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BOOSTING OPPORTUNITIES AND GROWTH THROUGH TAX REFORM: HELPING MORE YOUNG PEOPLE ACHIEVE THE AMERICAN DREAM

HEARING

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BOOSTING OPPORTUNITIES AND GROWTH THROUGH TAX REFORM: HELPING MORE YOUNG PEOPLE ACHIEVE THE AMERICAN DREAM

TUESDAY, JULY 10, 2012

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

The hearing was convened, pursuant to notice, at 2:50 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Hatch, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; and Tiffany Smith, Tax Counsel. Republican Staff: Jim Lyons, Tax Counsel; and Jeff Wrase, Chief Economist.

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

The CHAIRMAN. The hearing will come to order.

I first apologize to the witnesses and others in attendance for the delay. We had a somewhat unscheduled Senate vote, and I think we have now concluded the vote, and hopefully members of the committee will begin to file in.

President Truman once said, “All of us want our children to have a better life than we had, and it should be the constant aim of each generation to make things better for the next.”

As a father, I know how concerned parents can be about their children’s future. Americans just want their children to have a fair shot at earning a good living and succeeding in life. But more and more, American parents worry whether this dream could come true. These worries are well-founded, especially for parents who have not been able to climb the economic ladder as high as they would like.

I used to say—and I believed it strongly—that America was a land of greatest opportunity. There was more mobility, more opportunity in America than in any other country in the world. No more.

In the United States, a child born to a family in the top 10 percent of earners is 23 times more likely to end up financially well-off than a child born in the bottom 10 percent.

This does not mean that a child from a low-income family will never make it, but it implies that they face strong headwinds, where a child from a more fortunate background benefits from a strong wind behind their back.

The American children from lower-income families face stronger headwinds than low-income children in other countries. In a study of the U.S. and nine of our competitors, the United States comes in dead last in mobility. A Danish child born in the bottom 20 percent of earners is almost twice as likely to make it to the top 20 percent as an American low-income child.

This lack of mobility means we are not capitalizing on all of our citizens' talents and we are betraying the ideals on which our country was founded. Many of our foreign competitors are doing a better job advancing the American dream and opportunity than we are.

So what determines opportunity? What can we do to ensure that all American children have a fair shot at the American dream? To find opportunity, children need a high-quality education. They need skills to be successful.

But an American child from the top income quarter is 10 times as likely to go to college as a child from the bottom quarter. In 1979, the United States led the world in the number of people who graduated from college. That was back in 1979. We are now number 16 out of 34 countries, just above Estonia, Poland, and Chile. We used to be a leader. We have slipped to 16th.

To succeed, children also need to be healthy and cared for. They need mothers who are healthy during pregnancy. Lower birth weights result in children having lower lifetime earnings. They need parents who have the ability to provide for them. If their parents work, they need high-quality child care.

Congress has tried to improve opportunities for families and children through the tax code. There are numerous tax incentives to encourage work, education, health care, and savings. The Earned Income Tax Credit and the Child Tax Credit give low-income parents an incentive to work and help them provide for their children.

In 2010, the Earned Income Tax Credit lifted 3 million children out of poverty, and health reform will give more pregnant women access to quality health care. But many incentives in the tax system are upside-down. They give the most help to those who need it the least. Provisions like the exclusion for employer-provided child care provide more support for children with parents in high-income brackets than those with lower incomes.

For example, the most tax savings a family making $40,000 a year can receive from the exclusion is $750, but a family making $250,000 can receive twice this amount. For children in low-income families, this break may provide no benefit at all.

Today's hearing will focus on economic mobility and how we can use the tax code to strengthen the American dream. It is an important issue, very important. It is such an important issue that is very much on people's minds. The *Washington Post* and *USA Today* have stories today on the very study that one of our witnesses will discuss. The tax system clearly is not the only way to improve opportunities, but it is an important way. We should use all the tools that we have.

So, as we work to simplify the tax code, let us ensure that every child has a fair shot at a richer and fuller life, and, in the words of President Truman, let us help this generation make things better for the next.

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

The CHAIRMAN. I do not see Senator Hatch here yet, but when he arrives we certainly would like to hear from him.

But I would now like to introduce our witnesses. First is Dr. Katherine Newman. Dr. Newman is the James B. Knapp dean of the Krieger School of Arts and Sciences at Johns Hopkins University. Next is Dr. Miles Corak, professor at the Graduate School of Public and International Affairs at the University of Ottawa. Our third witness is Dr. Lars Lefgren. He is associate professor at the Department of Economics at Brigham Young University. Our fourth witness is Erin Currier. She is the project manager of the Economic Mobility Project at The Pew Charitable Trusts. Finally, we have Dr. Eugene Steuerle. Dr. Steuerle is an institute fellow and Richard B. Fisher chair at the Urban Institute.

Thank you all for coming. All of you know the drill: your statements will be automatically included in the record, and I ask each of you to summarize in about 5 minutes.

Dr. Newman?

STATEMENT OF DR. KATHERINE S. NEWMAN, JAMES B. KNAPP DEAN OF THE ZANVYL KRIEGER SCHOOL OF ARTS AND SCIENCES, THE JOHNS HOPKINS UNIVERSITY, BALTIMORE, MD

Dr. NEWMAN. Great. Thank you, Mr. Chairman.

The CHAIRMAN. And, as I always say to our witnesses, let her rip. Just say what is on your mind, right?

Dr. NEWMAN. I am about to do that.

The CHAIRMAN. Good. That is what we ask.

