play by the rules found that no matter how hard they tried, they could not get out of debt or lift themselves out of an impoverished life, while they watched more fortunate people with the right educations and connections pull away, be granted second or third chances, even get away with murder.

I heard this from people of all races, backgrounds, and political views. And, while they had different explanations and placed the blame in different ways—some blamed big business, some blamed big government, some blamed Wall Street, some blamed all of you—this widespread cynicism struck me as a dangerous sign about the health of American democracy. The idea that hard work and effort can lead to better prospects for one's self and one's children is at the heart of the American dream. It is one thing to read statistics about income inequality and social immobility. It is another to see the dream vanishing in the minds of ordinary Americans.

For example, in Tampa, I met the Hartzell family, Danny and Ronale and their young kids, Brent and Danielle. Danny worked as a welder, then at a packaging plant, but when those blue collar jobs disappeared with the recession, he spent months looking for work, with no luck. Then the Hartzells' daughter, Danielle, was diagnosed with bone cancer, and the parents put all their energy into her treatment and recovery, made possible by the charity of local hospitals.

Finally, Danny got a job stocking produce at Walmart for $8.50 an hour, which, because the store had him working part-time and his hours kept going down, put Danny at about $10,000 a year. Try supporting a family on that. By the end of the month, they had as little as $5 on hand. The only time they had extra cash for any purchases beyond the basics was when they received their Earned Income Tax Credit.

And yet, the Hartzells were not doing any of the things that poor people are rumored to do. They did not drink or do drugs. They obeyed the law. The kids were loving and respectful. The family stayed together through everything, even three periods of homelessness.

The parents continued to put their kids, who bounce between schools and miss out on their education because of the family's instability, ahead of every other consideration. The last time I saw the Hartzells, Danny said to me, "My view on everything? If you want to change this country, you have to put a person in office who has never done it for a day. Put a regular old guy like me, someone who has lived it and never done nothing else but live it."

I think Danny was saying something like "the game is rigged."

The Hartzells have made their share of mistakes, but they are the kind of people who used to do okay in America—not rich, but okay. There was a place of dignity for them in our society.

Today, without good educations or successful connections or other resources, the Hartzells are barely surviving. They feel themselves to be disposable, and it is hard to be optimistic about their or their children's future.

Just last week, Ronale Hartzell e-mailed to tell me that they have left Tampa, where they have lived most of their lives, to try their luck in Orlando. "We just want a little happiness, just a little," she wrote. "We're trying so hard since day one."

How many people like the Hartzells are there in America?

I am not the policy expert in this room. You have heard from others who are. But I have become a sort of expert on the people I wrote about in "The Unwinding." I can tell you that the institutions that used to support the aspirations of middle-class Americans, from Federal, State, and local governments to corporations, banks, public schools, and the media, are no longer seen as positive forces in the lives of the people I spent time with. These institutions are either very distant to the point of irrelevance, or else they are seen as negative.

There is no simple or single solution to this state of affairs, but it is real, it is out there, and every day it corrodes the sense of fairness and opportunity that is essential to our democracy. The people I wrote about do not have lobbyists or trade associations or public affairs firms to represent their interests here in Washington. The only voice they have is yours. For that reason, I hope that the members of this committee will put the Americans I have been describing and others like them at the center of all of the legislative work you do.

Thank you very much.

The CHAIRMAN. Mr. Packer, thank you very much. And I think your testimony is going to help us get that done, get it done in a bipartisan way. And I intend to make sure that those kind of cases, like Dean Price and the Hartzells, really drive home the economic tightrope that these middle-class families are walking, where you just point out how they have to make these choices between different bills, and any big expense literally pushes them off the tightrope altogether.

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

The CHAIRMAN. So thank you. And I know you are going to get questions from Senators here in a few moments. Particularly, I can tell you have a big cold. You faced a late train, and I very much appreciate your——

Mr. PACKER. Sorry for the sniffling.

The CHAIRMAN. No. We are glad you are here.

Dr. Dunkelberg, thank you. Why don't we go to you next? And we have very much enjoyed working with you all at the National Federation of Independent Business, and we welcome your testimony.

STATEMENT OF WILLIAM C. DUNKELBERG, Ph.D., CHIEF ECONOMIST, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Dr. DUNKELBERG. Thank you, Chairman Wyden, Ranking Member Hatch, and members of the committee. I am pleased to be here as chief economist for the National Federation of Independent Business, the leading representative for small business organizations, with over 350,000 members.

I now have been NFIB's chief economist longer than I have been a professor, which is kind of interesting, but I started with them back when I was teaching at Stanford University in 1970. And I retired from teaching a couple of years ago, but I am still the chief economist. So I appreciate the fact that you recognize the importance of the small business sector to the whole issue about the so-called middle class.

There are an estimated 6 million employer firms in the United States, and beyond that, of course, there are tens of millions of other people who make a living individually, like my electrician, Charlie, who, over the past 20 years, I have encouraged from time to time to hire somebody and train them. And he says, in response, "Half of my time would be used up complying with the regulations that I have to deal with if I hire one worker." So he does not hire anyone, and he does not train anyone, because of the regulatory burdens that are out there.

Just to give you some perspective, 25 percent of our members have annual sales under $200,000. That is gross sales. About 70 percent of those sales, on average, go to employee compensation. So we are talking about a $50,000–$60,000 bottom line here. I think that is definitely middle-class. So, not only are the small business owners middle-class people, for the most part, they also provide tens of millions of jobs for middle-class workers.

So an estimated, according to the SBA, half of the private sector workforce works for what they characterize as a small business. So the health of the small business economy is really important to what is happening in the middle class.

If you look at employment today, it is over 1 million below where it was back at the peak in January of 2008, and those people, I think, were probably not from the top 1 percent or even the top one-third. These people were out of the middle class and, of course now, are below that, and just getting a job would help put them into the middle class again rather than being unemployed.

So every 4 years, the NFIB looks at a random sample of its 350,000 members and gives them a list of 75 really important problems and asks, what are the top problems that your business faces; what are the things that are in the way for your growth and hiring?

And I will just share with you the most recent one, which we finished late in 2012. No surprise, top of the list is health insurance costs, number one—lots of confusion and uncertainty there.

Number two, uncertainty about the economy. That is what they told us. They are so unsure about where the economy is going to go, they are not going to bet their money, put their money on the table, and make the kinds of bets that they have to make with their own money. They cannot issue Facebook stock and so on. It is their money, and they are going to be very careful with it.

Number three, energy costs.

Number four, uncertainty about government policy. The Fed, the EPA, health care costs, tax policy, all of these kinds of things are very concerning to them.

The next, number five, is the cost of regulation and red tape, and we have done a lot about that. Keep in mind that the most valuable asset that a small business has is the time of the entrepreneur, the person who thought this up and runs it and makes it happen and creates the jobs, and all this compliance stuff just drains away that most important piece of capital. Not a very good thing.

Six, seven, and eight on the list are: Federal taxes, which take away the capital that small businesses use to grow their business, frequent changes in the tax code, and tax code complexity.

That is the top eight, and then the remainder of the 75 things follow that. So you can get an idea about what that list must look like, and we would be glad to provide that study to you. We have done it for a lot of years now. You can take a look. And I appreciate your focus on the whole tax code issue. It is very, very important.

So, as we look at that, as you look at the menu of possible things to do—you have suggested many. We certainly would like to see things that are more focused instead of comprehensive. That is pretty scary. So we like that, like making section 179 more permanent, because that is bottom-line capital for these firms. Things like that would be very helpful.

Worrying about the banking side, I am the chairman of a little bank in New Jersey. We lend to small businesses, and the complication coming down in the banking system is making my life very difficult. I spend 90 percent of my monthly board meeting worrying about complying rather than how to grow the bank and the business. That is not helpful.

These people are very important to providing capital to the little firms on Main Street, and I worry about the fact that the regulations for these big banks are very important, but to apply them to the small banks is probably not a good idea.

So I think that restoring the vitality to the small business sector is very important. If you look at the BLS data on new business starts, you will see that, of course, not only did we build too many houses in 2003 through 2007, we built too many strip malls, too many restaurants, and we lost a lot of them. And right now new starts are at a very low level relative to where they had been historically.

That is where jobs come from. A lot of new jobs come from just new barber shops, et cetera, that we have to have to help 3 million new people every year who come into our economy.

So I think that that is a very good place for us to go, and I commend you and the committee for the good work you are going to do to help revitalize this source of jobs and middle-class consumers.

Thank you.

The CHAIRMAN. Dr. Dunkelberg, thank you very much. And you raise a number of important issues, and, as you know, I have followed up on a number of them with you. And I think what is particularly relevant is, as we go into tax reform, every time you hear people talk about it, it is always about what are the C corporations, these big corporations, and, obviously, we want them to be competitive. They employ a lot of Americans.

But as you said, the barber shop, the cleaners, the Main Street businesses, somehow get left out because they, in effect, pay taxes as individuals, as pass-throughs. And I very much want to work with you on that in the days ahead so we do not leave these small businesses behind.

[The prepared statement of Dr. Dunkelberg appears in the appendix.]

The CHAIRMAN. Mr. Lindsey, why don't we go to you next?

STATEMENT OF LAWRENCE B. LINDSEY, Ph.D., PRESIDENT AND CEO, THE LINDSEY GROUP, FAIRFAX, VA

Dr. LINDSEY. Thank you, Mr. Chairman. I would like to thank you and Senator Hatch for inviting me today.

Mr. Chairman, you said that there was a special place in Heaven for those who do not read their statements. I need all the help I can get to get there, and so I will not read my statement.

The CHAIRMAN. Thank you.

Dr. LINDSEY. But I would like to refer to the charts that are attached to the statement.

The CHAIRMAN. Absolutely. Absolutely.

Dr. LINDSEY. I am in sympathy with everything I have heard today, and I think one of the themes we need to think about in terms of the middle class is really a psychological one, which is, it is one where self-reliance is key. These are all individuals who want to support themselves, and I think that is actually why most people think of themselves as middle class.

They do not think of themselves as part of some over-class which sets the rules and runs things. They do not think of themselves as an underclass, which is dependent on others. They want to be self-reliant.

With that in mind, let me refer you to chart 1. My theme today is going to be something one almost never hears in Washington, and certainly never hears or almost never hears from a policy wonk, which is a request for modesty. We have done a lot, but we are not doing a very good job.

So the first chart tracks two measures that the Bureau of the Census has for tracking inequality. And what I did was, I looked at each administration. The data only ran through the first 2 years of the current administration. But what you will note—by the way, these are called the GINI coefficient and the mean log coefficient, which you probably learned about in freshman economics, and I hope you have brain cells to put to use to remember how they are calculated, and I will not go into them today.

But what you will notice is that both rise under every administration, both measures. It does not matter. Neither party has done a very good job. In fact, the biggest rise in inequality was under President Clinton, where, in those 8 years, inequality rose under both measures more than it did under 8 years of Reagan and 8 years of Bush combined.

So I think, from a partisan basis, we all have to be very, very modest about our ability to influence things. So both parties have not done a very good job. But it is not for want of trying. And so—if I could ask you to turn to the second chart. So what do we do to try to make things more equal? Well, one thing we do is we try to make the tax code more progressive.

Now, I know it is not conventional wisdom that the tax code has become more progressive, but it *has* become more progressive. And what I did was I looked at IRS data. I also looked at Bureau of the Census data.

I looked at the share of income and the share of income taxes paid by the top 5 percent and everyone else in various years. And, as you will see, the share of income, according to Census, going to the top 5 percent has gone up since 1980, between 1980 and 2010. It went from 16.5 percent to 21.7 percent.

The share of income taxes paid by that group has gone from roughly 37 percent to roughly 60 percent. The point here is that the share of income taxes paid at the top has risen faster than the share of income at the top. That is mainly because all of the big tax cuts we have had have primarily been focused at cutting taxes on middle-income families, this in spite of the fact that we have this view out there that the middle class is shrinking.

And you can see it in the next two columns. If you compare the tax share paid by the top 5 percent to their income share versus everyone else, we started at a ratio of about 3-to-1 back in 1980. This was under Bill Clinton, when the top rate was 70 percent. In 2005, the top rate was half that, and the ratio of the tax share to income share of the top 5 percent was 5 times what everyone else was paying.

So, in fact, in spite of the conventional wisdom, in spite of all the rhetoric, the income tax has become more progressive. A greater share is paid at the top, and it has grown faster at the top than has the income share. This should be a cause for modesty that we do all this and it does not have the effect we think.

Chart 3 compares what is happening on the other side, which is with transfer payments. And these are government payments to individuals, a variety. Right now, they are primarily medical, but they also include direct cash income.

Back in 1960 when, actually, we had the most equal income distribution that we have seen in a long time, transfer payments were just 6 percent of personal income. Today, they are roughly 18 percent of personal income. So the share of personal income and transfers has tripled, thanks to the efforts of the government, in spite of what we have seen is the trend.

On the other hand, the share of income from interest and dividends, what the people call property income, has dropped since 1980. So, again, my lesson from this is modesty. It is not like we are not doing a lot. We have moved around a full 12 percent of personal income, which is a lot, $2 trillion, in the form of transfer payments, and yet we still have the inequality situation we do.

We should be very modest about our efforts to do things.

The fourth thing I would like to point out, and the next chart, is the decline in middle-age labor force participation. This is something Diane mentioned earlier, and I think it is very, very important. This is not the people in my generation, which I think of as the mature people, wise people with lots to contribute. [Laughter.]

We all actually have higher labor force participation than we did at the peak of the last business cycle. This is middle-aged. They are just leaving the labor force.

If you compare middle-aged labor force participation today versus what it was in 2007, we have lost 2 million middle-aged men and 1 million middle-aged women. And by definition, you are not going to build the middle class, if you do not have people participating in the labor force. It is as simple as that. The key is self-reliance. These people are choosing not to be self-reliant.

Now, the choice may be that there are not good alternatives out there. I am not criticizing these people. They are facing the world as it is in front of them. But we are not going to solve the problem as long as people leave the workforce, and the problem seems to be getting worse. And I was struck by the report of the CBO, for example, looking forward to another 2.3 million people leaving the labor force as the Affordable Care Act takes effect.

I think the reason we failed, in spite of our efforts, is complexity, and this was something that Bill Dunkelberg talked about. And I would like to turn to chart 5, which was actually put out by the Urban Institute.

I call this the benefits mountain. They looked at a number of different people, but this one has to do with a single parent with two kids. And you can see how complicated the benefit structure is. You cannot say this is a well-targeted transfer process. It just is not. And the phase-out ranges are different, and the standards for each one are different. And we here in Washington—policy wonks, Senators, staff—we have done this. This is our fault.

So, if we were to do anything, I would urge you to look at the complexity. And one thing they did at the Urban Institute was, they took this and they put it into a summary statistic, which is in chart 6, which is the effective marginal tax rate on the single parent with two kids. So this is the effect if he or she works a little bit more, tries to improve their own standard of living, how much of it does the government take from them, either in taxes or lost benefits.

And you will see that, for what most of us would call the middle class, say $25,000 to $50,000, we are talking about a tax rate over 50 percent. The tax rate is actually 82 percent for this single mom with two kids in the $30,000 range. We did this, policy wonks, staff, Senators; you did it, we did it.

We have a higher marginal tax rate on single moms making $30,000 a year than President Hollande has put on French millionaires. It is dumb French policy, and it is even dumber here.

And so the one thing I would urge us all to do is be very modest about our ability to tinker with things, because when we tinker, we make the world more complex. And these are people who are best-off when the world is simple and they are self-reliant and are given the means to solve their own problems and not told how to do it.

Thank you.

The CHAIRMAN. Dr. Lindsey, thank you very much.

[The prepared statement of Dr. Lindsey appears in the appendix.]

The CHAIRMAN. And I thought it would be very helpful to have you and Dr. Burman, in effect, as bookends at the end, because, if we can find common ground between the two of you on some of these issues, that will go a long way to coming up with a bipartisan tax reform proposal that will give everyone in America the chance to get ahead.

We are going to probably talk about it, but one of the kind of key numbers—and I appreciated your using a number of charts to document your points, Dr. Lindsey—is in the 2 years after Democrats and Ronald Reagan got together in the 1980s, and Dr. Burman was involved in it, our country created 6.2 million new jobs.

Now, nobody can say that every one of those jobs was due to tax reform, but it sure helped. And it helped particularly give all Americans the chance to get ahead. That is the operative phrase: all Americans—Dean Price, the Hartzells, everybody in America—got the chance to get ahead.

Dr. Burman, I am not going to put much pressure on you to try to find some common ground with Dr. Lindsey and the other three outstanding panelists, but you did it in 1986. You also helped Senator Coats and Senator Gregg and Senator Begich and I write a bipartisan bill. So, no pressure, but let us see what we can do to wrap up with some common ground on helping the middle class get up that ladder.

STATEMENT OF LEONARD E. BURMAN, Ph.D., DIRECTOR, TAX POLICY CENTER, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. BURMAN. Thank you, Chairman Wyden, and it is a great pleasure to be testifying before your committee, at the first hearing you are having without Jack Lew. And thank you, Ranking Member Hatch, and members of the committee.

Senator Wyden and Senator Hatch, you have both been my heroes, because you have spent so much of your careers trying to work on a bipartisan basis, trying to solve important issues, and I look forward to seeing what you can accomplish together.

Today, I want to talk about this important issue of what is happening to the middle class. There is a chart in my testimony showing real median earnings over time, and this is something, I think, Senator Hatch referred to earlier. The real median earnings, the earnings for somebody right in the middle of the distribution of pay, working full-time for a full year, after adjusting for inflation, have stayed virtually flat over the last 35 years.

At the same time, productivity has exploded. The amount that the average worker is producing has more than doubled. As Senator Hatch pointed out, part of the difference is attributable to health care costs and other fringe benefits. Payroll taxes have gone up over that interval.

And Senator Hatch also pointed out that, after taxes and transfers, we have actually been helping the middle-income people more, but the key point is that the market is not really rewarding work for people at the middle of the distribution the way it used to.

There are a number of reasons why. Globalization has often been targeted. Larry Summers gave a talk at the National Bureau of Economic Research last year, and he talked about how the traditional economist's view of the economy is that there is capital and labor, and capital makes workers more productive, which means they get paid more. He said now you need to think of a new kind of production function, which is that there is the old kind of capital that makes workers productive, but there is a new kind of capital that substitutes for some kinds of workers.

Every time you go to the grocery store and you go into the self-checkout line and look at the lonely cashier who is the only one left there, you are seeing the effect of this kind of capital that is not augmenting labor, it is replacing labor.

One obvious solution is not on the tax side. It is to train people so that they cannot be replaced by machines. And, Senator Wyden, your bipartisan efforts to make higher education more transparent and to actually produce real value for people is extremely important.

President Obama has proposed for the last 2 years to encourage community colleges to collaborate with local employers to train workers to use high-tech machines in manufacturing. That is an enormously promising approach and very cost-effective. I think making college, making retraining activities affordable for workers and accessible, without leaving them with a crushing debt burden, is probably the most important thing you can do.

You talked a little bit about savings. Senator Wyden, you have promoted the idea of child savings accounts, which I think are a really promising approach.

In the nature of recycling, I want to remind people of something I worked on in the Clinton administration, which was universal savings accounts, which involved restructuring the subsidies for savings so that low-income people would get an automatic contribution, kind of like what they would get from their employer if they actually worked in a job that was good enough to make a contribution to savings, and then a generous match that phased down with income. I think that is also very promising.

Obviously, encouraging savings and education will fit well into a bipartisan opportunity agenda. My most innovative proposal, and you might say radical, would be to change the way we do indexing for the income tax.

So in the 1980s, we changed the income tax so that rising price levels did not push up people's average tax burdens. So when the price level goes up by 3 percent, all of the tax bracket thresholds, the standard deduction, personal exemptions, some other parameters, would increase by 3 percent.

The idea that I put forward in my testimony is, well, maybe what we should do is think about the indexation as something we could use to redress inequality at the same time. We would not raise the real tax revenues that are collected by the government. We would make the same overall adjustment, but we could tailor it so that if the middle class continues to be falling further behind, we could increase the standard deduction by more, increase personal exemptions by more, maybe push up the credit rate for the Earned Income Tax Credit.