Dr. NEWMAN. I am very pleased to have this chance to contribute to your deliberations on the ways in which the tax code might facilitate upward mobility, and to do that I draw on a couple of decades' worth of research, especially in Harlem, on the Nation's working poor, as well as a wealth of data that has been contributed by other scholars, especially economists, who have studied the pathways of other countries whose mobility rates, as you pointed out, exceed our own.

My aim here is to try to contribute some thoughts on what kinds of investments might promote mobility and how difficult it is for working people below the poverty line to make those investments. I will conclude with some thoughts about the tax code, on which you have asked us to deliberate.

As you said, it is by now axiomatic that upward mobility depends on educational attainment. Even in the current economic downturn, unemployment is far lower among college graduates than high school graduates, and drop-outs are vastly over-represented among the Nation's poor.

The wage premium to higher education is substantial, and of course, accordingly then, ensuring that children of the working poor complete high school and attend college or seek some kind of advanced training is probably the best recipe for upward mobility.

But staying on that track is very sensitive to the quality of early childhood education. Low-wage jobs leave families with very few resources to invest in the next generation, and hence, among the families that I studied in Harlem, child care options were meager in supply, erratic, and poor in quality.

In the 14 years that I followed working and near-poor families in Harlem and the outer boroughs of New York City, my observations of their child care arrangements nearly always left me concerned about the fate of the next generation.

The most common source of child care for the working poor was a relative or a neighbor, often with four or five other children to take care of. The best of these settings would see young children scribbling in coloring books once in a while, but very often they were left to entertain themselves while grown-ups in the room watched television or ignored their presence.

Rarely were these children mistreated. They were fed, they were warm in the winter, and they were kept out of harm's way. Their mothers knew that they were safe, and that is not unimportant in the troubled neighborhoods in which they live. But I rarely observed attempts to engage these children, much less to introduce them to the kind of formal daycare or early childhood stimulation that more fortunate children receive.

One example from my research may serve to illustrate the problem. Danielle Wayne—this is a pseudonym—the divorced mother of three children, returned to the workforce during the course of my 8 years of following Harlem families. Her older children, ages 8 and 10, did very well in school, having benefitted from her undivided attention and engagement in their schools when they were very young.

But her youngest child, a 2-year-old named Safiya, had a very different experience. When Danielle went back to work, she took Safiya to her ex-mother-in-law to be looked after during the day. At the cost of $50 a week, which was the most she could afford—and she was grateful for that care—the 60-year-old grandmother accepted that child. I visited Safiya and her grandmother to see how she was doing and what she was doing during the day.

Her daycare was in a 2-bedroom apartment in the public housing unit in the center of Harlem. Her grandmother had three other children to look after. The day I arrived, the TV set was set to the "Jerry Springer" show, and the kids were glancing up to see topless women.

One of the grandmother's other children, a woman in her mid-30s, was sitting on the couch in a stupor. She explained to me that she had four teenaged children of her own but was no longer living with them. The grandmother explained to me later that her daughter had a serious drug problem and had nowhere else to turn for shelter.

The best we could say about this childcare situation for Safiya is that it is custodial. And it is taking a toll on that little girl. At an age where children in early childhood education are playing active games, learning to help, to be in groups, starting to recognize their colors, Safiya had a 2-word vocabulary: "no" and "shut up." That is it. She never said another thing to me or anyone else.

In the setting where she was spending more than 8 hours a day, it is not likely she is going to learn much more than that. That is not going to put this little girl in a good position to enter kindergarten ready to learn.

How do we avoid unproductive pathways like this? Well, in other countries the extension of universal or large-scale programs for preschool has become fairly common, and their experience reinforces the importance of this kind of opportunity.

The studies that we have from these other countries are following children all the way from their early childhood to their adult years so we can see exactly what kind of impact that investment had.

Let me just give you a few examples. In Denmark, the significant impact of preschool for children ages 1 through 6 on completing schooling and on earnings at the age of 22 to 30 is huge, and with larger effects for disadvantaged children.

We see positive effects of preschool on grade retention, on test scores, on high school graduation, and on adult wages in France. Here, too, the effects are particularly large for children from disadvantaged households.

More years in school, higher rates of college attendance, and greater labor market participation in Norway; again, the effects much larger for low-income children. Those are studies that can look at people all the way from zero to 30.

We have other studies from Germany, India, Norway, Sweden, and Uruguay that just look at adolescents, and there too we see that earlier childhood education experience leads to better school enrollment and achievement, especially, by the way, for immigrant children, where exposure to the language of the host country is positively affected by entering school early and provides the maximum time for them to acclimate.

What these studies are telling us is that early childhood education makes a very positive difference in the educational performance of children over the later years. What can the tax code contribute to this equation? The most important contribution it makes to educational outcomes for low-income families occurs, as you mentioned, through the Earned Income Tax Credit.

One study that looked at the impact of receiving the EITC on the math and reading achievement of 5,000 children, matched to their mothers in the National Longitudinal Survey of Youth, found that a $1,000 increase in income generated by an increasingly generous EITC raised combined children's math and reading test scores by 6 percent of a standard deviation in the short run, and again the gains were larger for children from disadvantaged households.

So what all of this research is telling us is that the injection of resources into households, either through the EITC or through income increases that mimic what the EITC provides for low-income households, is paying off in the educational performance of children. Those knock-on benefits of that improved track record surface later in the labor market and, hence, in intergenerational mobility.

But what can you do to improve the chances that children from low-income households will stay that course? Specifically, what can the tax code do? Well, part of the answer, as you mentioned, is already with us: enlarge, or at least preserve, the Earned Income Tax Credit and the Child Tax Credit, both of which put resources in the hands of parents.