If income gains were widely shared, then basically you would be doing the same thing as we are doing with price indexing now. I think this is a very promising approach. I do not think the income tax is the solution to economic inequality. I think structural issues, like education, savings, things like that, are much more important over the long term.

But in the short-term, especially as the market economy is basically not sharing much of the gains of productivity with middle-income workers, this is something that could help.

I would be happy to answer your questions. There are a number of other issues I talked about in my testimony, but I would like to end close to on time.

The CHAIRMAN. Thank you. And all of you, I think, have been very helpful in sort of illustrating our challenge.

[The prepared statement of Dr. Burman appears in the appendix.]

The CHAIRMAN. I thought I would start—I know Senator Grassley is on a tight time schedule—with a question for all of you.

Let us say, as unimaginable as it is in this town, that we will set aside the politics for just a minute. I would be interested in having each of you give the committee a fresh idea that you would like to see us pursue to try to help struggling Americans climb the economic ladder.

Ms. Swonk, we will start with you. Just give us your sense, if you could take one idea that has not just been politicized, shoed-over in the battle, the partisan battle, what would you pursue?

Ms. SWONK. Well, mine is just the obvious one that I concluded in my own remarks, and that is that we need to have a way to restructure out of student debt so that we do not keep these generations committed to an overhang of debt and the status that goes with that, which means they do not have access to other ways of building wealth and saving going forward.

So an ability to restructure that debt is, I think, one of the most critical issues. Some people do make mistakes, and they will pay the price for what they did. They should not have gotten the credit. It is not forgiveness, but just being able to restructure it.

The CHAIRMAN. Dr. Dunkelberg?

Dr. DUNKELBERG. Well, that is a challenge. As an educator for most of my life, or all of my adult life I guess, one of the things I see is that, as I look at our education system, lots of times, we are blaming teachers for not doing a good job, and there are certainly a lot of issues around that that we all know about.

But the more fundamental problem that I have observed kind of firsthand, working all the way from grade school to college level is parenting. And the kids show up not ready to learn, not understanding discipline. But I do not have a good policy recommendation for dealing with parenting other than that we just need to give these young people more guidance with more structure so that, when we do get our hands on them in the educational system, we can be much more productive in turning them into good, solid citizens.

The CHAIRMAN. Dr. Lindsey?

Dr. LINDSEY. I go back to the problem—my generic solution is less complexity, because I think complexity moves power up to the governing class and moves it away from the middle class.

A specific recommendation—since I wrote it, I will suggest it. I put out a book last year called "The Growth Experiment Revisited."

I had a very radical tax reform in it which would simplify things dramatically, and I would commend that book.

The CHAIRMAN. Giving people back their springtime so that they do not have to spend March and April tortured is pretty appealing.

Dr. LINDSEY. I just spent the other day with my accountant, and I told him what I was doing, and he said that it is now impossible for any accountant to do the tax form unassisted.

Now, I spent my life in taxes. Until 3 years ago, I took great pride in being able to do my own taxes. It took several days, but I did it. And then I got stuck on one of your new rules. I had a foreign account, which I did not want to have, I was given it because it was an ESOP, and, oh my God, I could not figure out for the life of me how on earth to comply.

And so he and I sat down, and he said, well, he would try three different ways. Finally I decided, all right, enough is enough.

And here is something you can fix, and I promised him I would pass it on. On foreign taxes, you, the Congress, and the President, have now mandated that we have to fill out yet another form if we have a foreign account, and we cannot submit it with the rest of our tax forms. It has to be submitted separately on June 30th, not on April 15th. Why you did that, I do not know.

So here he is, he is saying, "You know, I will fill it out for you, Larry, and just sign this paper and authorize me to fill it out. One problem. You have severe penalties if you don't fill out this form, but the IRS hasn't generated the form yet."

So come on, right, this is complexity that is not being followed through on your side, on the part of the government. If you are going to make life complex, at least make it doable. Complex and impossible is unacceptable.

The CHAIRMAN. Well, Dr. Lindsey, for you and everybody else paying attention to today's hearing, I have been chair of the committee for about 9 working days. So I have not yet figured——

Dr. LINDSEY. And you have not fixed it yet, Senator. [Laughter.]

The CHAIRMAN. I have not fixed it, but, by God, we are——

Senator HATCH. That is no excuse.

The CHAIRMAN [continuing]. We are all going to be on a bipartisan mission to do it.

Dr. Burman, and then, appropriately, wrapping up with Mr. Packer.

Dr. Burman?

Dr. BURMAN. Well, I completely agree with Larry that complexity is a major issue, and you have actually proposed tax reform bills that would make things much simpler.

Larry is focused on complexity for rich people—like him—which is a problem, but—just kidding. The tax code is too complex for lower- and middle-income working people as well.

Those marginal tax rates that Larry showed from a study by my colleague, Elaine Maag, have to do with the phase-in and phase-out of the Earned Income Tax Credit. We do not want to lose that, because, yes, EITC is the single-most effective anti-poverty program there is. It is an important part of the safety net.

When middle-income people fall on hard times and their earnings fall, they can get up to $5,000 in credits to help them if their earnings decline. But yet, you see it is needlessly complex, and you could make it much, much simpler.

One idea which I and other people have put forward is just turning it into a wage credit that maybe would provide a subsidy for the first $10,000 worth of earnings that anyone could get, and it could be provided through a payroll tax adjustment, if you wanted, and, then, a child credit that just depended on having children but did not phase in with income, did not phase out.

Basically, the IRS would have no problem administering that child credit, because all they would have to do would be to determine that only one person was claiming each child, and, as long as no more than one person claimed the child, they would be eligible. It would be so much simpler.

Right now, a majority of low-income people pay people to fill out their income tax returns using money they cannot afford. We should make things simple enough that people just with wage income can fill out their returns themselves.

The CHAIRMAN. But between the two of you, you have now made it clear that tax simplification is needed for the low-income, the high-income, and everybody in between, and I very much appreciate that.

We will wrap up with Mr. Packer. You have had a chance to see sort of Washington in action, and to have you bring it back to what you saw as you made your travels, I think, is an appropriate way at least for me to wrap up.

Mr. PACKER. So my idea is neither new nor particularly modest. It is campaign finance reform. It is giving Dean Price, the Hartzells, millions of people like them, a bit more of a level playing field here in Washington with the Chamber of Commerce and the National Association of Manufacturers.

I think one reason why we have the incredible level of growing inequality that we do, beyond anything you see in similar industrialized countries, in Europe, is because we accept it. We accept it. And our system of campaign finance is one aspect of that acceptance.

So I would say if you were to begin anywhere, it would be in convincing Americans that the game is not rigged by making our system of financing campaigns at least a little more equal and more fair.

The CHAIRMAN. I would be setting off a truly spirited discussion if I got into this. I will tell you, after we are done, Senator Murkowski and I have proposed a bipartisan proposal to start leveling the playing field.

Let us go with Senator Grassley, and I very much appreciate his involvement in these issues.

Senator GRASSLEY. Thank you.

Dr. Lindsey, I am going to start with you. Your testimony points to the labor force participation as the greatest challenge to increasing the middle class, but, also, to reducing income inequality and increasing economic growth.

You point out that many of our well-intended transfer payment programs aimed at helping low-income individuals can actually create a strong disincentive to work. Your testimony cites marginal effective rates as high as 80 percent. But as I understand it, in certain circumstances, that could be 100 percent.

During the debate on the Affordable Care Act, I requested the Joint Committee on Taxation to do an analysis of marginal effective tax rates, looking at all transfer payments, and the then-proposed premium tax credit. The JCT analysis actually said that, in certain circumstances, you could have what they said was an infinite marginal effective rate.

Now, before I ask you your question, I kind of add all this up, and Congress, over a long period of time, passes a lot of well-intended government programs, and they turn out to have some unintended negative consequences. And when we try to do something about income inequality, maybe we are spending too much time on that and not enough time on inequality of opportunity.

So here is my question. What suggestions do you have to ensure Federal programs intended to be a bridge to the middle class do not become an insurmountable wall?

Dr. LINDSEY. First of all, let me say, since we are trying to build bipartisanship, I agree with everything Dr. Burman said. The one thing you heard from us was complexity, and my chart here shows this is not the rich right here. And what we have done is, we have passed hopelessly, hopelessly complex rules so that the individual who wants to comply with the government's rules has a strong disincentive to work.

A lot of the people who are nominally out of the labor force may—may, we do not know—be participating in the gray economy. We should not be proud of that accomplishment either. But there is no question that when you have complex programs that ordinary people cannot follow, that punish them with very high rates when they try to work harder, you are making things worse. You are building a barrier to the middle class.

I am not saying that we should do away with these programs, and I agree with the Earned Income Tax Credit. I think it is a great program. I am saying if you put in this hodgepodge, which is what you have done, and you have no idea what the marginal tax rate is or what the complexity is for that middle-class person, that is what the problem is.

We could sit down and we could simplify this and we could agree on a simplified program that would be a win-win for the middle class. This is not what the Congress and the President have done. They have made it worse. And some of those infinite marginal tax rates you referred to come straight from the Affordable Care Act.

We know there are two different phase-outs. We do not have to go into that. Why that is there, I have no idea. Did anyone not figure it out when you passed the Act—no, I know the answer to that.

You cannot do things like that and expect to have government policy be on the side of the middle class.

Senator GRASSLEY. My next question is for Dr. Dunkelberg. Obviously, because of time, it is going to have to be the last question, although I do have other questions I may submit in writing.

As you mentioned in your testimony, small businesses are vitally important to building jobs for the middle class. So I would ask a couple of questions about the Affordable Care Act, because I have heard this from small businesses in Iowa.

Among the top concerns in an NFIB survey is the uncertainty over government actions and regulations. How is a haphazard implementation of the Affordable Care Act adding to the uncertainty facing many small businesses?

Dr. DUNKELBERG. Senator, thank you for that question. It is nice to see you again.

Obviously, there is a huge amount of confusion surrounding the Affordable Care Act, and the rules, of course, are changing. I do not know how many changes we have had in the implementation so far.

So people are very unsure. Again, these are not Ph.D.s running these little firms out here. They are trying to run a business, and they are trying to figure out where this thing fits in, what taxes apply to them, when will they be penalized, will they be penalized, how will that be changed in the future.

There is a 50-employee thing now, but we know that Congress may well make it 40, 30, 20. There is so much uncertainty about it that they cannot make hiring decisions.

Small business owners view hiring as an investment. It is not like a 1-year thing. You hire an employee, you train them, and the story is, it takes a year to get your investment back before they are really productive in the job you have them in.

So those are investments that owners are very unwilling to make now. They are very expensive. Hiring is very expensive, and, if you cannot be sure what the cost is going to be or whether you can even afford them, you do not make the hire.

So we are waiting. Everybody is waiting for some more clarity before they spend any more money, and that is the difficulty we have.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

This has been a particularly interesting panel, and I really enjoyed every one of you here. Let me direct some questions to Dr. Lindsey, though, and I wish I had time to direct to everybody.

By the way, you mentioned your book. I turned around and I said to my staff, "I've got to get a copy of that," and they said, "Well, he sent you a copy, but we kept it so we can read it." I guess they figured we cannot read. [Laughter.]

But you may have to send another copy, but I will be happy to pay for it. How is that?

Dr. LINDSEY. Senator, I will be happy to send you one, and, in honor of your public service, you do not have to pay for it.

Senator HATCH. Now, that is the kind of language I like to hear. [Laughter.]

Now, Dr. Lindsey, your testimony identifies effective marginal tax rates facing low-income earners that can rise to as much as 80 percent or more, and your testimony identifies that there are elements of our entitlement and transfer systems that help impose those rates. One result is that the structure of the entitlements and transfers puts in place some significant disincentives to work more or advance up into the middle class.

Indeed, I would remind the committee of the nonpartisan Congressional Budget Office's recent findings which indicate that the construction of the Affordable Care Act, with generous subsidies, financed by increased taxes, will discourage economic activity, including work and efforts to earn more, such as getting more education or training.

Now, Dr. Lindsey, can you give us some of your thoughts on whether high marginal tax rates and disincentives to labor supply and other economic activity inherent in many of our redistribution and entitlement programs, including the Affordable Care Act, are inhibiting economic growth?

Dr. LINDSEY. Yes, Senator. Even though I am about to turn 60 and old people are not supposed to change their minds, I changed my mind about this one.

I tend to follow the Federal Reserve very closely, and I think the labor force participation issue has been a conundrum for them. And their view, which I agreed with until December, was that the people who have left the labor force are likely to come back.

That had been my view. And then I actually began to do the kind of research on an anecdotal basis, and that led me to a statistical analysis, and I switched my view. I do not think they are coming back.

Senator HATCH. Why is that?

Dr. LINDSEY. Well, the Hamilton Project, for example, which is Mrs. Clinton's outfit, did a very careful look at this. Suppose you are a construction worker who has been laid off, and you are married to a nurse who has not been laid off. The question is, all right, do you want to go back to work?

Well, what they found was that, in most cases, the effective tax rate on the second spouse going back to work was on the order of 80 percent because of lost benefits and higher taxes. And that goes on top of the fact that you have just arranged a certain child care arrangement and now, oh my gosh, you have to turn that upside down.

So I do not think these people are going to come back, and that means that we are not going to get the GDP from them, we are not going to have the employment, and we are not going to have them move into the middle class. They are going to be getting by on one income.

And, if you look at the incentives for them to go back, the government has taken them away. I am sorry, but people do not go back to work when they lose 80 cents on the dollar of what they are going to earn.

And so, no, I do not think we are going to see a reversal in the rate of participation, unfortunately. That is bad for the economy, and it is bad for the middle class.

Senator HATCH. Well, as the economy sluggishly recovers from the 2009 recession, labor markets remain persistently sluggish, with the employment-to-population rate remaining stubbornly low at around 59 percent and the labor force participation rate down to 63 percent relative to an average of close to 67 percent between 1990 and 2007. Some people argue that most of the persistence of the low employment-to-population numbers and the persistently low and declining labor force participation reflects aging of the population.

Yet, even a recent analysis of the economy's long-run growth potential by the nonpartisan Congressional Budget Office, which they have ratcheted down, says that, "Changes in people's incentives caused by Federal tax and spending policies set in current law are expected to keep hours worked and potential output during the next 10 years lower than they would be otherwise." Now, that is in the CBO's view. The persistent sluggishness of the labor market does not stem solely from demographics. Policies also have played a role.

Now, what have you seen and heard about changes in people's incentives caused by Federal tax and spending policies since the recession that CBO thinks are contributing to and will continue to contribute to the sluggishness of the labor markets and the economy?

It is a little along the same line of what you have been saying.

Dr. LINDSEY. I think the CBO analysis is right. And yes, the population is aging. But one thing that you can do is, you can control for age, and my chart in there, chart 4, does that.

And so what you have had is 2 million middle-aged men and 1 million middle-aged women not participating. Not participating means not only not having a job, but saying, "I don't want to work." And, as an old-fashioned guy, I have problems thinking about a 45-year-old man saying, "Not only do I not have a job, but I don't want to work." And that is what got me to look into why that was possible. How could that possibly be happening? And the same thing, by the way, is true for a lot of middle-aged women. It is now the case that people do not want to go out there and work.

The answer that came up over and over again, came out across the political spectrum—I mentioned the Urban Institute, I mentioned the Hamilton Project, I mentioned the CBO—so this is not a controversial finding. The policies enacted in our tax and our transfer system are creating a huge disincentive for people to work. It is as simple as that, and that is a burden on economic growth.

Senator HATCH. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Brown?

Senator BROWN. Thank you.

I guess, Dr. Lindsey, I meet a whole different group of people from the people whom you seem to talk to. I want to talk about something different.

Clearly, people on this panel have promoted their books. I want to promote Mr. Packer's for a moment, if I could. You have written poignantly about the tragic history of Youngstown, what has happened in one of the most important cities in my State. You trace the life of a woman named Tammy Thomas, a single mother, trying her best to raise children.

Her story and her speaking through your eloquent words made two important points. First, manufacturing has been a long-time ticket to the middle class, especially between the coasts, but really including up and down the east and west coasts too. A factory job meant a steady income, a secure retirement, and often a pension that was a defined benefit, and some ability to send children to school, buy a car, buy a house, all of that.

Second, when communities lose these jobs, and you know what it has done to the Mahoning Valley, Youngstown, it is absolutely devastating for that family who may be foreclosed on, the family next door whose home is devalued, and the entire tax base and all of that.

So just walk through what we ought to do about that. What do you do to encourage and build upon the manufacturing renaissance in places like Youngstown, which is beginning to happen? How do we reach into these communities and help people like Tammy?

Mr. PACKER. In her case, she worked for 20 years in an auto parts assembly plant. It was one of the last good manufacturing jobs in the Mahoning Valley. And then Delphi declared bankruptcy, got out of its contracts, and moved all but a tiny number of jobs to Mexico. It was part of a whole North American restructuring on the part of Delphi, and that was pretty much the end of Tammy's career as a blue-collar worker.

She remade herself. She went back to school. She got a degree in social work. She became a community organizer, which is what she was when I met her in Youngstown, and she was essentially working with people whom she knew, people in her old neighborhoods, to try to rebuild, to get vacant houses torn down by the city, basic things, things that seem like—they are not about creating a shiny new economy. They are about making life livable in neighborhoods that had become pretty much unlivable.

I think one of the biggest challenges in bringing jobs to people in the Mahoning Valley is, there is this incredible ethic of work in Youngstown because of the history of the steel mills. People there know about work. But there is also a missing generation that did not have jobs and that probably did not get very good educations and that may have spent time in prison, which was almost a part of the education of people that Tammy knew, including her own brothers. So how do you get the jobs in things like natural gas and manufacturing that are beginning to trickle back into the old manufacturing parts of Ohio to people who do not have a history of working?

I have seen her stand up in front of a group of ex-cons, felons, who were desperate to find a job, but also felt hopeless about finding a job because of their record. And so she sort of worked with them to figure out how to tell their story to a potential employer in a way that they would be given a chance, and it is partly a matter of training and of education, but it is also a psychological problem.

There is a huge barrier between people of the next generation after hers and the people who are beginning to hire in the Mahoning Valley. As of now, what I heard is, a lot of those jobs are going to people with very specialized skills or people from outside the region who know how to do those jobs. So it is not yet becoming a part of the rebuilding of Youngstown.

Senator BROWN. Thank you. And I appreciate Dr. Lindsey's affirmative head nods as you were talking about much of that.

Last question, Dr. Burman. I do not have a lot of time.

You discussed using the tax code to combat wage stagnation. Talk to us about the importance of not just the Earned Income Tax Credit, but our efforts on this committee. Chairman Wyden is a sponsor; pretty much a number of us are.

It started with President Ford, as you know. President Reagan said it was the best pro-family, anti-poverty thing the Federal Government can do.

Talk about the expansion, the permanence, the importance of a permanent, predictable EITC—we talk about predictable taxes here, but we seem to leave out EITC and CTC as something that should be predictable long-term—and the expansion to people, to men and women who are childless, and the importance of all of that. If you would, just give us your thoughts.

Dr. BURMAN. Thank you, Senator. I think the EITC and the Child Tax Credit and other subsidies for lower-income working people, as Larry pointed out, they are too complicated, but they have been enormously valuable.

The evidence shows that the Earned Income Tax Credit does encourage people to work, particularly single parents. It raises the reward to work. You can work at the minimum wage, and, with the EITC, you can get close to an adequate level of income to support your family.

The President has proposed and Marco Rubio has talked about this as bipartisan support for the idea of increasing the Earned Income Tax Credit for people without children. Right now, there is a tiny, tiny credit that phases out at a very, very low income.

And I think that would be tremendously important, because it would encourage, for one thing, noncustodial fathers to go into the workforce, to be in the above-ground economy, by raising the reward to work, making it easier for them to make child support payments and stay connected with their children.

And education and being in the workforce are important avenues into the middle class, and the EITC does encourage that. There are some disincentives created by the phase-out, but, on balance, the empirical evidence shows that this is a very strong pro-work program, and it helps people who are really struggling, who are trying to get by and support themselves.

Senator BROWN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. All of my colleagues have been very patient. Senator Brown, I am looking forward to going with you to Ohio soon to meet some of those people, and I appreciate it.

Senator Bennet?

Senator BENNET. Thank you, Mr. Chairman. And I appreciate very much your holding this hearing.