There is a lot of debate about why that works as well as it does, or rather what the pathway is from higher household income to greater educational attainment and earnings. Candidate explanations include more money to spend on children's education, greater household stability, parents who are less stressed and hence do a better job of raising their children, and health outcomes which prevent the disruption to adult employment that can derail children or interrupt their own attachment to schooling. My guess is that all of these factors matter.

When the States follow the lead of the Federal Government, the benefits of the EITC are amplified.

The CHAIRMAN. I am going to have to ask you to wrap up the best you can, Doctor.

Dr. NEWMAN. All right. Let me do that.

So let me just mention a few other instruments besides the EITC. I do not think we should forget the other age groups that may be affected by the investments we make possible. Let me speak about teenagers and young parents. Anything we can do through the tax code to encourage teens to stay in school and perform at higher levels will impact intergenerational mobility.

Millions of inner city teens are left on their own in the afterhours of school. Supposing we were to provide tax incentives for parents to pursue high-quality after-school, as well as early childhood education? In addition, studies of long-term benefits of college education among young parents, especially mothers, on the mobility of the next generation show important results. First-time college students from low-income backgrounds raise their children differently than people from the same kinds of families who do not attend college. It is in college that they learn about the benefits of museums, reading aloud, doing homework, visiting the zoo, and so on.

When we follow those kids 30 years later and we look at what the impact of education on their mothers was for their mobility, we see very significant effects on their educational performance. Hence, the American Opportunity Tax Credit, the Lifetime Learning Credit, all of these instruments through the tax code that make it possible for low-income people to attend college in greater numbers, pay off not only in their intergenerational mobility, but in that of their children.

Thank you.

The CHAIRMAN. Thank you, Dr. Newman, very much. Very interesting.

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

The CHAIRMAN. Dr. Corak?

STATEMENT OF DR. MILES CORAK, PROFESSOR, GRADUATE SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, UNIVERSITY OF OTTAWA, OTTAWA, ONTARIO, CANADA

Dr. CORAK. Thank you, Senator, for the opportunity to engage in this conversation.

You summarized, I think, the facts on intergenerational mobility, and particularly international comparisons, quite clearly. What I would like to do in my 5 minutes is focus on the drivers. I think it is very important to understand the underlying causes, for two reasons.

One is, because the facts that we are talking about relate to a group of people born in the 1960s who went to school in the 1970s and 1980s and participated in the labor market of the 1990s and 2000s. So, if we wanted to get a sense of what will happen to the young people of today, we need to learn from that experience, understand what drove it, and make reasonable guesses in that sense. The other reason we have to focus on the drivers, of course, is because, if we want to do intelligent public policymaking, we have to understand the underlying causes.

My first message to you is that there is no single silver bullet in this literature. The causes of intergenerational mobility are complex and they reflect the interaction of three broad forces: the family, the labor market, and public policy.

Families that are stable and constructive can effectively raise their children and support them through all the transitions that they have to go through in their life, not just the early years, not just the primary schooling years, but also the teenaged years and the interface with the labor market. The stronger families are, the more mobility there will be.

Second, the more inequality in labor markets there is, the less mobility there is; more unequal labor markets with a higher return to education change incentives and change opportunities for families and lead to less mobility.

Finally, the third row is public policy. Public policy, to the extent that it is progressive, to the extent that it is relatively more advantageous to the relatively disadvantaged, will promote mobility.

So, in the time that I have, I just want to talk about two stereotypical societies, if you will, in which the interaction between these forces is very different. The first society I will call a "2nd-chance society." Canada and Australia might be 2nd-chance societies, if you will.

The second is a society that has more tracks to it. If you get on the right track, you are destined to move forward, or you could move backward. There are not as many second chances. I will call this sort of a "3-strikes-you-are-out" society, if you will. The U.K. and the U.S. might sit towards that extreme.

In a 2nd-chance society, families are able to invest, not just in the monetary well-being of the children, but also the non-monetary well-being. So money matters, but not just money. If we structured income support in a conditional way to young families, for example, and used something like the EITC, we should also recognize that the non-monetary resources available to children are also diminished, that we also have to provide more flexibility in work arrangements so that parents can balance the stresses of work and life more constructively. We also need more effective and creative child care to counter the kind of difficulties that Dr. Newman just spoke about.

Second-chance societies keep the relative and absolute poverty rate of children low, and they also reduce the risk of poverty of expectations and poverty of experience.

In the early years, 2nd-chance societies move towards fully integrating children into the schooling system. In many societies, particularly in Canada and Australia, there is talk and movement towards full participation of 4- and 5-year-olds in the schooling system on a full-time basis.

In 3-strike societies, we begin to see in the early years a differentiation according to family resources, with more use of private sector resources on high-income families, and other families dropping by the wayside.

Second-chance societies also allow children to drop in. There is always the risk of dropping out, but education systems are created more flexibly so that children can drop in later on in life. In 3-strike societies, it is much harder to drop back into school at a later stage in life, and the education system is structured very linearly.

Quality also does not vary very much. The quality of the schooling system does not vary very much in 2nd-chance societies. The funding for the schooling system is more broadly based and not necessarily based on a narrow property tax basis, and the quality of schooling does not get reflected in the housing market to the same extent it does in 3-strike societies. So funding the schooling system through a narrow property base accentuates labor market inequalities, and they get interfaced into the family.

Finally, I want to point to the fact that post-secondary education offers a lot more choices in 2nd-chance societies. There is a developed technical stream and community colleges as an alternative to university. While there may be high tuition fees, there are also strong bursaries.

To the extent that people use loans, 2nd-chance societies make the repayment of those loans contingent on income so that you do not necessarily have to be bound by these heavy debts to the same extent if you experience spells of unemployment.

Finally, I would point out that, in the interface with the labor market, connections matter. Families continue to play a role in helping their young adults transition to the labor market. In some societies, as many as 4 out of 10 young children have at some point worked for the same employer as their father.

Also, if there are internships used, they are much more broadly based. One can imagine a system in which people from lower socioeconomic backgrounds have a voucher attached with them so that they can accept unpaid internships and get payment from the States so that internships are not based necessarily on just family background.

Finally, in 2nd-chance societies there are wealth or estate taxes, or inheritance taxes, that level the playing field for the next generation and ensure a virtuous circle.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Corak. That was very interesting.

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

The CHAIRMAN. Dr. Lefgren, you are next.

STATEMENT OF DR. LARS J. LEFGREN, ASSOCIATE PROFESSOR, DEPARTMENT OF ECONOMICS, BRIGHAM YOUNG UNIVERSITY, SALT LAKE CITY, UT

Dr. LEFGREN. Thank you, Chairman Baucus and members of the committee.

In the United States, a 10-percent wage disadvantage in fathers' long-term income translates into roughly a 6-percent wage disadvantage in a son's long-term income. This suggests that the son of a poor father will have a strong tendency to have low income himself. Estimates from other developed countries, as you mentioned, Senator Baucus, imply much less persistence in income levels from father to son.

These results have caused consternation because they appear to refute the premise of the American dream that anyone can be successful. Indeed, if a person's economic position is determined entirely by the economic position of one's parents, independent of the person's skill or potential, there would be nearly universal condemnation of the institutions that led to such an unfair outcome.

Furthermore, it would lead to a poorer society as the mediocre children of wealthy parents were promoted to jobs beyond their capabilities, while the brightest children of the poor languished in occupations that failed to harness their full potential.

It would be equally symptomatic, however, of poor labor market institutions if there was no correlation between parents' income and that of their children, because capable parents tend to have capable children. So, for example, the heritability of IQ is on the order of 0.7. A zero correlation between the incomes of children and parents suggests that our labor market fails to reward skill.

Rewards for skill and hard work are essential signals for sorting our most talented workers to the fields and occupations in which they produce the most value. When we fail to allocate skill to its highest productivity use, we become poorer as a society.

I will now compare the special cases of Sweden and the United States. These countries represent the extremes of observed intergenerational income inequality in the developed world. The comparison highlights the tension between economic efficiency and equality as well as the importance of efficient human capital investments.

The degree to which paternal income difference persists to the next generations is about 26 percent in Sweden, compared to 61 percent in the United States. While Sweden is a more egalitarian country, Swedish citizens have lower incomes on average than do Americans. Once one adjusts for how much goods and services cost in Sweden, per capita GDP is about 20 percent less in Sweden than it is in the United States.

Sweden achieves this level of equality in several ways. Generous wages for many occupations are collectively bargained at the industry level and assume the role of the mandated minimum wage in other countries. A large public sector provides many individuals with a middle-class lifestyle. High taxes substantially reduce differences in take-home pay across workers. Aronsson and Walker discuss how these labor market institutions create incentives to limit work hours and educational investments.

These institutions also dole out incentives for individuals to enter demanding occupations where the value of their work product is high as opposed to pleasurable, but potentially less useful, occupations. High-quality public preschools, as well as primary, secondary, and college education, are provided to all citizens at little or no cost.

Conversely, in the United States, levels of unionization are low and falling. The minimum wage is low and binds for only a small fraction of the population. Tax rates and the size of the public sector are both low relative to other developed countries. The financial return to education is quite high.

Collectively, the tax code and labor market institutions of the United States do relatively little to equalize incomes at a point in time or across generations. They do, however, provide an efficient environment for individuals to undertake educational investments and to employ their skills in a setting in which they are most highly valued.

In the United States, primary and secondary school is provided free of cost. Access to publicly provided preschools through programs such as Head Start is available to some, but not all, families. Individuals have access to low-cost community and State colleges, and also have access to loans and grants to cover remaining expenses.

For well-prepared students, the United States has the best university system in the world. The United States does not, however, provide a strong educational foundation to the disadvantaged children. In Chicago, only 56 percent of students graduate from high school. Most of those who drop out and many of those who graduate have substandard numeracy and literacy skills.

While existing programs such as No Child Left Behind and title I have had some mixed success in increasing student achievement, improvements in educational policies should be an ongoing congressional priority. Research by Heckman and others underscores the importance of early childhood education in the formation of the soft skills required for success in school life and the workplace.

In conclusion, it is unclear what the right level of intergenerational income mobility ought to be. Tax and labor market policies designed to foster an egalitarian wage distribution and high levels of intergenerational mobility distort incentives for efficient educational investments, occupational choices, and effort levels.

In this regard, Congress must thoughtfully consider the tradeoffs between economic efficiency and equality. However, the failure to foster the educational development and success of all of America's children stunts the economic potential of many citizens, lowers our collective national wealth, and increases intergenerational inequality in a manner that most Americans, I believe, would consider unfair.

Thank you.

The CHAIRMAN. Thank you, Dr. Lefgren.

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

The CHAIRMAN. Ms. Currier?

STATEMENT OF ERIN CURRIER, PROJECT MANAGER, ECONOMIC MOBILITY PROJECT, THE PEW CHARITABLE TRUSTS, WASHINGTON, DC

Ms. CURRIER. Chairman Baucus and members of the committee, thank you for inviting me to testify today. I manage Pew's Economic Mobility Project, which is a nonpartisan effort to establish a fact base on economic mobility.

Today our project released the newest data available on intergenerational mobility in the United States, revealing a mixed picture of Americans' access to opportunity.