As we sit here today, we face income inequality that is greater than it has been since 1928 in this country. If you are a child living in poverty in the United States, your chances of getting a college degree or the equivalent of a college degree are roughly 9 in 100, which means the situation is getting worse and worse and worse, and 91 out of 100 of our kids are constrained to the margin of the economy, the margin of the democracy, from the very beginning. If we do not change what we are doing as a country, the gap is only going to get a lot worse.

Mr. Packer, I want to thank you for this book. It is one of the most extraordinary things I have read in a long time. I read it without knowing you were coming to the committee. My brother made me read it.

Mr. PACKER. Thank you, Senator.

Senator BENNET. And John Dos Passos, I think, would be proud of what you have done here. If people listening to this do not read any other part of it, please read the chapters about—is it the Hartzell family in Tampa?

Mr. PACKER. Yes.

Senator BENNET [continuing]. Which is one of the most shattering accounts I have ever read of something happening in America.

I wonder whether you could—I just want to give you the opportunity to share with the committee some of the things that you saw that might be least obvious to the people in Washington who are making policy, the chapters about Jeff Connaughton and what he learned while he was here on Capitol Hill. Because to me, the power of what you recount is the extraordinary disconnect that exists among the working Americans you are describing and their government, and their sense that the priorities here have nothing to do with the priorities that they have or the things that would be essential for them to be able to get ahead.

So, I apologize for the long-winded question, but I would love to give you the rest of my time.

Mr. PACKER. That is very kind of you, and thanks for your really kind remarks, Senator Bennet.

As I said in my testimony, the people I spent time with, I spent a lot of time with. This was not going and doing a half-hour interview. It was staying in their houses, eating their dinners, driving around the State with them. So I got to know them really well, and I just got to understand a little bit about what it is like to be inside their skin.

Washington felt very far away and utterly unresponsive, but so did Wall Street, so did Silicon Valley, so did corporate America, so did my profession, the media—and so did even the schools, even the local schools. So there was a sense in which they were on their own. Over and over again, I kept running into the same feeling that people had that there is no support out there, that there is no institutional structure that they can turn to that sort of understands what it is like to not have a strong voice.

So you mentioned Jeff Connaughton. The book has all these different characters, and one of them is a Washington guy, because I think to understand——

Senator BENNET. He is not a Washington guy anymore.

Mr. PACKER. No. He has burned those bridges completely. He has done the unthinkable. He has actually named names and told tales, and now he is in some kind of retirement at the age of, what, 53. He is one of those middle-aged men who has left the labor force voluntarily.

His story is the story of a guy who goes from being a Senate aide to a White House aide to a lobbyist. And of those three, the thing that makes him happiest is being a lobbyist, because he knows more about what is happening to legislation, and he is making more money, and he is more successful. He is someone who is doing things. And then comes the financial crisis, and there is a sort of moral crisis that comes for him, which is perhaps advanced by the fact that he loses half his net worth.

He goes back into government. Some of you may have known him when he was Chief of Staff to Senator Kaufman. And his mission is to make sure that the financial crisis is never repeated, by enacting strong Wall Street reform and by prosecuting some of the top executives who might have been behind the fraud that led to the financial crisis.

In his view, neither of those things happens. And the reason they do not happen is because of people like him. He sees how little voice ordinary people have in Washington when he goes from one side of the revolving door to the other in a hurry, and suddenly it becomes clear to him that the position he was in and that his partners from the firm are still in, is a much better position to be in in Washington than to be a Capitol Hill aide who thinks he is acting in the interest of, broadly speaking, the public, where he feels he has very little power.

So that is why, when I was asked by Chairman Wyden to name one idea that I would have for supporting the middle class, it is not a Finance Committee idea, but it is campaign finance reform.

Senator BENNET. My time is up, but I want to thank you again, Mr. Chairman. I want to thank all the panelists today.

If we do not figure out how to educate our kids better, and if we do not figure out how to recouple job growth and wage growth to economic growth, we are not going to recognize ourselves in the middle of the 21st century, and this is what we should be focused on 24/7.

The CHAIRMAN. Thank you, Senator Bennet.

Senator Thune is next. Senator Stabenow has been exceptionally patient, and I am looking forward to getting her in as soon as possible.

Senator THUNE. Thank you, Mr. Chairman. Thank you to you and Senator Hatch for covering and having a hearing on this important subject, and thanks to all our witnesses for being willing to testify today.

I think we have two kind of contrasting views about how to improve the plight of middle-class Americans in this country. And over the past several years, we have sort of tried the government approach, the redistribute income approach, and what we got is sluggish growth, stagnant wages, and a middle class that feels increasingly squeezed by health care costs and taxes and everything else.

The other approach, I think, looks at a vibrant, growing small business economy, where we incentivize work and really try to encourage small businesses to hire. Sixty percent of the jobs that are created in this country, I think—and I think the number may be even higher than that, but I know that that is the number that I have seen quite a bit—come from small businesses. So I would argue that the best thing that we can probably do in terms of improving the overall status and conditions for middle-class Americans in this country is to get a vibrant, growing, robust small business economy.

And to Mr. Packer's point, if people feel disenfranchised from Washington and big government, feel disenfranchised from big business and Wall Street, in most cases, they do feel a connection to the small businesses in their community, and that is where most of the jobs are created. That is why I think the focus of our policies ought to be on that.

And so I would ask Dr. Dunkelberg, because we are having a debate around here right now about the minimum wage and other types of policies that I think are intended to improve the plight of the middle class and to address the issue of income inequality, but I am interested in knowing if there might be some other types of policies, tax policies, that you can think of that would help small businesses grow and hire, maybe increasing small business expensing limits or expanding the use of cash accounting, those types of things that would be helpful, that would really encourage small businesses to hire and to grow and to get the economy expanding again.

That really is ultimately, I think, the best way to lift people higher up in the middle class.

Dr. DUNKELBERG. Thank you, sir, for that question. I think you put your finger on a couple of interesting issues, all of them pointed to the bottom line. That is where small business funds its growth. That is the source of capital.

So, whether it is a change in tax rates or expensing or any of these kinds of things, and, in particular, a reduction in the compliance costs that they have, with all the regulations that are coming out—I think I saw a statistic that said we had a new regulation in the Federal Register last year every hour and a half or something like that, some absurd number. I do not even know how small business owners find out what regulations they have to comply with, much less comply with them. It is very expensive.

So this is the important capital, the owners' capital, the intelligence and the smarts of the entrepreneur, as well as the financial capital. Those are the kinds of things that should be fixed. Simplification, as a number of our testimonials have suggested, would be really important here.

The other thing, of course, is that a lot of what Congress does for these things are temporary provisions. So it is not just complexity. A lot of our members do not use the investment tax credit, for example, because it is too complicated, or they will not use, say, some tax credit, like, we will give you $5,000 if you hire a worker. Well, the worker costs $25,000, and you get $5,000 after a lot of paperwork, later and maybe, and those kinds of temporary things do not help either.

Small businesses are investing for the long run, and they need a set of policies that are long-run policies, that are simple and that they can understand and comply with and still spend most of their time running the business and creating jobs rather than trying to figure out how to comply with all these regulations that are coming down on their heads.

Senator THUNE. I appreciate that.

Mr. Lindsey, there has been a good amount of discussion about the EITC. I think you were around when that was created during the Reagan administration. And it was designed, I think, to help reward hard work by offsetting some portion of payroll taxes.

As someone who served on President Reagan's Council of Economic Advisors, I would be curious to know what you think about the EITC and whether it was intended to be primarily a spending program that makes payments, in many cases, above and beyond both income tax and payroll tax liability. And do we need to consider reforms to the EITC as opposed to an expansion of it, which is what the President is proposing?

Dr. LINDSEY. I think the EITC is a very good program, and I think—let us put it in a little historical context.

It was intended as an alternative to an old program called AFDC, which was Aid to Families with Dependent Children, which basically put a 100-percent marginal tax rate on someone who was on welfare so he could return to work, and this actually reversed that. It was a very successful supply-side program and is now embraced by everyone.

I really do not want to do you all's job here. So I am going to tell you the pros and cons and try and get out of here alive.

I think the first decision you have to make is whether or not you want to stick to the basic premise that this was an alternative to AFDC; that the intent here was to help families with children who have unique problems and unique issues over and beyond those of childless individuals.

I think that is a very important decision. I am probably in agreement with you on it, but that is not a decision for me to make. I think that is something you do not want in an age of scarce dollars.

My preference would be to focus those scarce dollars on families with children. That would be where I would go. But I think that, first, the same decision, whether or not you extend it to childless individuals or not—and here is where Dr. Burman and I agreed—you can do it so much easier than you do it now. You really can, and that is where you want to go.

There are a lot of people who do not get it who should, and there are a lot of people who do get it but should not, and that is also well-documented. Let us admit that there is fraud in the program, but there are also people who do not get it.

Well, that has to do, let us be honest, with complexity. It is done in a very inefficient manner. So I do think that no matter what you do about expanding it and reaching out to childless couples, please, please, please, whatever you do, make it simpler.

The CHAIRMAN. Thank you, Senator Thune.

Senator Stabenow?

Senator STABENOW. Thank you very much, Mr. Chairman. I want to thank you for your first hearing being on what is the most important issue today, which is whether or not we are going to have a middle class in this country, and I thank you very much for that.

There are so many pieces to this. Ultimately, I think, in a broad economic picture, we do not have an economy, and we do not have a middle class, unless we make things and grow things. We need to focus on that in manufacturing, small business, all of the things being talked about.

But I am concerned that not much of the discussion that seems to be happening today is focused on how we reverse cuts in job training. And the number-one thing I hear from manufacturers is, we are not matching up the right job right now with the right skills, and that means job training and education and so on.

It is very much about somehow blaming people who are out of work, which, I have to say, coming from Michigan, boy, is not what

I see. I do not see people—unfortunately, Dr. Lindsey, when you say people are choosing not to be self-reliant, that surely does not speak to anybody whom I know in Michigan.

Dr. Burman, when you talk about the market not rewarding work, that is more what I see. And I want to just speak for a minute—when we have a minimum wage right now that allows people to work 40 hours a week and still be in poverty, there is something wrong with that, I think.

And we have a bill on the floor right now, Mr. Chairman, that we all support, on child care.

The CHAIRMAN. A bipartisan Mikulski–Burr bill.

Senator STABENOW. Exactly. And what is interesting about that, though, is that the average child care costs for families today equal somebody working 40 hours a week for a year at minimum wage. It is basically the same: $14,000, $15,000.

So I am very concerned about how we reward work and do not take away from someone who is 50 years old whose job went overseas or their plant closed down or we are more efficient and we do not need this type of work anymore, and they are out of work and they cannot afford to go back to school, to the community college, because they have no work, and we are not extending unemployment benefits so that they can go back and get job training and so on.

I think my first question just would be, Dr. Burman, in your testimony, you said that income concentration has not arisen because the middle class is working less. The opposite is true.

So is the average family working more or less? What is happening here? Is this people choosing not to work?

Dr. BURMAN. If you look at the data over time, labor force participation overall is much higher. It is a little bit lower among men. It is much higher among women. There are many more 2-earner couples than there used to be.

So for the average household, I think it was something like 20 percent more—in terms of labor force—hours in the workplace than there had been 20 or 30 years ago. Americans work really hard, and a lot of them are still struggling to get by.

Senator STABENOW. Would you agree with what I hear so often? I do not know if you are seeing this, but I know an awful lot of folks who are trying to piece together two or three part-time jobs, and they are actually working a whole lot more, just not getting ahead very well. So I do not know how that factors into what you see, but we have a lot of folks working awfully hard.

Mr. Packer, from your perspective, do you think folks just do not want to work, do not want to work as hard?

Mr. PACKER. The people I was with always seemed to be working or always seemed to be looking for work.

There is a demoralizing effect when you are working part-time because you cannot get a full-time job. Danny Hartzell wanted full-time work. He could not find it. All he could get was 35 hours a week at Target and Walmart, which then became 30 and then became 25 and by the end was down to 20—$10,000 a year. It is just untenable. And he did, in his mind, go through the calculation. If I somehow lost this job, I could probably make more from unemployment and food stamps than I am making working in the produce department at Walmart.

Then his daughter got sick and he had to go take her to a doctor's appointment. He did not call in, probably because he was pissed off at his employer, and he lost his job and did not get unemployment benefits because it was not found that the employer had laid him off.

So there is a little gray area——

Senator STABENOW. So it is a cycle.

Mr. PACKER. But, honestly, the cycle starts with a man who wants to work and cannot find a job that allows him to do anything more than allow his wife to pay $2.99 for six Salisbury steaks and cook them in the toaster oven or whatever. That is the level of life. And this is a family that worked, that worked all their lives and that has stayed together. They have not broken up and gone their separate ways and fought over the kids and started drinking and taking drugs.

They have done the things that society asked them to do, and they still cannot really survive in our economy, and I think the effect has been, to some degree, a demoralization about whether there is a job out there for him.

Senator STABENOW. Just very quickly, I know my time is up, but very quickly, what leads to that—and I want to say, again, we are never going to get out of debt with 10.5 million people out of work. This is about jobs, it is about the economy, it is about supporting small business, investing in innovation, manufacturing, job training, all of it. But we have people right now who are stuck here in this transition.

Ms. Swonk, just very, very briefly, we are both from Michigan. You know how hard things have been there. We are coming back right now. But your testimony discusses some of the permanent damage caused by people who are on the sidelines for too long, which is a concern of mine—the long-term unemployed.

I wonder if you might elaborate on that for just a moment.

Ms. SWONK. Sure. There are plenty of labor force studies that have looked at long-term unemployment, most of them from the early 1980s, actually, in places like Pittsburgh. Chicago Fed Director of Research, Dan Sullivan, and, actually, Mary Daly at the San Francisco Fed, have done some of this as well.

And I disagree with Larry a little bit on the permanence of unemployment, but I would argue that these problems compound over time. We know that for the long-term unemployed, particularly among men, not only is their earning potential—when they finally do get back in, if they are out more than a year—permanently reduced, but the earning and educational attainment of their sons, in particular, is reduced. So you are generationally setting these people back, and they are from those manufacturing jobs like we had in Michigan with a controlled, unionized workforce.

We do know that in the 1990s, they came out of the woodwork and came back, but they never earned what they did before. They were on a completely different trajectory.

And we also know that mental health, physical health, which are both intimately combined, in my view, in my own experience with what I see, but also, the data now supports it, they are intricately combined, and things like mortality rates among the long-term unemployed went up quite dramatically as well.

So there is a whole issue here that I think it is compounding. That said, we do know that in much better economic times, they do come back. They just never achieve what they once did.

So I do not completely disagree that these workers are permanently sidelined, but some of them are people who have taken disability, very few ever come back, and they are younger than they used to be.

Senator STABENOW. Thank you. And, Mr. Chairman, thank you for your patience.

I think when we look at extending unemployment benefits so folks have a roof over their head and food on the table and can go back and get the job training they need so that they can lift themselves up, that is all a very, very important part of this, and we need to get unemployment insurance extended so more people have the opportunity to be able to focus on getting themselves back on track.

The CHAIRMAN. Thank you, Senator Stabenow. And before Senator Stabenow leaves, I am pretty sure I heard you mention the words, Ms. Swonk, mental health.

Ms. SWONK. Yes.

The CHAIRMAN. And Senator Stabenow and a Republican colleague, Senator Blunt of Missouri, are the champions of the effort to expand mental health coverage, and I am very hopeful that we are going to be able to do that here very shortly. And our farm bill is also going to be helpful in terms of creating some of the agriculture jobs of the future, the jobs that are going to get our agricultural products into export markets.

So before she leaves, I just want to thank her for her leadership.

I have a couple of other questions, and I know my colleague, Senator Hatch, does as well.

I want to ask the panel a question on this issue of savings accounts and particularly child savings accounts.

There seems to be more agreement than might initially meet the eye. I have looked at some of the statements, for example, that our former colleague, Rick Santorum, has made on this issue, and Senator Santorum makes the point that he is sympathetic to child savings accounts because he sees them as part of an ownership society. Many of my Democratic colleagues support the idea of a child savings account because they would like to increase the tools for those with modest incomes to be able to accumulate wealth.

So my question for the panel would be, what, in your view, might be an appropriate role for government? And Senator Hatch and I already have begun discussing a lot of these issues, and, when we talk, the question always comes back to, what is the appropriate role of government? In some instances, on some issues, there simply is not an appropriate role for government.

But given the fact that conservatives and those who have a different place on the political spectrum seem now to be coming together around the idea of child savings accounts—making it possible for young people to accumulate wealth—I would be interested in whether the panel—and I am not going to conscript you into duty here, but what might be an appropriate role for the government on child savings accounts?

Would any of you like to take a crack at that?

Dr. Burman, you are moving cautiously toward your microphone.

Dr. BURMAN. The concern I have about child savings accounts is the idea that you just put a little bit of money in an account and then somehow people will get to be 18 years old and they will have a nest egg and that will give them a chance.

They, obviously, need to know how to manage the money, but I think it is a promising idea. What I would look for would be ways to actually teach people when they are quite young about the value of savings and not just put money in the account and say, read the statement and see how it grows but, also, encouraging them and maybe their parents to contribute, provide them with the kinds of match that upper-income people can get through their employers now, and then see how the account balance grows.

I think, actually, people want to save. My parents were quite poor, and my mother still would hide money and put it away, because she wanted to have something set aside. But we need to make it easier for people to do that.

The CHAIRMAN. You are absolutely right. There are a number of pieces to the puzzle, and that is why the committee is going to look at this. We are going to look at it in a bipartisan way. There is not going to be any kind of rush to address it.

But I am struck by the numbers, that young people who have a savings account are more likely by many times the ratio to those who would not attend college, they would move on. They clearly benefit, and the financial education you are talking about is a key part of it and particularly for those of modest means.

Any of the rest of you—Dr. Dunkelberg? And so the question is really the appropriate role of government, and if you think I am just off-base and you do not think there is any role for government at all, so be it. But that, to me, would be the initial question in terms of trying to see how Democrats and Republicans might come together behind it.

Dr. DUNKELBERG. Well, it could be a Federal-level issue, although lots of times we are doing things at the Federal level that we probably should leave to the States.

The American Financial Services Association has developed a program called Money Skill. It makes it available free to high schools. It is totally self-contained, because high schools have a lot of people who do not know how to teach personal finance.

But the States are requiring it. They are starting to ask for it. And Money Skill is made available, and, as I say, it is a self-contained, self-teaching kind of an instrument. But the kids in high school need to get this kind of an education to see what saving means and what it means over time and why you want to save. All they think about is, I want to spend.

I think there are good efforts underway, and anything we could do to encourage that would, I think, be very, very helpful, because once these kids get through this stuff and go through all the examples and the work, it is amazing what they learn and how much retention they have once they get out.

And that is a good time, I guess, when you graduate from high school, you are going to get your first job, maybe, to have had those skills pounded into your head.

The CHAIRMAN. Ms. Swonk, did you want to get into this?

Ms. SWONK. I just wanted to add one point of caution, as the cautionary tale here of complexity, agreeing that we all believe in simplification.

One of the things we saw during the 1990s—and I remember reading these studies and being quite moved by them—was that people who owned a home had a higher chance of people living in that house going to college, lower rates of high school dropouts, and higher rates of high school attainment.

The problem was, we ignored self-selection in the process. And what I worry about is, when we look at these students who have already saved—I had my first savings account at 5 years old. I had a little book. We had a savings book back then. But there is a self-selection involved among the family and among the children. And so, when we try to expand those ideas to a Federal level, we have seen already some dangers of unintended consequences by well-intended policies, despite the bipartisan nature of it.

And so I would just point that out as something to be cautious of.

I also think dispelling myths is really important, and I am going to really get on a third rail of politics here, and I probably should not. My colleagues at home are probably getting angry already that I opened my mouth, but people believe that they are getting back in Social Security what they earned, and they do not believe—my grandmother died at 99, thankfully, and she took back more than she ever could have earned in the stock market or anything else, and that was lovely for her.

But I think more people realize that they have to support themselves, as well as depending on these safety nets that we set up for a very small percentage of people initially. I think that is an educational issue for 28-year-olds and 25-year-olds, realizing they are going to have to support themselves, not because they might not get Social Security, but because it is not enough.