On the one hand, there is a glass half full, because 84 percent of Americans have higher family incomes than their parents did at the same age, and across all levels of the income distribution this generation is doing better than the one that came before.

But there is also a glass half empty, because Americans raised at the top and bottom of the income distribution are highly likely to stay where their parents were, a phenomenon called "stickiness at the ends."

Of those whose parents were in the bottom fifth of the income distribution, 70 percent remain below the middle as adults. Of those raised at the top of the income ladder, 63 percent never fall to the middle as adults. This stickiness at the ends challenges the notion that the United States promotes equality of opportunity. It is further underscored, however, by international comparisons of economic mobility, which show that the United States has less relative mobility than Canada and many European nations.

A recent study on economic mobility across 10 countries found that, in the United States, there is a stronger link between parental background and children's outcomes than in any other country investigated. The research found that family background begins affecting children's outcomes as early as they can first be measured, even by age 3.

The variation in outcomes across countries suggests that policies and institutions can and do influence economic mobility. A person's mobility outcome is not predetermined, and understanding the drivers of economic mobility can enhance opportunity in America.

Our research has found that a host of factors help push Americans up the economic ladder, and some push them down. Today I will mention three such factors: post-secondary education; savings; and neighborhood poverty.

Post-secondary education is extremely powerful. It both promotes upward economic mobility from the bottom and protects against downward mobility from the top and the middle. Having a 4-year degree triples the chances that someone who starts in the bottom income quintile will make it all the way to the top.

Personal savings are also influential. When families are able to create their own safety nets, they are less likely to be derailed by financial emergencies and are more equipped to make mobility-enhancing investments such as college for themselves and their children.

On the other hand, one of the most powerful drivers of downward mobility is being raised in a high-poverty neighborhood. Americans raised in the top three quintiles who spend their childhood in a high-poverty neighborhood are 52 percent more likely to be downwardly mobile.

Considering this data, it is important to assess the degree to which Federal policy is mobility-enhancing and who benefits from the investments currently made. In fact, the government spends a great deal to encourage movement up the economic ladder, but, because the vast majority of that spending is delivered through the tax code, it largely misses families at the bottom who do not owe income taxes.

In 2009, a group of bipartisan advisors to the Economic Mobility Project drafted a set of policy recommendations to enhance economic mobility in the U.S. They called for a portfolio shift in Federal investments to better target low- and moderate-income families. Public opinion polling suggests Americans support this goal. An overwhelming 83 percent want the government to boost mobility for the poor and middle class, a feeling that cuts across party lines.

Americans believe in the American dream, and they also believe that our Nation is, and should be, exceptional in its ability to promote opportunity for all citizens, regardless of family background. Still, Americans are increasingly concerned about their children's economic chances and believe that policymakers can, and should, help level the playing field.

An emerging body of research provides insight into the drivers that influence economic mobility and serves as a starting point for dialogue and action on how to promote economic mobility for all Americans.

Thank you.

The CHAIRMAN. Thank you, Ms. Currier.

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

The CHAIRMAN. Dr. Steuerle?

STATEMENT OF DR. C. EUGENE STEUERLE, INSTITUTE FELLOW AND RICHARD B. FISHER CHAIR, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. STEUERLE. Thank you, Mr. Chairman, Mr. Wyden, Mr. Thune. It is a privilege to testify before you again. Nothing exemplifies the American dream more than the possibility that each family can get ahead, and through hard work advance from generation to generation. No committee, I believe, in Congress has more influence over this issue than does the Senate Finance Committee.

I am not claiming government can solve these problems. I think mobility is largely induced by the hard work and the efforts of our citizens, but this committee has a great deal to say about how government makes possibilities available.

Today, I suggest that mobility across generations is threatened by three aspects of current Federal policy. First, we have a budget for a declining Nation. It is one that promotes consumption ever more and investment, particularly in the young, ever less.

Second, we have relatively high disincentives to work and save, especially for those who move beyond about a poverty level of income. Third, we have a budget that, largely through the tax code, favors mobility for those with higher incomes, while promoting consumption but discouraging mobility for those with lower incomes.

So let me elaborate briefly. First, in many ways we have a budget for a declining Nation. Even if we would bring our budget into balance or to sustainability—and we are a long way from achieving that goal—we would still have a budget that allocates smaller shares of our tax subsidies and our spending to children and investment and ever-larger shares to consumption.

Right now, the Federal Government is on track to spend about a trillion dollars more annually in a decade in spending and tax subsidies. The number might be slightly smaller if the Republicans are in power, it might be slightly larger if the Democrats are in power. That is a trillion dollars more annually that is scheduled to be spent.

Yet, if you look at those projections, you will find that the programs that might promote mobility, such as education or job subsidies or programs for children, would get nary a dime of that trillion dollars more a year. Right now, those relative choices are reflected in both Democratic and Republican budgets.

Second, consider that one of the many ways that the population rises in status relative to others is by working hard and saving a higher portion of their income or their wealth. Discouraging such efforts can reduce the extent of intergenerational mobility, which I will remind you is largely measured by their command over private income and private resources, not their command over public resources.

One way to look at the disincentives facing lower-income households is to consider the effective tax rates that derive from combining together the direct taxes that you see in the tax system and the phase-outs that are prevalent in so many of the tax subsidies in welfare and benefit programs.

After reaching about a poverty-level income, those moderate-income households with children often face marginal tax rates that are 60, 80, or even 100 percent when they earn an additional dime of income.

Finally, in a study I led for The Pew Economic Mobility Project with Ms. Currier here, we concluded that a sizeable slice of the Federal budget—in fact, about $746 billion, or $7,000 per household in 2006—did go to programs that arguably tried to promote mobility.

Unfortunately, almost three-quarters of the total comes mainly through programs such as tax subsidies for home ownership and other saving incentives that flow mainly to middle- and upper-income households. Moreover, some of these programs inflate key prices, such as the prices of homes, and thereby actually detract from the mobility of low- and moderate-income households.

Finally, I would like to add a note about some current opportunities. Outside of education, and particularly early childhood education and health, if Congress wishes to promote the mobility of lower-income households as well as protect the past gains of moderate- and middle-income households that are also now threatened, almost nothing succeeds more than putting them on a path of increasing ownership of financial and physical assets that can carry forward from generation to generation.

Two opportunities largely neglected in today's debates may be sitting right at our feet. First, rents have now moved above home ownership costs in many parts of the country. Unfortunately, we seem to have adopted a housing policy in this Nation that encourages low-income households to buy when the market prices are high, and then, when the market prices drop, we encourage them to sell and not to buy. This does not seem to me to be a particularly advantageous home ownership policy for these households.

Second, pension reform is a natural accompaniment and add-on. I am not referring to the old individual account debate, but I am talking about pension reform. It is a natural add-on to the Social Security reform that I believe is around the corner that is often not being discussed. So, I hope you will give some consideration to these two opportunities.

In conclusion, the hard future ahead for programs that help children, invest in our future, and promote mobility for low- and moderate-income households does not necessarily reflect the aspirations of the American people, or I believe of either political party, and I appreciate the efforts of this committee in moving on this front today.

Thank you.

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

The CHAIRMAN. Well, thank you all. I am going to start with you, Dr. Corak. I do not know if you suggested many specific suggestions as to what we can do in this committee to address the phenomena you are talking about, the 2nd-chance and 3-strikes-you-are-out. I assume 2nd-chance is your preferred choice between the two. But just, what would you advise that this committee consider to help kids, help more mobility? That is the subject of this hearing.

Dr. CORAK. Well, different policies at different stages of the child's life cycle. Perhaps, let me focus on the very last stage of the transition to the labor market. What I was trying to say, for example, is that children from more privileged backgrounds have more opportunities and more connections available to them.

Let us imagine how internships work in this country. My understanding is that many internships are unpaid, and this is valuable job experience for young people. They have to be able to afford to take an unpaid internship, and that involves family support. So these internships generally, or the more valuable ones, may go to people of more privileged backgrounds.

Why not give to children of less-privileged backgrounds a voucher, if you will? If they find an unpaid internship, the State will support them for that summer and give them that kind of work experience. That is one example.

The CHAIRMAN. Let me ask all five of you your reaction to this. What about universal service, with every younger person in America from the ages of, say, 18 to 22 or 23, whatever, having to serve in the Peace Corps, or military service, for a couple of years? My thought is that it would be a way for our younger people to learn about other people, learn about the world, learn about other people's conditions, and have a very positive educational effect. I do not know what the latest studies are, how expensive it would be.

I mean, clearly I could think of some people who would say, oh, no, that impinges on our individual freedoms or our liberties and so forth. But my thought is, if it could be made to work, it would help bring America together again. I think about World War II and all of that, we were a country together and so forth. We were together in World War II.

Now, of course we had an external threat, an existential threat back then. But we are being threatened now. It is a stealth threat. It is harder to see, but it is out there. I mean, this is just stunning that we are no longer the number-one country in the world in mobility, and we are sinking, I think, in that respect.

So I would just like your candid, honest thoughts whether universal service would help or not help, whether it is something we should think about. Is it just not worth thinking about, and let us try to find other ways to deal with this issue? I will go the other way and go down this way this time. Dr. Steuerle?

Dr. STEUERLE. Senator, I am not sure that I would mandate universal service, but I think we could make many of the types of programs that we provide to the public conditional upon service, such as, aid for college could be limited, or people could avoid having to pay off their loans if they participate in service. I think we should also perhaps require that doctors who go through medical school provide some sort of service in exchange for all the subsidies they get. I think there are a lot of ways of encouraging service. I do not know that you would have to go all the way to a mandate.

The CHAIRMAN. So you would look creatively to find ways to get incentives to serve on a voluntary basis?

Dr. STEUERLE. Yes.

The CHAIRMAN. That is your suggestion. All right.

Ms. Currier?

Ms. CURRIER. Well, I guess I will pivot a little bit and just mention that our project has conducted two public opinion polls, one in 2009 and one in 2011. In both cases, Americans solidly identified things like hard work and ambition as the key drivers of mobility.

But they also believe that the government has a role to play in helping level the playing field to the degree that policies can do that, can expose children from all backgrounds to better educational attainment, better jobs, better labor force participation. I think you would see quite a bit of support from the American public.

The CHAIRMAN. All right.

Dr. Lefgren?

Dr. LEFGREN. I am personally actually very sympathetic to the benefits of service. If service is mandated, in my opinion, then it loses much of the potential benefits. Mandated charity really is not charity at all.

Even though I am actually very sympathetic with Dr. Steuerle's view that there are potential levers to provide incentives for service, I think a key aspect of the growth aspects of service and sacrifice is the voluntary nature of it, and it is important that people bear some of the costs of the service that they are getting.

The CHAIRMAN. Yes. I appreciate that. We will have two more to answer. For whatever it is worth, my son went to school where service was "required." Community service was required. It is clear to me he is a much better person as a consequence, there is no question about it. But that is a little bit different.

Dr. Corak?