I think those issues are really important, because we have to dispel some myths. People think of these things in a different way than they were intended to be, and they were not designed to support it.

The CHAIRMAN. Your point is well-taken. And I think part of what I try to bring up at practically every town hall meeting is that I want to promote this ethic of private saving, particularly as it relates to Social Security, on top of Social Security, so that people do not walk out of there and immediately say, there is going to be a big brawl.

My time has expired. The point is, we are going to be anxious to talk with you all about the details on this, because of your point about self-selection and analysis, particularly in one area or another that may or may not be comparable for young people.

I have been struck, and we will get them to you, about the data that show that this does look like a path to upward mobility, particularly for those youngsters of the modest means that I am talking about.

Senator Hatch has been very patient.

Senator Hatch, do you have other questions?

Oh, let us see. We have our colleague, who may be out of breath. Senator Carper, would you like Senator Hatch to go and then you, or would you like to go now, because Senator Hatch, as usual, is being his collegial self?

Senator CARPER. I would like for Senator Hatch to go, and I thank you very much for the offer.

I just would say to all the witnesses, thanks very much. Welcome. Thanks for waiting for me.

The CHAIRMAN. Let us have Senator Hatch ask any questions he would like on another round, and then we will go to Senator Carper.

Senator HATCH. I just have to say, this has been a very interesting panel. I have to read your book, Mr. Packer, and I will try to do that.

Mr. PACKER. Thank you. I have read yours.

Senator HATCH. You have?

Mr. PACKER. "Square Peg in a Round Hole." Yes, I have.

Senator HATCH. You did read that.

Mr. PACKER. I did. Why are you so surprised?

Senator HATCH. I have been surprised at anybody who read my book recently. Although, it actually sold quite a few books.

That reminds me, it is hard for me to understand why anybody would not want to work. And to hear you, Dr. Lindsey, explain why they do not want to work, even then, it is hard for me to understand, although I understand what you are saying, because I was born in poverty.

My family lost our home right after my birth. I always felt like I was responsible for that. And then my father borrowed $100 and bought an acre of land in the hills of Pittsburgh and tore down a burned-out building to build our home. We did not have any indoor facilities or anything.

And from the time I was 6 years old, I was working. My dad did teach me his trade. I became a skilled tradesman. I was a member of the AFL–CIO for 10 years and worked at the trade. To get through school, I worked as a janitor. When Ted Kennedy found out that I had worked as a janitor, he said, "Orrin, you should have stuck with it." [Laughter.]

I will not tell you what I told him he should have stuck with. [Laughter.] We were good enough friends, we could really badger each other.

But it is hard for me to get this concept of why people would not work at anything.

Now, in your book, Mr. Packer, you have indicated that they cannot get anything. But I have always found you can if you move or if you have to.

How do we get out of this mentality? You can hardly blame people for not working when, with the transfer of payment systems that we have in this government today and the welfare payments that we have, people can make, in some States, upwards of $55,000 a year, which is a little bit more than the average wage, by staying home and just getting the transfer payments.

Am I wrong on that? I mean, I have been reading about that, and I get that from all sources. I am happy to have any of you talk about that.

Let me direct it to you, Dr. Lindsey. You made the point.

Dr. LINDSEY. Yes, Senator. And I think we——

Senator HATCH. Why can we not get people to work?

Dr. LINDSEY. Senator Stabenow said that I said something that I do not think I said, and I think it is a way of answering your question. She said that I said people choose not to be self-reliant. I do not think anyone chooses not to be self-reliant.

Senator HATCH. I do not either. That is one of the points I am making.

Dr. LINDSEY. And what happens is, they lose their job, and they get into one of these programs. That program leads to another program and——

Senator HATCH. Or a whole bunch of programs.

Dr. LINDSEY [continuing]. They need the program. It is that benefit mountain chart.

There is nothing wrong with any of these programs if they need the help. But then comes the time when maybe a job does come along, and what they either get from personal experience or from their social network—it may be that their sister-in-law tried this.

She says, "You know, I got a $15-an-hour job, and I thought I would be a lot better off, and I took home $3 more. I was better off by $3 more." It is not that they are choosing not to be self-reliant. It is that it does not make sense for them to be self-reliant.

Senator HATCH. Well, how do we solve that problem? That is what I am getting to.

Dr. LINDSEY. Again, we are going to have to balance the generosity, and I think we are a generous Nation, and I am all for it, with the complexity and with the phase-outs.

The fact is, people are not going to go back to work when they face 80-percent marginal tax rates. It is not because they do not want to be self-reliant. It is that even a self-reliant person is smart. They know whether or not they are better off if they go back to work. And, if the government says you are not better off if you go back to work, they are not going to go back to work.

Senator HATCH. How do we solve the problem? Take away the transfer payments? How do we do it?

Dr. LINDSEY. Dr. Burman was mentioning reforming EITC as one example. These are soluble problems.

With all respect to this body, I think what happens, and the reason we have a chart that looks like this, with a mountain there, is, we pass a program and then we have a different Congress that comes along and somebody else wants their name on a bill and we put that program on top of that program and that program on top of that program, and they are all well-intended, but because there is never an effort to go back and really think through what we are doing, to think about the consequences, we build up a situation where you have 80-percent marginal tax rates.

Senator, if I may just give one other example that just puzzles me—and this is from the implementation of ACA. We have mental health programs in the country, and I do not disagree they could be made more generous. We have rehabilitation programs. We have programs for habilitation. They are paid for out of general taxation, which is progressive.

One of the things Secretary Sebelius did was to put all three of those programs into a mandate for insurance. Now, what she has done by doing so is take programs that are financed by progressive taxation and turn them into programs that are financed by lump-sum taxation of the middle class.

If I were thinking simply about a way to hurt the middle class—this is 20 percent, by the way, of the cost of a silver plan premium. Why on earth would the administration, if it is interested in helping the middle class, move 20 percent of health care costs from progressive taxation to lump-sum taxation?

I have asked that question of everyone, and this is, again, an unintended consequence. The answer I get is, "Well, it got it off her budget and onto the insurance budget."

I do not know what else there is. We have to work smarter in Washington.

I am sorry I am talking too long.

The public is fine. Dr. Dunkelberg's members are very smart people. They know how to run their lives. The people in Mr. Packer's books are very smart people. They are able to run their lives despite very difficult circumstances.

The people who are not being smart are the people here in Washington, and I will include myself in that, in how we design the programs that they have to live under. And we have to get smarter here. We have to get more efficient. It is not more or less. It is, come on, guys, there is plenty of money out there, let us deliver it in a way that is much more efficient.

Senator HATCH. And we are going to need all of your help.

The CHAIRMAN. Thank you, Senator Hatch.

I know we have a vote going on. We want to get Senator Carper in before the vote.

Senator Carper?

Senator CARPER. Thank you very much, Mr. Chairman.

Again, our thanks to each of you.

I chair the Senate Committee on Homeland Security and Governmental Affairs. We just had a budget hearing with our new Secretary, Secretary Jeh Johnson. We just concluded that. So I have missed most of this hearing, and I apologize.

I want to share a thought and then maybe ask for a response, maybe from Dr. Burman on this.

On the Affordable Care Act, let me just say as a preamble here, for years, we spent more money for health care than a lot of the rest of the world, industrial nations; we spent way more money.

I like to talk about Japan. I spent some time there when I was in the Navy. They spend about 8 percent of GDP. Up until a year ago, we spent about 18 percent. It actually came down a little bit last year, and we have seen a sort of leveling off and a slowing of growth in health care costs.

But my view is, if we want to make sure that people have some money for their incomes and in their paychecks, we have to continue to bend the cost curve, make sure that we get better health care results for the same amount of money or less money.

The Affordable Care Act is not the answer, the be-all in terms of actually getting there. There are a lot of things that can be done. But among, I think, the good ideas in the Affordable Care Act, one is moving away from a sick care system to a healthy care system to try to encourage people to take better care of themselves and incentivize that behavior.

I think it is moving toward Accountable Care Organizations, which is really cooperative care, collaborative care organizations—another good idea. Incentivizing people to lose weight, to stop smoking, that kind of thing, that is a good idea. Moving toward electronic health records, so we can better coordinate the delivery of health care, is a good idea. I think the exchanges, large purchasing pools, the Republican alternative to Hillarycare in 1993–1994, I think that is a good idea.

The idea that came out of Massachusetts—thank you, Governor Romney—where we have an independent mandate to make sure that we had an insurance pool that was not just the sick, but we had some healthy people there too, I think that is a good idea, although those ideas are criticized by many.

But let me just ask, if we want to make sure, at the end of the day, that employers do have some money to pay more money in wages to folks, trying to maintain the middle class, what are some further things that we need to do, can do, in terms of stuff that can be done outside of the Affordable Care Act?

Dr. Burman, just share some thoughts with us, if you would.

Dr. BURMAN. Thank you for your question. I am not an expert on health care, although I have written a fair amount about the tax aspects of health.

One thing that clearly would be worthwhile would be to do more kind of cost-benefit analyses of health care procedures. We spend an enormous amount of money on procedures that do not even necessarily make people better off. People get old and sick, and doctors think, "Well, we'll spend $1 million to keep you alive for another 6 months and probably make your life a living hell while we are poking and prodding and medicating you."

One of the aspects of the Affordable Care Act was setting up—I do not remember exactly what it was called, but there was an agency that was going to look at the effectiveness of different kinds of procedures. And because of the demagoguery around the whole idea of death panels, it said, "Okay, we are going to look at whether things work, whether they are cost-effective, but this will in no way affect anything we do in terms of providing medical care." I think you should take out that last part.

If you are paying for care—we do not have an unlimited amount of money to pay for health care, and you should be making rational cost-benefit decisions. I think for people at the ends of their lives, we probably spend too little money keeping them comfortable. A lot of people are in really horrible nursing home situations, and we spend way too much money on acute care.

So there are a lot of things we can do, but it has to be done on a bipartisan basis, because it is so easy to demagogue the issue. I think both sides have done that.

Senator CARPER. I think living wills or health care directives—I have one for myself. I go to a doctor. That doctor may be aware of my directive. If I go to a hospital, an acute care hospital, they may not be. If I go to a nursing home, they may not be.

So it does not travel; it does not migrate. And one of the things that Senator Grassley and I are working on is an effort to make sure that that directive, my wishes, actually goes with me to where I am receiving the health care.

The other thing I want to say is on defensive medicine. One of the things we did on defensive medicine—in Naval aviation, we used to call it watching our 6 o'clock, who is coming up behind us to shoot us down.

And in the delivery of health care, doctors, hospitals, nurses, they are worried about somebody coming up and suing them. And so they order more tests, more visits, more MRIs, more everything, in order to cover their 6 o'clock, to ensure that when they are sued, they can say, "Look, I did everything I could have done."

There are actually some very exciting alternatives that are out there. One actually came out of the University of Michigan, "Sorry Works." In a place called Illinois, there is some great work going on. They took "Sorry Works" and put it on steroids to actually do an even more interesting job in reducing the incidents of defensive medicine.

They realized better health care results, fewer lawsuits, and greater patient satisfaction. It is like the trifecta. It is something to keep our eye on. I think we are going to try to spread it across the country, including in the first State of Delaware.

Thank you so much.

The CHAIRMAN. Thank you, Senator Carper.

Senator Hatch and I want to thank all of you as well. And I am just going to wrap up with a quick minute.

For the record, Ms. Swonk, we are going to ask you to expand a little bit on your notion about less traditional kinds of education. You talked about apprenticeships, and that is very good.

The only other point I would make, really, I think, sums up what you all had to say. We talked a bit ago, 2 hours ago, about Henry Ford, and Henry Ford said, in effect, we are all in it together. And today, you have something of a Dollar Tree–Neiman Marcus economy, where you have the bargain stores and the high-end stores doing well.

We have to find a way to come together in a bipartisan fashion to give all Americans the opportunity to get ahead. I am going to be working very closely with my partner on this, Senator Hatch, and all our colleagues.

Thank you all. This has been a terrific way to begin my service on the Finance Committee.

With that, the Finance Committee is adjourned.

[Whereupon, at 12:24 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Statement of

Leonard E. Burman

Director, Urban-Brookings Tax Policy Center

Professor of Public Administration and International Affairs,
Maxwell School, Syracuse University

Before the
Senate Committee on Finance

Policies to Support the Middle Class

March 13, 2014

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

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

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

The tax system has played a mixed role with respect to the middle class. On the one hand, federal tax burdens on middle class families have moderated over time. Moreover, the progressive income tax is now an important part of the safety net, automatically reducing tax liabilities or even providing subsidies through refundable tax credits like the EITC when households fall on hard times. On the other hand, especially generous tax treatment of the "carried interest" earnings of takeover specialists have contributed to downward pressure on wages and have cost many workers their jobs. Tax subsidies for saving have been relatively ineffective at encouraging middle income households to save enough to protect themselves from adverse shocks to income such as job loss. And a panoply of education tax breaks are confusing and less helpful than they might be.

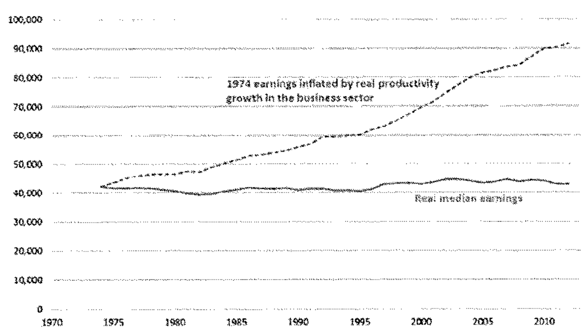
I put forward several options that might help the middle class:

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

<u>Challenges Facing the Middle Class</u>

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

Figure 1. Median Earnings Compared with Productivity Gains for Full-Time, Full-Year Workers, in 2012$, 1974-2012

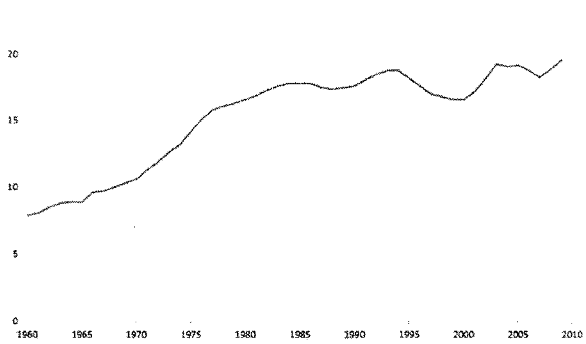


Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, for median earnings; and Bureau of Labor Statistics for output per hour in the business sector.

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

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

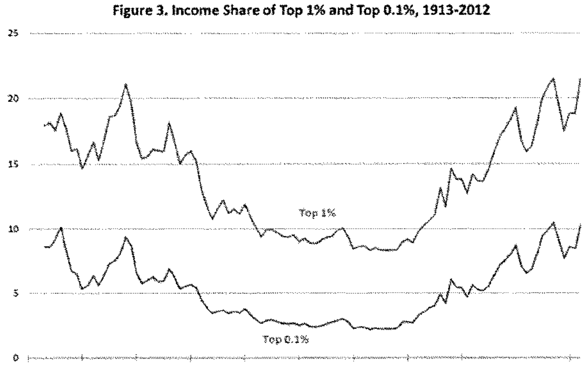
Figure 2. Employee Benefits as a Percentage of Total Compensation, 1960-2010



Note: Includes contributions to insurance, pension, and retirement plans as well as the employer portion of payroll taxes.
Source: Burtless and Milusheva (2013).

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

Figure 3. Income Share of Top 1% and Top 0.1%, 1913-2012



Source: Picketty and Saez (2003), with updates from http://elsa.berkeley.edu/~saez/TabFig2011prel.xls

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

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

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

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

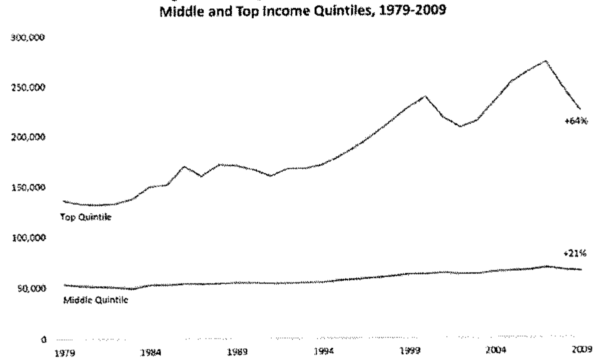
Figure 4. Civilian Labor Force Participation Rate by Gender, Age 25-54, 1950-2011

Source: Bureau of Labor Statistics, http://www.bls.gov/data/#employment

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

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

Figure 5. Average Pre-Tax Household Income Middle and Top Income Quintiles, 1979-2009



Source: Congressional Budget Office (2013) much debt)—although they likely have rebounded given the surge in the stock market but more recent asset data are not yet available.

Figure 6. Median Value of Financial Assets by Age, in Thousands of $2010, 1989-2010

Source: Federal Reserve Board of Governors, Survey of Consumer Finances (various years). Available at http://www.federalreserve.gov/econresdata/scf/files/scf2010_tables_internal_real.xls, Table 6.

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

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

Figure 7. Personal Saving as Percentage of Disposable Income 1950-2013

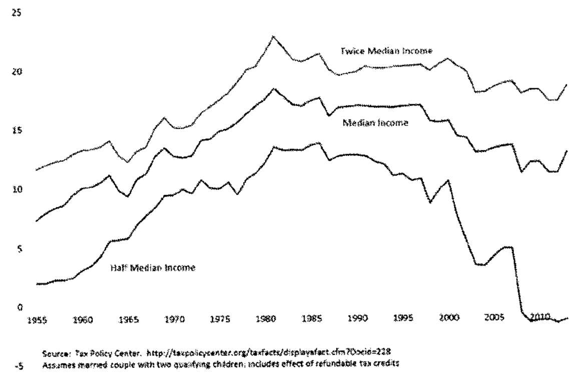
Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1.

Direct Effects of Taxes on the Middle Class

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

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

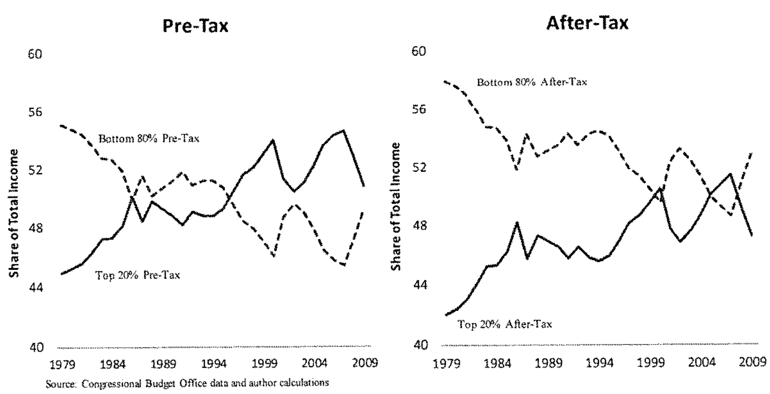
Figure 8. Average Federal Income and Payroll Tax Rate for Family of Four at Three Income Levels, 1955-2013



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

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

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

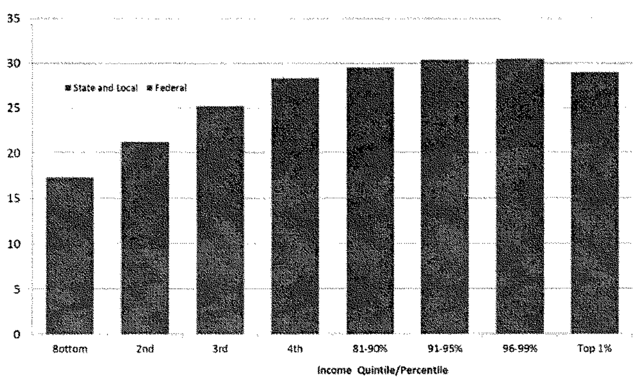


the bottom four-fifths in 2000 and again in 2005–2007. Nonetheless, after-tax income remained significantly more equally distributed than pre-tax income.