Dr. CORAK. I think your call for that option sort of reflects a need to develop community in a spirit of the collective. My own sense is—I am not informed on what the long-term benefits of service at the later part of the age spectrum would be, but I can certainly imagine starting that much earlier in the schooling years, in the sense of universal provision of high-quality care in the early years. It would seem to me the community would have to start much earlier than that.

There is also the possibility certainly of having volunteer hours attached to the possibility of graduating from high school, so you could imagine having each child spend a certain amount of time in some community-oriented activity, and they would have to have X number of hours to graduate.

The CHAIRMAN. All right.

Dr. Newman?

Dr. NEWMAN. Mr. Chairman, I am very sympathetic to your point of view. I think universal institutions generally do pay off in mobility. That is what public schools are all about. What you suggested is sort of an extension, if you will, of the same idea, that all Americans would have the opportunity to serve. This is beyond the high school level. But what they learn when they do are new skills, new opportunities, new ways of doing work, new cultures, as you have said.

In that sense, universal service provides the same kind of human capital benefit that the other universal institutions we have do. So I think anything that you can do through this committee to extend opportunities to all Americans, starting at the earliest ages and carrying them all the way through to that later and later transition to adulthood in the mid-20s, would be enormously beneficial.

The CHAIRMAN. Thank you very much. My time has expired.

We are honored to have the Senator from Utah, Senator Hatch, with us today. Senator?

Senator HATCH. I am happy to be with you.

The CHAIRMAN. The ranking member of this committee.

Senator HATCH. I will put my opening statement in the record.

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

Senator HATCH. I apologize for being late, but I was on the floor making some remarks that had to be made.

We welcome all of you, especially you, Dr. Lefgren, from Brigham Young University. We are really happy to have you here, and all of you, as a matter of fact.

Let me start with you, Dr. Corak. Figure 2 in your written testimony, which has recently been labeled the Great Gatsby Curve, shows the correlation between measures of inequality and mobility across countries. Now, there are, of course, measurement issues associated with the data. Not everyone would agree with the inequality measure, perhaps, that you use.

In any case, your Gatsby Curve shows a positive relation between inequality and lack of mobility across countries. You suggest that the positive relation can give us a "rough" way to see outcomes of all of the forces governing intergenerational earnings and inequality.

You also say in your testimony that "this picture is one of association," yet you have written elsewhere that "to dismiss this relationship as purely a statistical artifact or myth, with there being no causal impact between inequality and opportunity, would be a mistake."

I certainly do not dismiss your relationship as necessarily being an artifact or myth, but it is important not to confuse association with causality. Nonetheless, some people go so far as to use the rough correlation you present to make structural forecasts about how inequality today will influence mobility in the future. And while I do not doubt the association you present, given the data that you use, I think it is a stretch to treat it as structural and something that can be used for forecasting.

So I have a couple of questions intended to help me understand what your figures are supposed to show. First, do you believe that your Gatsby Curve establishes statistically that lower mobility in a country, from whatever year your mobility data may have been obtained, causes the inequality measures that you say are estimates from "around the year 2000," or maybe that greater inequality around the year 2000 somehow was caused by less mobility for children who were born and reared decades ago in far different policy and economic environments?

Second, I wonder if you could discuss evidence that the U.S. is moving up your curve and how robust the evidence is across various measures of inequality.

Finally, you have recently been quoted as saying that "the most important thing that the U.S. is leaving behind as it moves up the Great Gatsby Curve is the vision of itself."

So I wonder why you take from your curve or other research an impression that we in the United States are losing our vision of ourselves.

Dr. CORAK. Well, thank you, Senator.

Senator HATCH. The question was too long, I know.

Dr. CORAK. Yes. But let me divide it up into the three that you suggested. First, is the relationship causal? Let me make clear, Senator, that I do not believe that if you simply gave people money, you would solve all of these problems.

Money certainly matters. People in lower incomes certainly face stresses in life, but more than money matters. That is why we should not interpret that curve as something that we can move along by just tax-and-transfer policies, for example. It is not causal in that sense.

It is a nice way of describing a whole series of transitions, or the outcome of transitions that children make through their lives. Inequalities begin to get imbedded in children's lives in the early years. We know that there are inequalities in health outcomes in the very early years. That is one causal step that helps build that figure.

We know that there are inequalities across neighborhoods and schooling. Those are causal. They build another step. We know that there are inequalities to good jobs and access to good jobs. That is another layer that gets played onto the whole process. In the end, you get a picture of that sort.

As for losing our vision of ourselves, all I am stating in that statement, which was in, I believe, *Business Week* earlier this week, is the concern of this committee right now, the concern that all children should be able to become all that they can be.

In the United States, if you look closely at the data, there is in fact a good deal of mobility in the middle parts. What makes society different is the stickiness at the two ends. That is related to inequalities in the labor market and access to important institutions. If those continue to grow and exacerbate over time, it is hard to imagine the situation changing for the current generation compared to the people who were part of that graph. Does that help?

Senator HATCH. That helps. That helps a little bit.

I will turn to Senator Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman. I want to thank all of you.

Let me begin, if I might, with you, Dr. Steuerle. You have been a veteran of the tax reform wars. I believe real tax reform gives everybody, not just those who are born on third base, the opportunity to get ahead. The current tax system primarily benefits those who own the ballpark.

When you look at your numbers in particular, you come to the conclusion that, under the current tax code, the younger you are, the less income you make, the less our government does to boost opportunity for you to get ahead. That sure is a poster child for a tax system that is in the business of picking winners.

So my first question to you is, would it not make sense, as a fundamental principle of tax reform, to clean out a lot of the special interest clutter, to hold down rates for everybody, and use it as a ladder to create more opportunity, especially for young people who are not getting those opportunities early on that you have described?