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

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

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



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

Indirect Effects of Taxes on the Middle Class

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

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

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

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

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

Structural Explanations for Wage Stagnation

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

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

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

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

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

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

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

Possible Approaches to Supporting the Middle Class

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

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

Improve access to higher education

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

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

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

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

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

<u>Slow health care spending</u>

Health care spending, like spending on education, continually outpaces inflation. Since workers ultimately pay for health insurance through lower wages, controlling health care costs would be enormously helpful, especially for households with incomes too high to qualify for substantial subsidies under the Affordable Care Act. The solution to excess spending on health care is beyond the scope of my testimony, but I'll note that any effective approach is likely to require bipartisan cooperation since it is so easy to demonize opponents for proposing controls on unnecessary medical spending (e.g., "death panels"). It is encouraging in this regard that Chairman Wyden has attempted to craft a bipartisan approach to control Medicare spending.

Reduce subsidies to rent seeking

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

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

Encourage saving

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

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

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

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

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

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

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

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

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

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

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

A more modest alternative would be to set a budget for progressivity adjustments whose cost would equal the revenue loss that would be attributable to price indexation. Instead of adjusting all tax brackets and other parameters automatically by the amount of price increases, bracket adjustments would be designed to get closer to the target distribution of after-tax income. If pre-tax incomes at different levels grow in proportion, then this scheme would be identical to the price indexation that occurs under current law. If not, then some bracket thresholds and other indexed parameters would adjust faster than others. In addition, the credit rate for the EITC might be adjusted to help hit targets at the bottom of the income distribution. This would directly take on the failure of the market to provide adequate wage growth in a way that seems to be garnering some bipartisan support.

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

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

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

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Senate Committee on Finance
Questions for the Record
"Innovative Ideas to Strengthen and Expand the Middle Class"
Hearing Date: March 13, 2014
Questions for Dr. Len Burman

Question from Chairman Ron Wyden

1. **While there is no one size fits all definition of a "valuable" degree or certificate, reasonable people can generally agree that most prospective students and workers expect that the program they pursue will give them a decent shot at graduating and securing employment all with manageable debt. However, graduates today often question whether their degree or certificate was worth it. How can we use federal policy and federal dollars—particularly through the tax code—to help connect students to programs that match both their personal needs and the future labor market?**

Answer

The problem this question highlights is a very real one that is an appropriate target for federal government action. But the tax code is not likely to be an effective mechanism for guiding student choice or for providing the appropriate incentives to institutions. Many of the institutions failing to serve students well are in the for-profit sector and these institutions are not getting a lot of tax breaks, so cuts in tax incentives would have little or no effect on their choices. It would be much more effective to attack this problem on the spending side: make institutions with the worst records ineligible for Title IV aid and/or make institutions responsible for a portion of federal student loan principal on which their students (whether they graduate or not) default, perhaps with a safe harbor for institutions whose default rate is below a certain threshold.

On the tax side, you might reexamine the 501(c)(3) status of nonprofit colleges and universities that fail to meet standards. Some non-profit institutions (both public and private) are not serving students well, but targeting their tax benefits could address only a fraction of the institutions at issue. As you know, many of the worst offenders are in the for-profit sector.

Questions from Ranking Member Orrin Hatch

1. **Dr. Burman, your Tax Policy Center estimates distributional effects of various tax policy proposals or laws. I presume that your Center has fully analyzed distributional effects of the myriad of taxes involved with the Affordable Care Act.**

   I have seen information from the Joint Committee on Taxation that pretty clearly shows sometimes significant tax increases on what most would regard as middle income households stemming from taxes associated with the Affordable Care Act. Of course, that seems entirely inconsistent with promises and pledges that the President has made to not raise any taxes at all on the middle class.

   I have two questions with respect to scoring of the Affordable Care Act:

   a. **Do findings of your Center on distributional effects of taxes associated with the Affordable Care Act show any significant tax increases on middle class taxpayers?**

      Answer

      The Tax Policy Center has not performed a comprehensive analysis of the taxes and subsidies in the Affordable Care Act (ACA), although we would be happy to work with you staff to try to answer specific questions about its impact if we can. You are certainly right that some of the taxes in the ACA will affect middle class families. The most obvious one is the penalty for failure to obtain qualifying health insurance. The Obama Administration argued that these penalties were not taxes, but Supreme Court Chief Justice John Roberts concluded that the penalties are indeed taxes and that was the basis for his decision to uphold the constitutionality of the mandates. If those penalties are viewed as taxes, they can be quite substantial. The Tax Policy Center created a calculator to estimate those penalties for sample taxpayers without qualifying health coverage. See http://taxpolicycenter.org/taxfacts/acacalculator.cfm. A single person with no dependents and AGI of $100,000 would owe $899 in 2014 and $2,236 in 2016 if he or she did not obtain qualifying insurance (or fall into one of the groups exempt from the penalty).

      There are also smaller taxes that could affect middle income families such as the tax on medical device manufacturers and the tax on tanning bed salons. After 2018, the surtax on Cadillac health plans will affect middle income workers whose employers provide especially generous health coverage.

b. **Does the Tax Policy Center make publicly available the model or models that it uses to produce out its tax distribution tables and, if so, where can I find the full exposition of the model(s)?**

Answer

We do not make the model code or the data publicly available. The model is described in detail on our website. See http://taxpolicycenter.org/taxtopics/Model-Related-Resources-and-FAQs.cfm.

2. **Dr. Burman, you propose to institute a scheme to change tax brackets and indexations around periodically, with the changes tied to some measure of income inequality measured by, say, data constructed by researchers Piketty and Saez. However, those analysts are careful to stipulate that their data come from tax returns and are somewhat limited. For instance, transfer payments, which make up a significant share of low-income taxpayers' incomes, are not included.**

Since your scheme of somehow indexing taxes to an inequality measure which could be one involving measurement issues, aren't you concerned that your scheme could be unduly distorting and based on incomplete measures?

Answer

I think it would be a good idea to include transfers in the measure of economic status. The Tax Policy Center does that to some extent in our income qualifier, *expanded cash income (ECI)*, which we use for our distributional analyses. ECI includes the value of cash transfers such as Social Security, SSI, and TANF, as well as certain cash-like transfers such as SNAP (food stamps) as well as the value of employer contributions to health and retirement accounts, which are significant components of income that are excluded from AGI. (See http://taxpolicycenter.org/taxtopics/Explanation-of-Income-Measures-2013.cfm.) CBO also uses a comprehensive measure of income for its distributional analyses.

3. **Dr. Burman, your proposal to index parameters of the tax system to some measure(s) of inequality seems to recognize that annual indexation using our scheme could have undesirable properties (e.g., lowering of taxes at the top of the income distribution during a downturn or extraordinarily high top rates). You then argue that "a more modest proposal" would set a budget for progressivity adjustments, but it is not clear how that would work, and it is not clear whether you intend to set up some sort of slush fund for redistribution.**

    a. **Since your proposal could, in practice, increase the variability of low-income supports (effective negative taxes) and upper-income tax rates, do you believe**

that such variability could have adverse effects, at least on household financial planning?

Answer

As long as inflation stays low, the annual adjustments would be relatively modest—adding up to no more in the aggregate than current inflation indexing adjustments. Perhaps to further smooth year to year volatility, the adjustments could be averaged over several years.

b. **Have you back-casted any variant of your proposal to determine what the results might look like in terms of year-to-year variations in tax rates?**

Answer

Not yet. I came up with the idea in response to Senator Wyden's call for new ideas. It is a modification of a proposal that Yale University economist Robert Shiller and I outlined some years ago. We plan to update our analysis to include this new proposal and will certainly look at how it would have played out historically. I will send your staff a copy when we have completed the analysis.

4. **Dr. Burman, your Tax Vox blog entry related to the hearing identifies that indexation of tax parameters to inflation under current law will "reduce tax revenues (compared with the current level of tax parameters) by over $200 billion in 2025." Indexation to inflation is both current policy and current law.**

a. **Why would any analyst be interested in comparing both current policy and law to a hypothetical in which inflation indexation is frozen at current levels?**

Answer

I did not intend that language to imply a revised baseline concept. My proposal suggested that instead of allocating annual inflation adjustments across the board, the total annual adjustment could be allocated in inverse proportion to relative income gains and losses. The total annual adjustment would be the same as under current law (and policy) so that inflation would not increase total real tax revenues (at least due to bracket creep; some components of income and expenses are still affected by inflation under current law), but the allocation formula would take account of secular changes in the distribution of income.

b. **To do so and to state that, as a result, tax revenues are in some sense reduced seems only to make sense if you believe that bracket creep from phantom inflationary income gains ought to be enhanced. Do you advocate elimination of**

indexation of tax parameters, in order to increase taxes on some gains that are purely nominal?

Answer

My proposal would not change total tax revenues from what they are under current law. It would simply change the allocation of the annual adjustments. If income inequality did not change, the proposal would be exactly the same as current law indexing. Inflation by itself could not cause bracket creep.

5. **Dr. Burman, your testimony offers a variety of information to display that income inequality has increased, that median wages have "stagnated," and that "workers are, at best, capturing only a fraction of the gains from robust economic growth" (i.e., there is a wide and growing gap between a measure of productivity growth that you use and a measure of inflation-adjusted earnings that you use).**

By contrast, a number of researchers have, paying close attention to measurement and consistency of measurement across data being used, have reached other conclusions. Some have concluded that the rise in inequality, as measured by Picketty and Saez data, "exaggerates" inequality. Some have found that the conclusion that median wages or income or earnings have "stagnated" may be sensitive to the wage, income, and earnings measured used and to the unit of analysis. Some have found that the growing and wide gap between productivity and earnings, like the one you display, largely vanishes when using conceptually consistent measures.

Are you comfortable that the data that you used in your testimony to display inequality, a productivity-earnings gap, and growth in things like earnings or wages are robust to alternative measures? Or, do you believe that the studies that raise questions about the robustness of your results are inaccurate.

Answer

I think there are legitimate measurement issues, and Piketty and Saez take a sensible approach to addressing them. The Piketty and Saez figures are especially revealing because they found a credible way to measure the change in the income distribution going back nearly a century. (Piketty, in his new book, applies a similar methodology to compare trends in income and wealth inequality across 20 countries.) One may certainly raise questions—I mention one issue in my testimony which is the growing share of compensation that goes to pay for health insurance—but, as I show in that case, it explains but a small portion of the remarkable secular trend. I think most economists from across the political spectrum recognize that inequality in the United States is historically quite large. Most of the disagreement in the profession is about the causes of inequality and how best to mitigate it.

6. **In his testimony, Dr. Lindsey stated that the 200 percent increase in the share of personal income from transfer payments over the last half century has generated a state where transfers account for 18 percent of personal income. In your testimony, you advocate expansion of programs that generate these transfer payments. At the same time, demographic pressures are pushing transfer and entitlement programs exponentially upward. President Obama's latest budget recognizes the unsustainable path of these programs, even with over $1 trillion of new tax increases.**

   With the rapid growth of these programs and transfer payments, can you identify a maximum amount of transfers that you advocate as a percentage of personal income—for example, would you like to see overall transfers correspond to 20, 40, or 80 or maybe some other percentage of overall personal income in the economy?

   Answer

   I believe that the overwhelming majority of the transfer payments that Dr. Lindsey tabulates are for Social Security, Medicare, and Medicaid (which pays for a lot of senior citizens' long-term care). As you note, demographics (and Congress's decisions at various points to expand those programs) are the primary drivers of the growth in spending on transfers. They are still a fairly small share of the income of working-age families.

   I cannot identify a specific maximum share of income to allocate to transfers. It would depend on voters' preferences with respect to economic inequality and the underlying forces driving it over time as well as the economic cost of those transfers. However, the proposal I outlined in my testimony would have a very small effect on the amount of net transfer payments for the foreseeable future. Even assuming that the entire $200 billion in indexing adjustments in 2025 were allocated to increases in refundable tax credits that would amount to only about 1 percent of GDP.

7. **Dr. Burman, economists Peter Diamond and Emmanuel Saez recently wrote an article which identified that, at the time the article was written in 2011, the top marginal income tax rate was about 42.5 percent. They also construct an economic model and, from it, propose that the marginal tax rate on upper-income earners be hiked to as much as 76 percent.**

   a. **Do you believe that the top marginal tax rate could go up to 50 or 60 or maybe 76 percent, to fund further redistribution through transfers or more government, without affecting economic growth?**

Answer

No.

b. Do you believe that a tax rate on upper earners of as high as 76 percent could in any way harm the middle class?

Answer

Yes, of course. It would depend on the policy context. As Diamond and Saez note, the economic costs of taxation might be significantly reduced by comprehensive tax reform, which would reduce the avenues available for inefficient tax avoidance activities. Although I think the kind of broad-based tax reform they envision could be desirable (abstracting from the issue of top tax rate), it would be politically quite a long shot if not impossible. D&S recognize that in our current loophole-ridden tax system, the economic costs of very high marginal tax rates are much greater, and that could ultimately hurt middle-income households by weakening the economy. I also suspect that the authors understate the scope for tax avoidance and evasion, even under their hypothetical very broad-based tax system, given global financial markets and modern technology. Put differently, a top tax rate of 76 percent is much less viable in 2014 than it was in 1964. I think such a high tax rate would be counterproductive.

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB

The Voice of Small Business.®

Testimony of William C. Dunkelberg

Senate Committee on Finance

March 13, 2014

Exploring Innovative Ideas and Policies That Can Strengthen the Economic Foundations of American Households and Contribute to the Growth of the Middle Class

Good morning, Chairman Wyden, Ranking Member Hatch, and members of the Committee. I am pleased to be here as the Chief Economist of the National Federation of Independent Business (NFIB), the nation's leading small business advocacy organization representing over 350,000 small businesses owners across the country.

My invitation to appear before the Committee today said that you were looking for new, innovative ways to help the small business economy, which accounts for about half of private GDP production historically, half of private employment and most of the new jobs created.[1] My suggestion is that we get back to basics first, fixing what we know is wrong before we try to overlay new "innovative" policies on the economy. The basics will provide the largest payoff to policy efforts.

The employment problem we face today is of two types: (1) cyclical, rehiring positions lost in the recession and (2) new firm creation, the source of net job growth. In simple terms, if our population grows by 3 million people, the demand for goods and services will increase and new firms will be formed. However, all demand is not alike in job creation. For instance, cars are produced with less new labor required than in services, which account for 70 percent of consumer spending. New firm creation has not attained pre-recession levels when tens of thousands of employer firms disappeared, especially in construction. In addition, existing firms have increased employment only modestly after dramatic reductions in the recession.

However, not all businesses are experiencing a slow recovery as the US economy is currently bifurcated. Manufacturing and exporting firms are growing nicely as profits hit a record share of GDP and financial markets hit record highs. The unemployment rate remains high and workers are abandoning the labor force at a far greater pace in unexpected age groups than demographic analysis would lead us to expect. Although GDP is far greater than its peak in 2007, employment remains over one million below its peak (January, 2008). Measures of economic activity monitored by the National Federation of Independent Business[2] over the past 40 years make it clear that the small business sector has not successfully emerged from the recession.

The consumer is the main driver of the economy, and consumer spending has been weak, especially in the services sector which is labor intensive and dominated by small firms. The University of Michigan's Index of Consumer Sentiment has not made a robust recovery and only about one in 10 consumers think government policy is "good," an historically poor showing. Weak consumer spending translates into poor sales for small firms which in turn provide little incentive to order new inventories, expand firms and hire workers.

Business owners, like consumers, are also pessimistic and uncertain about the future. Consequently, they are unwilling to borrow money and spend on expansion, or hire new workers. With weak sales growth, few new workers and inventories are needed. NFIB's Index of Small Business Optimism (Index), a composite of 10 questions, had not managed to escape recession level readings since the recovery started in 2009. Currently at 91.4, the Index averaged 100 from 1973 to 2008, and in recoveries, the Index went as high as 108. Even today, 19 percent more owners expect the economy to be worse in six months than expect it to be better.[3] The net percent expecting higher real sales in the coming months is about zero, with as many expecting lower as expecting higher. A record high percent have no interest in borrowing money since they have no good use for it given their pessimism about future prospects and their uncertainty. The survey also asks owners to select one of 10 issues as their single most important problem operating their business. In the most recent survey, 21 percent of owners cited regulations, 19 percent taxes and 16 percent poor sales. Financing and inflation are tied with 2 percent of owners citing each as their most important problem.

In addition to the monthly economic trends survey, NFIB conducts a more extensive survey every four years where members are asked to rate the severity of 75 potential problems on a scale of 1 to 7, anchored by "Critical Problem" on one end and "Not a Problem" on the other. The 10 most severe problems for small-business owners assessed are: "Cost of Health Insurance," "Uncertainty over Economic Conditions," "Cost of Cost of Natural Gas, Propane, Gasoline, Diesel, Fuel Oil," "Uncertainty over Government Actions," "Unreasonable Government Regulations," "Federal Taxes on Business Income," "Tax Complexity," "Frequent Changes in Federal Tax Laws and Rules," "Property Taxes (real, inventory or personal property)" and "State Taxes on Business Income." This list of challenges is a good starting menu for addressing the question of how to help the small business sector and create jobs.

Small businesses are a major source of economic activity and job creation in the economy, but small businesses have struggled to recover from the recession. The "middle class" includes millions of small business owners who compete with each other for the business of consumers. And most of the 6 million employer firms provide tens of millions of jobs to "the middle class", people who want a job and want to earn a living. The best way to help the "middle class" or those who want to join it is to provide job opportunities in the private sector where they earn their way by producing value. Washington sets the tone: it controls the major prices, incentives, taxes, regulations and policies that impact decisions made in the private sector by consumers and business owners. Meaningful changes here can do much to get the great private sector job generating machine back in gear.

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[1] An economy without population growth cannot have secular job growth. Given the culture of the economy (who can work, get educated etc.), once labor laws (such as minimum wage) and regulations

are established. There will be no meaningful job growth, just shifting jobs as new technologies and discoveries replace old ones. The small business sector is the "R&D" of the economy, where new ideas are tried and tested. Many fail, but provide millions of jobs and invaluable work experience in the process.

[2] NFIB has about 350,000 member firms and has collected basically the same economic and expectations data from a random sample of members since 1973. These data provide a meaningful time series of data on the small business sector through recessions and booms. Although not a scientific random sample of all small businesses, it is likely that NFIB members experience the same economic and policy shocks as its non-member peers experience. There are an estimated 6 million employer firms in the small business sector plus many single worker businesses.

[3] NFIB's Small Business Economic Trends survey ask whether owners believe that business conditions will be better, the same, or worse in the next six months. The data is reported as a net percent; the percent reporting "better" minus the percent reporting "worse." February's data reported a net negative 19 percent of owners feeling the economy will be better than worse in the next six months.

Senate Committee on Finance
Questions for the Record
"Innovative Ideas to Strengthen and Expand the Middle Class"
Hearing Date: March 13, 2014
Questions for Dr. William Dunkelberg

Questions from Ranking Member Orrin Hatch

1. **Dr. Dunkelberg, your organization represents, and is in regular communication with, independent businesses. Those businesses are small and, as I understand it, are well populated with entrepreneurs who you could reasonably say fit the bill of being middle class Americans. And a large number of the businesses that you represent are formed as flow-throughs, passing their business income through the personal tax code, and likely reinvesting much of what is left over to grow their businesses.**

   I noticed in your testimony that your members see government, and government policies, and taxes as at least eight of their top ten worries.

   I wonder if you can provide some discussion of what you have been hearing from your members over the past few years after the recession was declared over in 2009. In your discussion, I wonder if you could tell me if you have heard any concerns over effects on businesses run by middle class Americans stemming from the Affordable Care Act and over effects on flow-throughs stemming from the administration's tax hikes.

Answer

Since the recession was declared over in June 2009, the NFIB Index of Small Business Optimism ("Index"), which is based on random samples of NFIB's 350,000 member firms, has not been above 95, historically recession territory. For context, the average Index reading from 1973 through 2007 was 100. Record low numbers characterize the "current period as a good time to expand" is about one-third of the 42 year average. About 27 percent of those saying it is a bad time to expand, blame the political climate, and far more owners believe that business conditions will be worse in six months than think they will be better. Overall, small businesses are reporting that current conditions are not good and not expected to get better, and government is a major reason for this sentiment. The Small Business Economic Trends survey does not poll specifically about the Affordable Care Act ("ACA"), but regulations and red tape, and reports that the political climate is the major reason for not expanding certainly encompass the impact the ACA is having.

In a special study, Small Business Problems and Priorities, released every four years, "Cost of Health Insurance" was identified as the most critical problem out of 75 choices and has been since 1986. "Uncertainty over Government Actions" ranked 4th, right after the "Unreasonable

Government Regulations" in 3rd position. Federal taxes, including complexity and frequent changes occupied positions 6, 7 and 8. These are important issues, and Washington is not addressing them.

2. **Dr. Dunkelberg, your testimony points to a bifurcated economy, with some firms like exporters and manufacturers seemingly in better shape in terms of recovery from the recession than is the small business sector.**

   Interestingly, the administration has been proposing further tax incentives and other special incentives to manufacturing firms, further special breaks for export promotion, and support for Fed policies to weaken the dollar.

   Interestingly, as well, the administration's most recent income tax hike, along with all the taxes and mandates embedded in the Affordable Care Act, look like things that can hamper the capacity for a small business or any flow-through entity to grow.

   I wonder if you have heard from your membership that policies toward small businesses that have been followed by the administration have been helping or holding back the small business sector.

Answer

The Small Business Administration indicates that, based on Census data, small businesses produce about half of private Gross Domestic Product (GDP) and employ half of private sector workers. NFIB data make it clear that beyond growth driven by population increases, the small business sector has been stagnant. Employment is still one million below its peak level, indicating that fewer people are making GDP. The unemployment rate over 6.5 percent, yet corporate profits are at a record share of GDP and asset prices are also at record high levels. Both indicate that the largest firms are having a very different experience than our nation's small businesses. So, weak growth in the small business half the economy coupled with stronger growth in the big business half, averages out to 2.5 percent GDP growth, the experience in most of the recovery. Tax breaks and subsidies do not create this success, strong sales do.

Higher individual tax rates and other taxes including those in the ACA simply discourage work, investment, expansion and drain the resources used to support growth. More regulatory compliance consumes resources in the same manner. The issues that owners identified as most troublesome, rising health insurance costs, the cost of regulation and red tape, uncertainty about government economic policies, energy costs and the tax code are not being addressed at all, so it is not surprising that small business owners have been pessimistic through the entire recovery.

3. Dr. Dunkelberg, our nonpartisan Congressional Budget Office estimates that half-a-million job losses, as its central estimate, will result from the minimum wage hikes backed by the administration. Those hikes amount to a 39 percent increase in the near term in the federal minimum wage, and an increase in the tipped-minimum of more than 230 percent. Those hikes will apply equally, because they would be federal mandates, across all states. Effectively, that means that the administration wants to mandate the same wage hikes on small business owners in New York, where they can sell things at high prices, as on small business owners in Utah, where they cannot sell things at high prices.

That is, of course, inequitable and unfair. And it is especially puzzling given that States can set their own minimums, and given that pay adjustments to reflect differences in costs across locations are applied to federal pay scales, but similar adjustments are not considered in the administrations wage controls for businesses.

I wonder if you have heard anything from your members about the minimum wage. And, as an economist, would you think that a 39 percent hike in the federal minimum wage would have the same negative employment effects in a place like New York City as it would in a place like Ogden Utah?

Answer

Washington's "one size fits all" approach to regulation imposes major dislocations and costs on the economy. The minimum wage is just one of many examples. A $10 minimum wage in New York City will not go as far as it will in a mid-western or rural city in real terms. Although state and local governments can set a higher wage, they cannot set a lower one to offset distortions.

The solution to this problem in particular and to the unemployment problem in general is a strong, healthy, growing economy. In 2000, small businesses employed a record high 64.5 percent of the adult population, a 40 year record high, 34 percent of NFIB's 350,000 member firms reported hard to fill job openings, and 23 percent reported their top business problem as finding qualified labor, only slightly less than cited taxes, the perennial winner. These are not "high tech" firms but enterprises that dominate the service sector (hospitality, restaurants, and also retail). Firms that used "unskilled" labor could not find enough and compensation reflected it. Some employers were paying twice the minimum wage to hire service workers. That was made possible because demand was strong, so workers generated more revenue, and were worth it until the economy collapsed.

<u>Questions from Senator John Thune</u>

1. **Census data shows that the largest recent declines in household incomes came not just during the recession years of 2001 and 2007 – as you would expect - but also the non-recession years of 2010 and 2011. How do you account for this? Were there government policies instituted in the first 2 years of the Obama Administration that played a major role in inhibiting business activity and the economic recovery, thus depressing incomes?**

<u>Answer</u>

NFIB's Small Business Economic Trends survey showed the small business economy slowing before the peak of the expansion in 2007. However, the real hit was felt after the financial collapse in September 2008. Consumers reacted immediately by increase their saving rate from 1 to 6 percent, still low, but a dramatic increase as each percentage point equated to a spending reduction of $100 billion. In turn, Gross Domestic Product growth declined significantly in the six months that followed, and did not stop falling until the official end of the recession in June 2009. As a result, businesses radically cut prices to reduce inventories, reduced employment and hundreds of thousands of businesses failed altogether.

This adjustment process extended well into 2010 and 2011, creating major distress in the small business economy. Only the success of the large firm half of the economy, mainly due to manufacturing and exporting, provides some forward momentum for the economy which was now bifurcated. However, the small business half is still in trouble. NFIB's Small Business Economic Trends survey continues to show more owners believing the economy will be worse than better and those reporting higher sales are still far lower than pre-recession levels. The Federal Reserve's initial response to the recession was appropriate by providing liquidity, but this generated a huge amount of uncertainty. The stimulus package had little stimulus, and the policy debate in Washington D.C. did not focus on the real issues that affect small businesses. NFIB's Problems and Priorities survey ranks "Uncertainty over Economic Conditions" and "Uncertainty over Government Actions" as the second and fourth most severe problems facing small business owners. Uncertainty is indeed the enemy of economic progress and hampering growth.

2. **I want to bring to your attention a recent op-ed dated March 6, 2014 in the <u>Wall Street Journal</u> by economists Donald Boudreaux and Liya Palagashvili entitled The Myth of the Great Wages 'Decoupling' that argues that there has not been a decoupling of wages and productivity as is often claimed. Using census bureau data, these economists assert that between 1975 and 2009 – using constant dollars - the percentage of Americans earning less than $50,000 fell from 58.4 percent to 50.1 percent while the percentage of households earning more than $75,000 increased substantially. In fact,**

they note that the share of American households earning annual income in excess of $100,000 went from 8.4 percent in 1975 to 20.1 percent in 2009.

Do you agree with the analysis by these economists which seems to imply that income inequality is being driven, at least in part, by Americans moving from the middle class to the upper-middle class?

If the substantial growth in taxpayers earning more than $100,000 is accurate, does it make more sense to encourage those Americans who have moved up the income ladder to help those on the lower rungs – such as through charitable giving and philanthropy – as opposed to trying to redistribute income by means of the federal bureaucracy?

Answer

Boudreaux and Palagashvili are correct, if you define "middle class" using a measure of inflation adjusted income, then decade over decade, people move out of the middle and into the higher rankings, and poor people move from "poor" to middle in terms of material well-being. Census data make it clear that our poor get richer and richer over time having more and more of the material amenities of life, home ownership, etc.

Voluntary private charity is very large in America and, added to public charity (welfare programs, etc.) amounts to trillions of dollars. In spite of this, poverty rates have not improved much even though material well-being on an absolute basis has. The best way to help is to have a strong economy, thus making it easier to have a job. Employment is still over a million below its peak in 2008. Monetary policy has fueled asset prices, and this has contributed substantially to measured inequality as has the reduction in home ownership. Rising home prices helps fewer people now.

Trying to address inequality via tax policy is probably the least productive approach. Marginal tax rates are penalties for working and incentives for tax evasion. Trying to redistribute the existing pie with the federal government as the agent of redistribution is unlikely to help at all. Improving the economic position of the poor is best accomplished by promoting strong economic growth.

3. **Can you elaborate on your testimony about the hurdles facing job creators and the extent to which these hurdles are created by many of the same lawmakers who now claim we need new laws to help the middle class? How meaningful would it be for small businesses, and job creation, if Washington simply got out of the way and stopped creating new barriers to success, such as higher taxes and more onerous regulations?**

Answer

A major impediment to growth is the "red tape tax." The most valuable asset a firm has is the time of the entrepreneur. Hours spent filling out forms diverts attention from managing growth and job creation. This burden is growing all the time, exhausting more of this valuable capital. Compliance also consumes scarce capital that cannot be invested in growth and expansion, a tax on the bottom line as is the income tax that reduces funds available to grow the business.

My electrician, Charlie, is an example. In this economy, he will not hire a worker because the red tape and associated employment taxes that would involve, in his view, reduce his income substantially since he cannot be on the job when he is filling out forms. This also prevents the training of a young new electrician for our future labor force. The benefits of all of this are dubious, the complexity is costly, and it is hard to keep up with the flow of new regulations. The Affordable Care Act has 21,000 pages and growing, how does a small business owner manage this? Most regulations do not face a stringent cost/benefit test, and some are legislatively exempted from the test. Dealing with government at all levels (federal, state, and local) is a fixed cost that grows every year and a regressive "tax" as it takes a higher share of sales for a small firm than a Fortune 500 company.

4. **What would be a more effective incentive for small businesses to expand and hire, a minimum wage increase or a package of tax relief measures, such as permanent higher small business expensing levels and the expansion of cash accounting for small businesses?**

Answer

The only real incentive for hiring a worker is sales growth. The best job creator is economic growth. Because an employer cannot pay workers more than the value they add to the firm, raising the minimum wage will only discourage hiring. Tax breaks for hiring only give breaks to firms that would have hired anyway. For example, a temporary $5,000 tax credit to hire a $25,000 worker will only appeal to a firm that sees sales rising by more than $25,000 permanently, not just in one year. A new worker is very expensive, and is an "investment" in most cases, as the employer hopes the time spent training will pay off with a longer term good employee. Other rules like depreciation versus expensing only change the time distribution of taxes paid, not the amount over time. Tax simplification might provide a benefit, but such measures do not change the value of a worker, and that is what really drives the hiring decision. A strong economy is the best way to get firms to expand and hire as was done from 2003 to 2007.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF MARCH 13, 2014
INNOVATIVE IDEAS TO STRENGTHEN AND EXPAND THE MIDDLE CLASS

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining ways to strengthen and expand the middle class:

Focusing on the middle class is, of course, always a safe political landing spot. A host of surveys reveals that many Americans see themselves as residing in the so-called "middle class," including many that, to an outside observer, would appear to reside elsewhere. That being the case, when politicians say they are working for the middle class, there is clearly a large constituency.

Yet, I don't believe that the motivation for today's hearing is politics or class warfare – at least I hope that is not the case.

The motivation, I trust, is to explore the evolution of middle-income families in America over the past few decades, to discuss what can be done to enhance their prosperity in the future, and to find ways to allow lower-income Americans to climb into the middle class or beyond.

There are two ways to analyze the condition of middle-income Americans.

One way is to cherry-pick economic data that conform to the policy or political points that one wants to make, without checking to see if the position is also supported by other evidence.

The other way is to analyze data to see if they are consistent with one's position and to compare the findings with different measurements, data sets, or economic models.

If you're only interested in making a political point, you'll likely choose the first option.

But, if you really want to see what's happening with the middle class, the second option is the better one.

I mention this because, in debates concerning things like inequality and middle-class incomes, people often tend to choose the first option, utilizing only the data that confirms their preconceived notions.

For example, if you try to measure median income using a measure that is pre-tax and pre-transfer and with a tax unit as the unit of measurement, you find growth of only around three percent between 1979 and 2007, which is consistent with the common claims of middle class stagnation.

However, if you look at post-tax, post-transfer income data that includes valuation of health insurance benefits, and take a size-adjusted household as the unit of measurement, you find that, over the same period, median income has grown by close to 40 percent which is decidedly less stagnant.

There are similar measurement issues when it comes to data commonly used to analyze income inequality.

Mr. Chairman, I know that I make these observations at great risk of being accused of denying stagnation, inequality, or any number of struggles facing the middle class. However, given what I think is the spirit of this hearing, I believe that we should fully examine the issues and measures surrounding the middle class, including income growth and income inequality. That is the only way we can get to the heart of the problems we should be addressing and to what our priorities should be.

Mr. Chairman, I can point to positive examples very close to home.

The latest data from Harvard's Equality of Opportunity Project rank Salt Lake City as the number one city in America in terms of upward mobility. Keep in mind that, in terms of policy, the vast majority of Utahns support a vibrant private sector. We seek lower taxes, individual responsibility, and less intrusive government. And, we take a back seat to no one in terms of caring for the less fortunate in our communities. The means by which we care for the less fortunate is, by and large, through strong charitable institutions.

I think Utah's story is instructive on what we can do to help grow the middle class.

Finally, Mr. Chairman, I must say that, while there has been a lot of rhetoric in recent years about the middle class, I believe that the Obama Administration's focus has been misplaced and that its policies have actually been hurting the middle class.

Four and a half years after the end of the recession, economic growth remains sluggish and the labor market remains depressed. Yet, in all that time, what has the administration been focused on?

We've seen a massive expansion of our national debt due to policies like the failed stimulus.

What little deficit reduction we have seen has been – by a factor of nine-to-one – due more to increased taxes than reductions in spending. And, to date, the administration is unwilling to do much of anything else unless there is yet another tax-hike attached.

We've seen the effort to pass and implement the Affordable Care Act, which further increased taxes and health care costs for middle class families and is, according to the Congressional Budget Office, having an adverse impact on labor-market incentives.

We've seen a vastly expanded federal bureaucracy through the Dodd-Frank Act, which has failed entirely to address known significant contributors to the recent financial crisis.

And, we've seen a regulatory effort from the EPA to the Department of Labor to the NLRB that has imposed costs on American businesses that will surely be passed along to employees and consumers in the middle class.

I do not see a laser focus on job creation or growing the middle class anywhere in those policies.

Mr. Chairman, if we're serious about helping and expanding the middle class – and I think we should be – it needs to be more than just a slogan. Sadly, I believe that, over the last five years, the talk about helping the middle class hasn't translated into policies that would actually do the job.

I look forward to working with you to explore other ideas that will lead to a strong middle class and an economy with robust growth in jobs, private investments, and prosperity for all American families. And, I hope today's hearing will provide us with some insights on how we can do better.

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Strengthening Economic Foundations & Growing the Middle Class

Senate Committee on Finance

March 13, 2014

Dr. Lawrence Lindsey

Senator Wyden, Senator Hatch, Members of the Committee. It is an honor to be here today to discuss the challenge our country faces in growing its middle class. America has always been a middle-class nation – one in which most people are neither a part of a permanent "over class" of the type which governs many nations politically and economically nor part of an "under class" that is dependent upon the charity of others or of the government. The key attribute of the middle class is self-reliance; something that is part of our national identity from our beginnings as a country, and something that in my judgment public policy should encourage, not inhibit.

I'd like to begin by laying out some facts that are not part of the conventional wisdom regarding income in America and the state of the middle class. The first observation is that neither political party has been particularly effective at fostering policies that make American income distribution more equal. Chart 1 shows the change in two measures of income inequality used by the Department of Commerce to give a summary statistic of the state of income inequality in America. In both cases the higher the number the more unequal the income distribution. Note that income inequality has risen under every President for half a century. It rose fastest under President Clinton. During those eight years it increased more than under the eight years of President Reagan and the eight years of President Bush combined. Rising income inequality was not the intent of any of these Presidents; it just has not been something that has proven very tractable to public policy.

That apparent intractability is not for want of trying. For example, Chart 2 shows how much more progressive income taxation has become since 1980. The first column shows the share of income received by the top 5 percent of the income distribution according to the Department of Commerce. The second column shows the share of income taxes that they pay. Note that both columns have been moving up. The share of income received by the top 5 percent has risen a little over 5 percentage points in the last 30 years. The share of income taxes paid by the top 5 percent has risen a bit more than 20 percentage points over the same time. The third and fourth columns compare the taxes paid and income received by the top 5 percent and by the other 95 percent of households. In 1980, for example, the share of taxes paid by the top 5 percent of the income distribution was roughly 2 1/4 times their share of the income they received. For the remaining 95 percent, the share of taxes they paid was about ¾ their share of income. Thus, by comparing these ratios we get a sense of how much the average taxes paid by the top 5 percent compares with the share of taxes paid by everyone else. In 1980 the top 5 percent paid about three times what everyone else paid in terms of their share of income. By 2010, the share of taxes relative to the share of income for the top 5 percent had risen to about 2 ¾ while the same ratio for everyone else had fallen to about ½. This means that by 2010 the relative tax burdens had risen from 3 times to 5 ¼ times.

The chart is illustrative for two reasons. First, the top marginal tax rate generally declined during that period. It was 70 percent in 1980 and fell to just over 35 percent by 2010. Despite this, the share of taxes paid by the top 5 percent rose consistently, and it also rose consistently faster than their share of income. Second, despite an ever increasing share of income taxes being paid by the top 5 percent, income inequality continued to rise. In other words, higher taxes are simply not an effective means of levelling out the income distribution. None of these points are what one would consider conventional wisdom.

The other important indicator about the inability of government policy to affect income distribution is that income inequality has risen despite a massive increase in the share of income that government redistributes. Consider the third chart in this presentation. It shows the shares of personal income that come from government transfer payments to individuals and the share of income coming from what the national income accounts call property income – interest and dividends. Despite the indications of rising income inequality over the last half century or so, the share of personal income coming from transfer payments has roughly tripled, from six cents on the dollar to eighteen cents on the dollar. It is almost incomprehensible that one can move a full twelve percent of income around in an effective matter and not make income distribution more equal if that is the intent. Of course, the answer is that our massive panoply of income distribution programs are not effectively designed, a point I will return to.

The other line on the chart shows the share of income that is property income. That shows a more complicated pattern, rising until 1980 and then falling after 1990. Today transfer payments are a more important source of personal income than are interest and dividends, an enormous change. If we think about the issue of class, and Mr. Chairman, you have called this hearing to think about what is happening to the middle class, one need only look at these lines to understand the middle class issue. As I said at the beginning of my testimony, the key sociological fact of being in the middle class is self-reliance. Middle class individuals are not dependent on government for their livelihood, nor are they coupon clippers, dependent on income from capital to live on. They live on wages they earn in the market place.

What is fascinating is that income inequality has increased and many believe the middle class has shrunk DESPITE more income redistribution and DESPITE having the share of income coming from "coupon clipping" dropping. The only explanation for this must be that something is happening to the third main source of income and the main source of middle class income, which is wages. The data on this are clear – fewer people are working. With fewer people working, wages are a less important source of income and with fewer people working there are by definition fewer people who are going to be able to be self-reliant.

There is no greater challenge to the growth of the middle class and promoting income inequality in America, and might I add to the pace of economic growth, than the rate of labor force participation. This rate has collapsed in the last five years. More than half of the explanation for the drop in the unemployment rate since the recession began has not been due to job creation – but people dropping out of the labor force. Consider the magnitude of this. Figure 4 shows what has happened to middle aged labor force participation between 2007 and the end of 2013. If we had the same fraction of middle aged people participating in the labor force as we had in 2007 there would be 2 million middle aged males and a million middle aged females active in the economy than we actually had . Note, these people aren't saying they can't find a job, they are saying they don't want a job.

This drop in labor force participation has corresponded to a large increase in the scope of government transfers and the increase in the effective disincentive to return to work. I would urge you to examine a paper on the subject developed by the Urban Institute and published in the National Tax Journal. It found out that the effective marginal tax rate faced by a single mom with two kids was between 50 and 80 percent. I append two charts from that paper. Is it any wonder that middle aged people who lose their jobs and get trapped in our entitlement system choose to leave the labor force rather than return to work?

So, Mr. Chairman, you asked for a creative thought on how to prevent the bar-bell like developments in the income distribution. I have one suggestion: Keep It Simple. The expansion of complex government solutions has not worked well. An ever more complicated income tax system, despite placing an ever increasing share of the tax burden on the top 5 percent of taxpayers has not made income more equally distributed. Redistributing 18 percent of personal income has not either. And from the "Benefits Mountain" chart from the Urban Institute, one can understand why. These programs are not well co-ordinated. They are layered one on top of the other. And as such they are neither well thought out from the government side. As a result, they create a complex problem for the intended beneficiary and a disincentive for them to participate in the labor market. In terms of tax reform, with apologies for some immodesty, I commend a recommendation I made in my recent book The Growth Experiment Revisited. Tax Simplification –an outright abolition of the personal, corporate and social security tax – and a replacement with a single cash flow tax is the goal.

Thank you and I would be happy to answer any questions.

Chart 1

Neither Party Has Reduced Income Inequality

Presidency		Change in GINI Coefficient	Change in Mean-Log Coefficient
Nixon/Ford -	8 years	+ 0.012	+ 0.005
Carter	4 years	+ 0.005	+ 0.014
Reagan	8 years	+ 0.023	+ 0.026
Bush - 41	4 years	+ 0.007	+ 0.015
Clinton	8 years	+ 0.029	+ 0.074
Bush - 43	4 years	+ 0.004	+ 0.051
Obama (first 2 years)		+ 0.003	+ 0.031

Source: US Dept. of Commerce, The Lindsey Group, See Also Lindsey *The Growth Experiment Revisited* (2013) p. 208

Chart 2

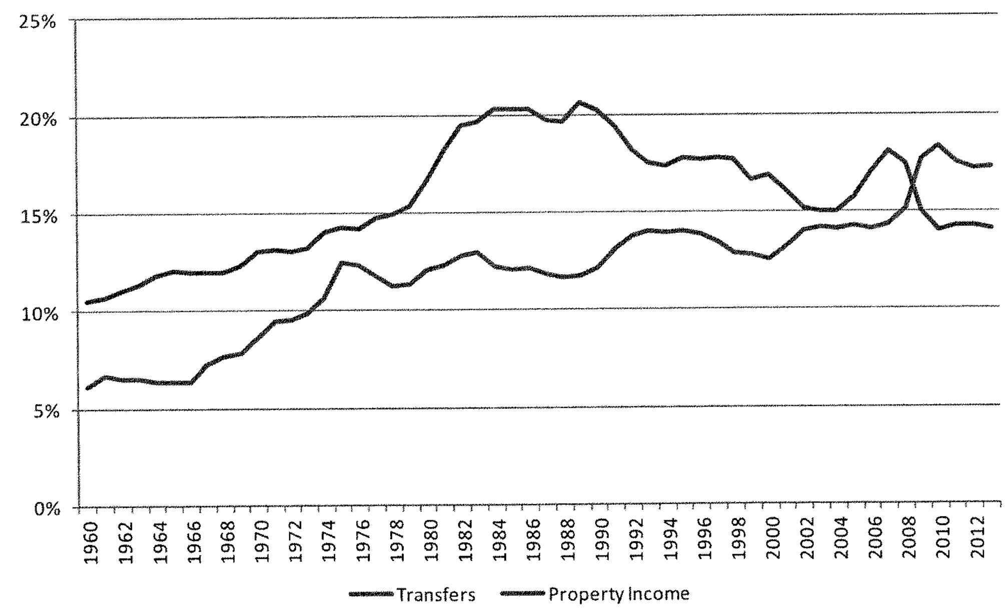
Share of Taxes Paid by Rich Rose Faster Than Their Share of Income

	Top Five Percent		Tax Share / Income Share		Ratio of Tax/Income
	Share of Income	Share of Income Tax	Top 5%	Everyone Else	Shares Top/Bottom
1980	16.5	36.9	2.24	0.76	2.95
1990	18.5	43.6	2.36	0.69	3.42
1995	21.0	48.9	2.33	0.65	3.58
2000	22.1	56.4	2.55	0.56	4.55
2005	22.2	58.9	2.65	0.53	5.00
2010	21.7	59.1	2.72	0.52	5.23

Source: Bureau of Census, Internal Revenue Service

Chart 3

Transfer Payments Now Bigger Than Capital Income



Source: Bureau of Economic Analysis

Chart 4

Decline in Middle Aged Labor Force Participation

Men	2007* Participation	Dec-13 Participation	Lost Workers	Women	2007* Participation	Dec-13 Participation	Lost Workers
25 - 34	91.4%	87.9%	734	*25 - 34*	75.4%	74.2%	241
35 - 44	91.1%	89.4%	335	*35 - 44*	74.7%	73.8%	188
45 - 54	88.3%	84.3%	850	*45 - 54*	76.2%	73.0%	725
Total *('000s)*			1,918	Total *('000s)*			1,154

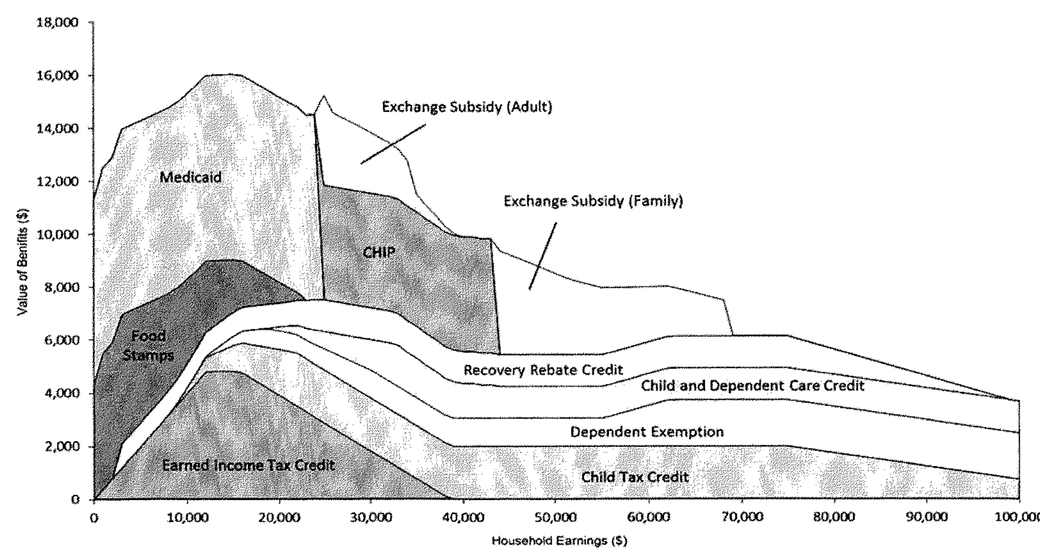
Total Both Genders: 3,073

* Avg. monthly participation

Source: Bureau of Labor Statistics, Current Population Survey, TLG

Chart 5

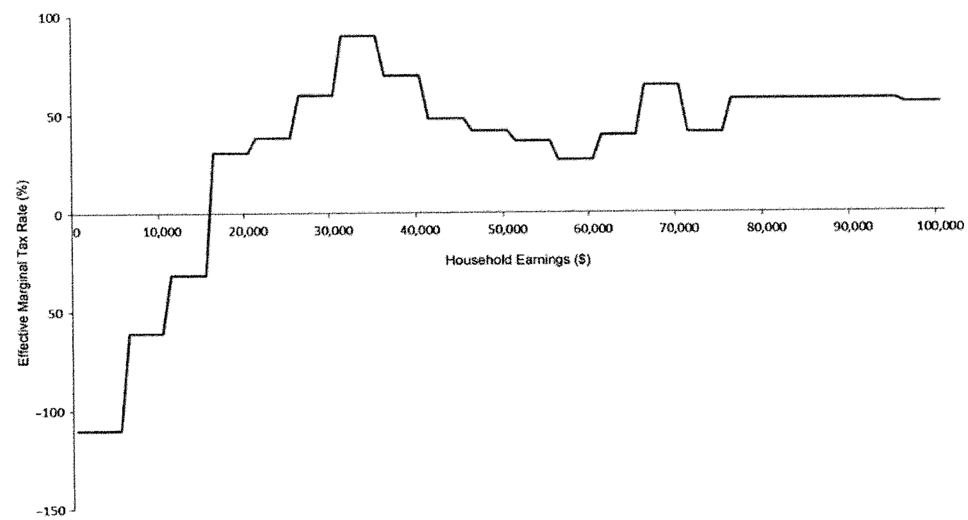
Benefits for Single Parent With Two Children



Source: The Urban Institute

Chart 6

Marginal Tax Rate for Single Parent With Two Children



Source: The Urban Institute

Senate Committee on Finance
Questions for the Record
"Innovative Ideas to Strengthen and Expand the Middle Class"
Hearing Date: March 13, 2014
Questions for Dr. Lawrence Lindsey

Question from Chairman Ron Wyden

1. **While there is no one size fits all definition of a "valuable" degree or certificate, reasonable people can generally agree that most prospective students and workers expect that the program they pursue will give them a decent shot at graduating and securing employment all with manageable debt. However, graduates today often question whether their degree or certificate was worth it. How can we use federal policy and federal dollars—particularly through the tax code—to help connect students to programs that match both their personal needs and the future labor market?**

Answer

The problem of student loan debt is a real one. So too is the underlying reality that many students took on debt to finance an education that did not provide the skills necessary to earn sufficient income to service that debt. It is useful to consider why that is the case.

First, although the student loan programs are well intended, economic studies document that the actual beneficiaries of the program were educational institutions, not students. The reason is quite simple. Student loans have helped to sharply reduce the constraint on the ability of educational institutions to raise tuition. Tuition has consistently risen at a pace far higher than the overall inflation rate for roughly three decades. Moreover, tuition has risen faster than the salaries of faculty members. So, the net proceeds of student loans did not go into the classroom, but into the bureaucracies running these institutions.

Second, there was no incentive in any of these programs for educational institutions to channel students into programs that were likely to lead to loan repayment. The institutions had no "skin in the game". Instead, these institutions catered to the wishes of their own internal politics and to the general preferences of students to study things that they would "enjoy". In the latter case this was simply a matter of expanding the "volume" of product sold – and tuitions collected. Hence there was no effort made to match education to skills that would lead to future income.

If the Congress wants to design student loans that actually increase workforce skills in an economically productive manner then it must create a program structure that incentivizes the true beneficiaries of these programs – educational institutions – to deliver the desired product. This would entail placing these institutions on the financial hook for the failure of the students they "educate" to repay their loans. This would both incentivize them to encourage students to repay (which they routinely do not do now) and to provide an educational experience that would lead to the incomes that allow students to repay the loans.

Questions from Senator John Thune

1. **Census data shows that the largest recent declines in household incomes came not just during the recession years of 2001 and 2007 – as you would expect - but also the non-recession years of 2010 and 2011. How do you account for this? Were there government policies instituted in the first 2 years of the Obama Administration that played a major role in inhibiting business activity and the economic recovery, thus depressing incomes?**

   Answer

   The failure of household incomes to recover during the recent economic recovery is linked to a general failure of employment to recover sharply. The thrust of government policy was not employment focused. The "stimulus" bill channeled money inefficiently into the economy and produced a "multiplier" of perhaps 0.3. The reason for this was one that was discovered as early as the response to the 1970 recession. State and local governments, the beneficiaries of much of the funds, are inefficient at turning those funds directly into increased spending and jobs. Some of the money is absorbed by the state and local governments for existing programs. The rest only trickles through the governmental appropriations process slowly. In addition, the focus on increasing entitlement programs has, as the testimony indicated, created large disincentives for those who did lose their jobs to return to work. Finally, the Dodd-Frank legislation has had a chilling effect on the expansion of credit through the banking industry. While this may have been well intended, it did not help the pace of the economic expansion or job formation or household income growth.

2. **I want to bring to your attention a recent op-ed dated March 6, 2014 in the Wall Street Journal by economists Donald Boudreaux and Liya Palagashvili entitled *The Myth of the Great Wages 'Decoupling'* that argues that there has not been a decoupling of wages and productivity as is often claimed. Using census bureau data, these economists assert that between 1975 and 2009 – using constant dollars - the percentage of Americans earning less than $50,000 fell from 58.4 percent to 50.1 percent while the percentage of households earning more than $75,000 increased substantially. In fact, they note that the share of American households earning annual income in excess of $100,000 went from 8.4 percent in 1975 to 20.1 percent in 2009.**

   Do you agree with the analysis by these economists which seems to imply that income inequality is being driven, at least in part, by Americans moving from the middle class to the upper-middle class?

   If the substantial growth in taxpayers earning more than $100,000 is accurate, does it make more sense to encourage those Americans who have moved up the income ladder to help those on the lower rungs – such as through charitable giving and philanthropy – as opposed to trying to redistribute income by means of the federal bureaucracy?

Answer

I think that the evidence is clear that the more one screens for other factors, including family size and composition, workforce skills, and looks at detailed income changes, that the actual decline in the middle class is far less than is commonly reported. The study cited is just one of many that bears this out.

3. **Many believe that the EITC has been an effective anti-poverty tool because it incentivizes work and targets those who need the assistance the most. However, the EITC is plagued with high rates of fraud and some argue it is a poor wage subsidy since beneficiaries receive one lump sum payment at the end of the year. How would you reform the EITC or replace it with another mechanism that incentivizes work, targets those who need the assistance the most, reduces fraud, and provides a more timely wage subsidy for those lower-income individuals and families?**

Answer

The EITC is, compared to other government programs, a relatively well structured one. However, there is room for improvement. One way that is commonly suggested and has support across the political spectrum is to move it from a program that pays the taxpayer to one that pays the employer via a wage subsidy scheme. While programmatically more efficient, there is some question as to whether it would have the same impact on the thinking of the individual. More study of this question would be useful.

4. **The Obama Administration and many Democrats in Congress view higher taxes on wealthier Americans as the means by which to address income inequality. Is there any credible evidence to suggest that the government simply taking more income from those at the top of the income scale will result in better jobs for those lower on the income scale? What does the data reveal regarding the effectiveness of the trickle-down government theory of income redistribution?**

Answer

There is no evidence that government can make someone better off by making someone else worse off in any sustainable fashion. Economists have recognized this for at least the 40 years that I have been involved in economic study. My freshman economics text, by Paul Samuelson, called this the "leaky bucket". Moving a dollar from one person to another creates disincentives to the taxpaying individual to work as hard, disincentives for the recipient as well, and involves administrative costs. It also tends to distort market signals.

While government must provide a safety net to those who are unable to care for themselves, redistribution for its own sake is generally counterproductive in terms of raising overall living standards.

Statement of George Packer

Author, *The Unwinding: An Inner History of the New America*

Before the Senate Committee on Finance

Innovative Ideas to Strengthen and Expand the Middle Class

March 13, 2014

Chairman Wyden and Ranking Member Hatch, I am honored to have been asked to testify before the Senate Finance Committee today. I am a staff writer at The New Yorker Magazine, and last year I published a book called *The Unwinding: An Inner History of the New America*. I conceived it as a thirty-year history of the political and economic upheavals that have transformed America during my adult lifetime. I might have added another policy book to the long shelf of such tomes, or written a more conventional work of American history, but I didn't feel very qualified to do either. I'm a journalist, and I wanted to write about this generational change through the lives and stories of a handful of unknown Americans in some of the more forgotten corners of the country. From 2009 to 2012 I spent a lot of time in the Piedmont region of North Carolina; in Youngstown, Ohio; and in the unincorporated subdivisions around Tampa Bay. Here is what I learned from some of the people with whom I spent many weeks and months.

First, everywhere I went, I heard again and again: there's no more middle class here. There's just rich and poor. Even if this wasn't statistically true, it felt true to the people I talked with. The disappearance of jobs in manufacturing, small-scale agriculture, or construction (depending on where I was) has been going on for a long time—since the late seventies in the case of the steel industry in Youngstown—and any long-term trend can begin to seem normal, even unnoticeable. But the financial crisis and the Great Recession seemed to focus people's minds on how far things had gone. I remember walking along Main Street in Madison, North Carolina with Dean Price, the son of tobacco farmers and a native of the area. He had grown up thinking of himself as middle class, but just about every store he'd known as a kid was closed down, and he said, "If you think about it, the people that ran the hardware store, the shoe store, the little restaurant that was here, they were the fabric of the community. They were the leaders. They were the Little League baseball coaches, they were the town council members, they were the people everybody looked up to. We lost that."

How many Madison, North Carolinas are there around America? When you leave the more prosperous areas of the country, it becomes almost routine to see deserted main streets in town after town. In Rockingham County, North Carolina, population 93,000, three Walmarts opened up in one six-month period a few years back, with almost ten applicants for every position, which paid an average of $16,108 a year. Those were just about the only jobs available to workers who had once held manufacturing jobs in the textile mills and furniture factories before those moved overseas. Dean Price told me that, with the housing bust, a lot of people in his area had to choose between paying the mortgage and putting gas in the car to drive ever-longer distances to ever-lower-paid work. Again, this is not the exceptional case—it felt to me closer to the norm. It's the economic success stories that we hear about in the media, in Silicon Valley and on Wall Street, that felt like the exceptions. As Dean Price said to me, "How many investment bankers and software designers are there around the country? Then think of how many farmers."

The second thing I kept hearing was that the game is rigged. People who were trying to play by the rules found that, no matter how hard they tried, they couldn't get out of debt or lift themselves out of an impoverished life, while they watched more fortunate people, with the right educations and connections, pull away, be granted second or third chances, even get away with murder. I heard this from people of all races, backgrounds, and political views, and while they had different explanations and placed the blame in different ways—some blamed big business, some blamed big government, some blamed Wall Street, some blamed all of you—this widespread cynicism struck me as a dangerous sign about the health of American democracy. The idea that hard work and effort can lead to better prospects for oneself and one's children is at the heart of the American dream. It's one thing to read statistics about income inequality and social immobility; it's another to see the dream vanishing in the minds of ordinary Americans.

For example, in Tampa I met the Hartzell family—Danny and Ronale, and their young kids Brent and Danielle. Danny worked as a welder, then at a packaging plant, but when those jobs disappeared with the recession, he spent months looking for work with no luck. Then the Hartzells' daughter Danielle was diagnosed with bone cancer, and the parents put all their energy into her treatment and recovery, made possible by the charity of local hospitals. Finally, Danny got a job stocking produce at Walmart for $8.50 an hour, which—because the store had him working part-time—put Danny at about ten thousand dollars a year. Try supporting a family on that. By the end of the month, they had as little as five dollars on hand. The only time they had extra cash for any purchases beyond the basics was when they received their Earned Income Tax Credit.

And yet the Hartzells weren't doing any of the things that poor people are rumored to do. They didn't drink or do drugs; they obeyed the law. The kids were loving and respectful. The family stayed together through everything—even three periods of homelessness. The parents continue to put their kids—who bounce between schools and miss out on their education because of the family's instability—ahead of every other consideration. The last time I saw the Hartzells, Danny said to me, "My view on everything—if you want to change this country, you have to put a person in office who has never done it for a day. Put a regular old guy like me, someone who's lived it and never done nothing else but live it." I think Danny was saying something like the game is rigged.

The Hartzells have made their share of mistakes, but they are the kind of people who used to do O.K. in America—not rich, but O.K. There was a place of dignity for them in our society. Today, without good educations or successful connections or other resources, the Hartzells are barely surviving. They feel themselves to be disposable, and it's hard to be optimistic about their or their children's future. Just last week, Ronale Hartzell e-mailed to tell me that they've left Tampa, where they lived most of their lives, to try their luck in Orlando. "We just want a little happiness, just a little," she wrote. "We are trying so hard since day one." How many people like the Hartzells are there in America?

I'm not the policy expert in this room. You will hear from others who are. But I've become a sort of expert on the people I wrote about in *The Unwinding*. I can tell you that the institutions that used to support the aspirations of middle-class Americans—from federal, state, and local governments to corporations, banks, public schools, and the media—are no longer seen as positive forces in the lives of the people I spent time with. These institutions are either very distant, to the point of irrelevance, or else they are seen as negative. There is no simple or single solution to this state of affairs, but it's real, it's out there, and every day it corrodes the sense of fairness and opportunity that's essential to our democracy. The people I wrote about don't have lobbyists or trade associations or public affairs firms to represent their interests in Washington. The only voice they have is yours. For that reason, I hope that the members of this committee will put the Americans I've been describing, and others like them, at the center of all the legislative work you do.

Thank you very much.

Testimony of Diane C. Swonk
Chief Economist & Senior Managing Director, Mesirow Financial
Before the United States Senate Committee on Finance
Hearing on Innovative Ideas to Strengthen & Expand the Middle Class
March 13, 2014

Chairman Wyden, Ranking Member Hatch and distinguished members of the Committee: My name is Diane Swonk. I am Chief Economist and Senior Managing Director for Mesirow Financial in Chicago. I thank you for the opportunity to testify. As an economist, I spend much of my time studying data on the labor force and calculating implications for the U.S. economy in terms of spending and investment. This testimony takes a closer look at the challenges still facing the majority of American consumers. In it, I pay special attention to the unevenness of improvements in incomes and balance sheets across income strata, and how that is impacting both the pace and the composition of consumer spending. The middle class, in particular, remains a laggard and even if conditions do improve in 2014, this tide we call a subpar recovery is still unlikely to lift all boats. Those who have their incomes and fortunes tied to financial market gains, an extremely small percentage of households, are expected to continue to do substantially better than the majority of Americans.

The Bifurcation of Consumer Spending

Recent Taxes Changes and the Effects on Wages and Other Income

Real disposable income growth has been tepid since the onset of the recovery. Gains in 2013 were particularly weak. Several factors contributed to that weakness. Tax hikes on higher income households coupled with the expiration of the payroll tax holiday reduced after-tax incomes. The threat of higher taxes prompted wealthier households to shift income from 2013 into the end of 2012. That precipitated a drop in income at the start of the year. Wages remain stagnant while the composition of employment gains has been less than stellar.

The expiration of the payroll tax holiday, added to cuts in unemployment insurance and many food subsidies, has been particularly hard on lower and middle income households since the turn of the year. Grocers have complained that low and middle income households are spending significantly less, particularly on packaged foods. Hence, the decision by the mid-market grocery store chain, Dominick's in Chicago, to close its doors on December 31, 2013.

Prospects for 2014 are better, as the pace and composition of employment gains are both expected to improve once we get past distortions created by unusually harsh winter weather. Wages are expected to remain relatively stagnant, however, given the ongoing slack in labor markets.

Income and wealth inequalities have intensified. Median incomes continued to fall in 2012 (the most recent year for data) and remain well below the 1999 peak,[1] while the wealth lost in the crisis has been recouped but is concentrated in the top 7% of households.[2] Recent housing price appreciation has alleviated some of the distribution problems in recent years. The equity held in homes, however, remains below the levels hit prior to the crisis in 2006, which means that the majority of Americans who rely on the family home as the primary asset are still trying to regain ground lost to the recession.[3] Moreover, the surge in foreclosures and short sales and the drop in home ownership rates have disproportionately hit low and middle income households, many of whom took on loans that they never should have qualified for in the first place.

High Long-term Unemployment

This is all in addition to the increased stress that middle and lower income households are enduring in response to the cumulative problems associated with persistently high unemployment and a low level of labor force participation. The percentage of young adults living at home (more than 31% of 18-34 year olds) has risen fairly dramatically in recent years,[4] along with the percentage of households with several generations of families living together.[5] The drop in the labor force participation rate among 35-44 year olds[6] is particularly disturbing; it suggests that we are sidelining people who under "normal" circumstances would be in their prime "earning and learning" years.

No one knows exactly what the long-term effects of those losses will be but our experience from the deep recessions of the 1980s is not encouraging. Long-term unemployment, particularly among men in their prime earning years, permanently reduced their earnings relative to a comparable group of unionized workers who escaped layoffs. It also reduced the educational attainment and earning potential of their sons relative to counterparts who stayed employed. (Louis Jacobson, 1993)[7]

Improvements in Debt Uneven

On the brighter side, aggregate debt-to-disposable income levels have fallen to early 2003 levels; default rates on credit outstanding have fallen; and, recent surveys by

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1 (Carmen DeNavas-Walt, Issued September 2013)
2 (Richard Fry, April 23, 2013)
3 (Board of Governors of the Federal Reserve System, Issued March 6, 2014)
4 (United States Census Bureau, Current Population Survey, 2013)
5 (Livingston, Issued September 4, 2013)
6 (Toossi, December 2013)
7 (Louis Jacobson, 1993)

the Federal Reserve suggest access to consumer credit is easing. The recent loan officer survey showed an easing of mortgage credit, while credit available to consumers on credit cards expanded in 2013. All is relative, however, as the hurdles to obtaining a mortgage remain extremely high. Also, the recent expansion of credit available to credit card users has been concentrated among the most credit-worthy of borrowers, who appear to need it least. Credit card balances remained almost unchanged over the last year, despite a sharp increase in credit available to those who still have credit cards.[8]

Debt service burdens have also dropped precipitously, which should be providing some offset to stagnant wage gains when it comes to spending. Improvement, however, is concentrated among homeowners; financial obligations as a share of disposable income for renters, who are increasing, have actually risen in recent years.[9]

Defaults on credit have also fallen fairly dramatically. The exception is student loans, which have not only grown dramatically but are going bad at an accelerated pace.[10] This is limiting the current and potential pool of first-time home and vehicle buyers. The number of first-time homebuyers dropped to 26% of existing home sales in January, well below the 40% norm, despite a persistently high level of affordability.[11] This is one of many reasons that home sales have slackened in recent months. Existing home sales are the largest single trigger to additional consumer spending.

Home equity lines of credit also remain weak but are likely to pick up as we move into 2014.[12] Recent housing price appreciation makes it easier for many to qualify for home equity lines of credit. This is just one of many reasons those who own a home are opting to repair and remodel their current homes rather than sell to trade up and risk not qualifying for a new, larger mortgage.

Separately, payday loans have returned. With the collapse in the shadow banking industry, pawnshops are substituting for banks; layaway plans have returned to serve customers who have lost access to credit; and discounts, particularly in the apparel industry, are close to the all-time highs hit during the height of the financial crisis in 2008. (Promotions by low-end and mid-market retailers during the 2013 holiday were particularly aggressive.) Crowd lending is also picking up, with lenders like Lending Club matching investors and borrowers online. The high returns those lenders are achieving, however, is a red light to anyone who has watched consumer credit markets closely.

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[8] (Board of Governors of the Federal Reserve System, January 2014)
[9] (Board of Governors of the Federal Reserve System, December 13, 2013)
[10] (Federal Reserve Bank of New York , February 18, 2014)
[11] (National Association of Realtors, Housing Affordability Index , Issued February 12, 2014)
[12] (Federal Reserve Bank of New York , February 18, 2014)

Confidence. Consumer confidence has gradually improved but remains well below the highs hit prior to the crisis and differs widely by income strata. Those earning over $50,000 a year are significantly more confident about the economy than those earning less than $50,000 a year. This reflects the differences in financial stress that have emerged across income levels in the wake of the crisis; it is simply easier for higher income households to absorb the costs associated with kids who never leave home or return home after college than it is for lower income households, especially in light of the rise in incomes and net worth in the wealthiest of households.

Implications for Consumer Spending

Consumer spending picked up, but remained suppressed relative to previous recoveries in the second half of 2013. Consumer spending is expected to remain more buoyant in 2014than it was earlier in the recovery. The wealth that was accumulated over the last year has been slow to materialize in spending but should play at least a marginal role in spurring gains for the wealthiest of households and some upper middle income households. Gains are expected to remain extremely uneven, however, with lower and most middle income households still reaching for value and moving down the retail food chain, while luxury retailers and service providers expand. More of the spending we see will be on big-ticket items such as vehicles, appliances, furniture and remodeling, as that is where pent-up demand is the greatest.

Unusually harsh winter weather exacerbated the pressure on big box retailers, apparel stores and restaurants in recent months. Consumers either hibernated, which took a toll on mall traffic as temperatures plummeted and storms raged or (if they could afford to) migrated to sunny vacations and ski resorts. The early surge in demand for travel to Disney World was so great that the amusement park was able to raise ticket prices in February, four months earlier than in 2013.

That said, the stress we are seeing on retailers who serve low and middle income households relative to those at the very high end clearly goes beyond weather disruptions. In response, the bulk of consumer spending is expected to remain concentrated in a small number of wealthy households. The bifurcation that we have seen in both spending and the type of businesses that win and lose is expected to continue:

- Spending at grocery stores is expected to remain constrained, with competition intensifying. Big box discounters have gained market share relative to more traditional stand-alone grocers but still have little pricing power. Whole Foods, which serves more affluent customers, is trying to restructure stores, offer more discounts and shed its image as a high-priced grocer. This is at the same time that competition is growing among higher-priced specialty grocers such as Fresh Market and Mariano's, a new entrant in Chicago, that is taking over many of the stores vacated by Dominick's and adding more hires per store; its CEO has said he wants Mariano's to be the "Nordstrom of the grocery world," with enhanced service and one-stop shopping.)

- Spending at luxury retailers has come back, while department stores are failing and losing market share to the big box discounters, outlet malls and online discounters. Moreover, those who serve the most affluent of buyers have increased prices and upped their offerings of high-end merchandise; it is not uncommon for luxury retailers to sell out of purses with price tags in the thousands of dollars, before they even hit the shelves in New York.
- Spending at high-end restaurants is picking up with an influx of both wealthier and/or business clients, while spending at family restaurants is being squeezed. This is forcing mainstream restaurants to offer "value" menus and, more recently, adopt new technologies to lower labor costs; Applebee's is just one of many mainstream restaurants switching to tablet computers that customers can use to order food directly, instead of relying on wait staff. Moreover, stresses in lower and middle income households appear to have finally reached fast-food chains, which are also offering more value-priced menus and looking at ways to reduce labor costs with new technologies.
- Demand is on the rise for boutique hotels catering to the demands of the wealthiest clientele.
- Vehicle sales have come back but the average price of a vehicle is rising, as producers are increasingly chasing more affluent buyers. (The popularity of the Tesla, which has a base price of more than $70,000, is just one example.) The upswing in home values and equity prices will only exacerbate this trend, as we have yet to see the wealth effects on spending associated with the most recent surge in household net worth.
- Homebuilders, who were hurt by competition from the nearly-new market at the onset of the recovery, have almost abandoned building homes for first-time buyers and moved upscale to attract all-cash buyers and those who can still qualify for mortgages with the stricter requirements. Indeed, the premium in prices for new[13] compared to existing homes[14] has reached all-time highs in the last year, as builders chase price instead of volume in the single-family home market. This has spillover effects on the kinds of appliances, furniture and fixtures that are used in that construction as well.
- Multifamily construction is also on the rise,[15] as apartment vacancies have plummeted and rents have risen in recent years. Increased demand for homes in urban areas with close access to jobs and mass transit, however, is pushing up construction costs and forcing developers to appeal to higher

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[13] (U.S. Department of Commerce and U.S. Department of Housing and Urban Development, February 26, 2014)
[14] (National Association of Realtors, Existing Home Sales, February 21, 2014)
[15] (U.S. Department of Commerce and U.S. Department of Housing and Urban Development, February 19, 2014)

rather than lower income renters. The result will likely exacerbate the shortage of affordable housing for lower and middle income households.

Summation

The Great Recession and subpar recovery that followed both revealed and exacerbated income and wealth inequalities in the U.S. Those shifts have had a profound effect on both the pace and composition of consumer spending and are not likely to reverse any time soon. Most consumers measure their living standards by the pace at which they can accumulate goods and services, rather than just the level that they have achieved; both have deteriorated for the majority of Americans. This will have long-reaching consequences for confidence in the economy, willingness to invest in long-term assets and the potential for economic growth.

Thank you for the opportunity to testify. I would be pleased now to answer any questions the Committee may have.

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Senate Committee on Finance
Questions for the Record
"Innovative Ideas to Strengthen and Expand the Middle Class"
Hearing Date: March 13, 2014
Questions for Ms. Diane Swonk

Question from Chairman Ron Wyden

1. **Ms. Fonk, your testimony highlighted the value of apprenticeship programs. Can you speak briefly to the merits of apprenticeships and how we can improve federal programs to help workers of all ages get the skills they need?**

Answer

Yes, Mr. Chairman.

The shortage of skilled workers appears in field reports from the regional Federal Reserve banks. On April 16, the Federal Reserve's Beige Book says that manufacturers in the Cleveland, Richmond, Chicago, Kansas City and Dallas districts are having trouble finding experienced, skilled workers to fill job openings. These could be industry-specific engineers or machine tool operators. For larger companies, the model expanding across the country involves pairing a company, often a manufacturer, with a local or community college to offer students on-the-job training, frequently followed by full-time employment after graduation. In the Chicago district, the report says,

> Demand remained strong for skilled workers, with positions often difficult to fill in engineering, information technology, accounting, and other technical occupations. Contacts cited an increasing willingness on the part of firms to train workers, where shortages exist, through in-house training, tuition reimbursement, or partnerships with local high schools and community colleges.[i]

One example I came across in the Chicagoland area when delivering an economic outlook for DuPage County businesses is the Benedictine University based in Lisle, Illinois. It has a program offering what it terms "cooperative education;" that is, an opportunity to put classroom information to use in the workplace with practical training at local employers in return for academic credit, compensation and a much stronger chance of a job offer upon finishing the program. As we start to see more of a recovery in the housing industry, the lack of skilled professionals in some regions of the country includes carpenters, plumbers and electricians. Older workers may have retired, while younger people who might have gone into these careers in the past have chosen instead to pursue a four-year degree; some are now un- or underemployed and struggling to pay off student loans. You asked about solutions at the Federal level. The challenge to providing training programs is inherent in the building trade, as skilled subcontractors tend to work for smaller companies not capable of spending time and money on apprenticeships.

A national approach to the regional shortages might involve larger associations or trade unions working together to communicate and establish training programs that could be scaled down for smaller groups of workers, aimed at specific job qualifications. An example is the wood products industry; its materials are necessary for housing construction. This subsector has numerous small manufacturers who subscribe to a national, umbrella organization. That is my suggestion. (There are social issues as well, that I cannot address as an economist. I have heard anecdotally that some employers in wood products and at lumber companies are having trouble recruiting new workers who are able to pass a drug test.)

Mr. Chairman, thank you for the opportunity to present my perspective on what I consider the number one issue confronting the American economy long-term: growing income inequalities.

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[i] Board of Governors of the Federal Reserve System. (April 16, 2014). *The Beige Book: Current Economic Conditions by Federal Reserve District.*

The United States Senate
COMMITTEE on FINANCE
CHAIRMAN RON WYDEN, D-OREGON
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Hearing Statement of Chairman Ron Wyden (D-Ore.)
On Innovative Ways to Sustain and Expand the Middle Class

A century ago, shortly after the Ford Motor Company introduced its Model T, Henry Ford shocked the business world by increasing his workers' pay to five dollars a day. It was more than double the going rate, but Ford knew it would guarantee he would have the best workforce in Detroit. It also meant his employees could afford to buy the cars they built with their own hands. It ensured that they could own homes, send their kids to school and accumulate wealth. It was the birth of the middle class in the United States, and in the hundred years since then, that middle class has defined the strength of America.

Yet today, the middle class is under siege. In spite of the work ethic, ingenuity and productivity of millions of Americans, globalization, technological change and flawed tax policies have contributed to a steep decline in manufacturing jobs and wages. Since 2000, employment in manufacturing has dropped by nearly a third, and those same forces are putting pressure on service industries. The portion of our economy made up by wages and salaries – the lifeblood of the middle-class – is now at the lowest level on record, leaving many hard-working families struggling from paycheck to paycheck. And because consumer spending drives 70 percent of the American economy, that is a prescription for slower economic growth.

Today this committee is going to begin, on a bipartisan basis, a drive to develop policies that get more Americans inside the middle-class winners' circle. And we need to focus on this, because the alternative is unacceptable. If working families fall further behind now, still fewer will be able to climb America's ladder of economic mobility and secure better futures for their kids. As those who fight our wars, educate our children, and hold our communities together, the middle class deserves better. I believe this committee, working on a bipartisan basis, has the ability to produce policies that can help buck those trends, build new pathways into the middle class, and expand the winners' circle for all. And here are just several ideas for getting started.

First, America has to find fresh policies to improve education and lifelong learning and use them as springboards to economic opportunity. It's critically important that our students not only have access to higher education, but also the ability to prosper once they've gotten in the door. Senators Warner, Rubio and I have offered a bipartisan proposal that would get up-to-date and accurate information to students, allowing them to compare schools and programs based on completion rates, debt, employment and earnings.

With today's technology, it seems almost unbelievable that students are being denied access to that information. And in addition to that step, additional efforts need to be launched to improve the rigid structure of federal aid so that students can put that information to good use. It has been said that one of the best ways to raise wages for the middle class is to have businesses compete for skilled, educated workers. Our bipartisan bill helps promote that.

Any effort to improve education also has to include people outside the school system, such as workers who want to learn new skills and find unique pathways to new careers. In my home state, I often talk with small business owners who want to hire carpenters or electricians, but can't find people with the skillsets that are needed. So there's real potential here for apprenticeships to help bridge that gap as a pathway to the middle class. Our colleague Senator Cantwell of Washington here on the committee has done good work on this issue, and I look forward to bipartisan efforts to partner with her on that.

A second boost for the middle class would be finding policies that encourage people to save – and especially get started saving early in life. I've been struck by the interest conservatives and liberals have shown in creating child savings accounts, and I'm interested again in working with colleagues on both sides of the aisle to explore that. What's indisputable is giving everybody in America the opportunity to save and get ahead – and especially for those who are struggling today – that's something that will help sustain and expand the middle class.

Our third focus is going to be retirement security. Too often, our families save money for a lifetime only to have it wiped away by chronic conditions like diabetes, cancer and heart disease. Millions of Americans of all generations suffer from these conditions, and it's not just the government that bears the costs. I've been pleased to partner with Senator Isakson of Georgia, another outstanding member of this committee, to come up with a bill that would bring health care providers together to keep these chronic-care patients as healthy as possible in their homes and in our communities.

Fourth, steps ought to be taken to make the tax code more friendly to the middle class – and not put up barriers that prevent its growth. Right now, a nurse who's married to a police officer in Medford, Oregon, could be paying a higher tax rate than someone who makes a living entirely off investments. Any tax reform plan needs to narrow that gap. Over the years, I've had a bipartisan proposal with Senator Gregg, Senator Begich, and Senator Coats and we would do just that. And on a bipartisan basis, we have sought to triple the standard deduction to put more money into the pockets of our families.

A bedrock principle for tax reform ought to be to give the middle class – and everybody else in America– the chance to get ahead. Right now, despite good intentions, it doesn't always work that way. Take, for example, the child and dependent care tax credit. Because of the way that credit is structured, a young family just starting out might not get any meaningful benefit. Even with a meager level of assistance, child care could still be unaffordable, and a parent might have to sacrifice a career to stay at home. It's an obvious flaw in tax policy that again prevents our families from climbing up America's economic ladder.

Our people have proven time and time again that they are an almost endless fountain of ingenuity and innovation. American ideas, and the businesses built on them, have transformed the world. Mr. Packer, who will be here with us shortly, writes about Americans, like Dean Price and Peter Thiel, who want nothing more than to build a business from the ground up and nourish its growth. Our tax code should create a pathway for innovators and entrepreneurs –and not erect barriers to their success. Millions of Americans dream of being the next Elon Musk or Mark Zuckerberg, and our focus should be on policies that lay the groundwork for bringing those dreams closer to reality.

And too often, tax policies that should encourage innovation and entrepreneurship don't deliver. Far too often, conversations about tax reform focus on the big businesses, the big, successful businesses, and ignore the rest. But economic growth, and the jobs that follow, so often flow from our small businesses. So as this committee continues to consider the best ways, again on a bipartisan basis, to fix this broken tax code, let's ensure that young startups and green-shoot entrepreneurs have the opportunity to succeed.

Working taxpayers, I'd also point out, face an obvious double standard with respect to enforcement of the tax law. It's more likely that people working their way out of poverty will have their Earned Income Tax Credits reviewed and denied than it is wealthy tax dodgers will have their tax shelters audited.

Finally, the government has an obligation to maintain and strengthen the social safety net. The promise to hard-working Americans ought to be twofold: just as it helps them climb into the middle class when times are good, let's also take steps to prevent our people from falling into poverty needlessly when times are bad. That means boosting the minimum wage, extending unemployment insurance, and updating the workforce programs that connect our people with the jobs of the future. The safety net needs to be strong and modern in order to sustain a thriving middle class.

The best way to reinvigorate the American economy is with a thriving, educated middle class that can find good-paying jobs, afford homes and cars, and be able to accumulate wealth over a lifetime. That's the ideal Americans have aspired to since, in effect, the middle class was born in Detroit a century ago. Our challenge is to take the policies I've mentionec – education, savings, retirement savings, taxes, and a strong safety net – and come together as a committee and help retool these policies into a stronger economic engine for lasting economic prosperity.

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