Dr. STEUERLE. Senator Wyden, I certainly agree with your conclusion, but let me try to answer this in a way that I think is fairly bipartisan.

Senator WYDEN. What I have described, as you know, is what Senator Coats and I have offered. It does not get more bipartisan than that.

Dr. STEUERLE. That is what I said: I am agreeing with you on that. I guess where I am going along that path is, I want to distinguish between size of government and allocation. The issues you are raising have to do with how we allocate the budgets, which also, I think, reflects a little bit the previous question, the previous discussion.

We actually have a social welfare budget in the United States, via the tax subsidies and the direct spending, of about $30,000 a household. That is not a trivial budget. We could argue whether it should be $35,000 or $25,000. A lot of it is in the tax code, a lot of it is in other parts of the direct spending system.

There are ways of taking that money and reallocating it so that it more favors, not just lower-income households that are excluded from some of these tax breaks you are talking about, but also so that it moves more on the mobility side of the budget.

I kept emphasizing that what we have now is a budget that favors consumption, so low-income households are not left out, for instance, of the housing programs. But they are encouraged, for instance, to take rental housing where they might get rental subsidies, but not to own, whereas the subsidies for ownership, which are in the tax code, they are not encouraged to participate in.

So it is not just upside-down in the tax code, it is upside-down across both the tax code and the social welfare system. I think there are ways of reallocating this money that would favor mobility in ways that I think that both political parties would favor. Many of these are in the tax code, many of them are also in the social welfare system.

Senator WYDEN. Ms. Currier, let me turn to you, because I think you all are doing extremely important work as it relates to upward mobility at Pew. I am especially attracted to your ideas about personal savings. I mean, in effect this is an opportunity for a family to create their own safety net.

In this regard, Senator Coats and I have proposed creating a new American Dream account which could be used for any purpose. What we would like to do is particularly address some of the judgments that you are making in terms of how young people could benefit from enhanced savings.

How would you go about, at this point, setting up a new kind of savings opportunity? Where would you start it, and how would you use it in a way so as to create the best possible array of incentives for young people?

Ms. CURRIER. Well, I think, as you know, our project has been fortunate enough since its inception to work with a bipartisan group of thought leaders and advocates, including Dr. Steuerle. They reflect views from across the political spectrum.

A few years ago, they worked with our project to develop a set of policy recommendations that they unanimously agreed would enhance economic mobility. One set of those policy recommendations falls under the category of financial capital and includes a host of recommendations specifically about ways that families across the income distribution can develop savings.

One of their policies includes child savings accounts and establishing accounts early in life so that children from the very beginning have opportunities to become more financially literate, build expectations for themselves about how that money could be used for human capital development, and also tap into behavioral economics, giving people an easier opportunity to invest in themselves and their children.

Senator WYDEN. Mr. Chairman, if I could just ask one additional question.

On education—and I think I would like to ask you this question, Dr. Lefgren—Senator Rubio and I have teamed up to propose a bill on higher education. You have been very interested in this field over the years.

What Senator Rubio and I are proposing is called the Right to Know Before You Go Act, so as to help particularly college-bound students deal with this mountain of debt that so often they rack up. It has really become the 2nd-biggest investment, after buying a home, in their life.

I know that you have looked at this issue, particularly as a springboard to economic mobility for young people. What kinds of Federal policies would you suggest that could help young people who are getting shellacked by these enormous debts that they are facing for higher education?

Dr. LEFGREN. One thing that I actually want to make clear is that higher education is still one of the best investments around. If you look at the economic literature, the returns from education have not been declining, they have actually been increasing over time.

So I think it is important that, as we move forward, we do not send the message to our young people that higher education is a boondoggle or is a bad investment. It will, for most people, be the best investment that they can ever make.

Now, there are a couple of problems. A lot of the mountains of debt, or the big problems, are people who go to expensive private colleges with a major in things that do not have a very high financial return, so there is an issue of major choice. Then there is also an issue where you look at some of the for-profit colleges that cater to disadvantaged applicants. In some ways they provide an opportunity, but many of those people who go through those programs have very poor outcomes.

I think what I would like is for there to be just a lot more information. For example, if colleges sort of gave information on what a typical labor market outcome is for people who go through their institution or people who go through their program, that would allow people to make informed decisions, but still make efficient decisions.

Senator WYDEN. That is exactly what Senator Rubio and I are proposing. We want young people to have that kind of information in front of them. The fact of the matter is, today, in many respects, you can get more information about buying a used car than you can about the point you are making in terms of what your economic prospects are when you get a degree from a particular school. So, we are going to be following up with you, because I think your point is spot-on. Thank you, Senator Hatch.

Senator HATCH. Thank you.

Senator Thune, we will turn to you.

Senator THUNE. Thank you, Mr. Chairman. I want to thank our witnesses for sharing their insights today. We have had some discussion from our witnesses about a range of tax provisions and other programs that affect economic mobility, but I would also suggest that the greatest driver of upward economic mobility is not a government program, but the ability to find a good-paying job. Unfortunately, right now the policies that we have in place have failed to create enough jobs to lift incomes and raise living standards.

The lack of a robust economic recovery has fallen particularly hard on younger Americans. If you look at the statistics, there is a recent Brookings Institute study that found that the percentage of Americans aged 20 to 24 who were employed fell nearly 8 percent between 2007 and 2010. This compares to a decline of less than 1 percent for Americans over the age of 55.

There is another study that estimated that a young person graduating from college today will earn roughly 17.5 percent less than they would if they had graduated during a stronger labor market. That translates into about $70,000 in lost income over a decade in time.

So we can discuss specific government incentives at the margin, but I think we really need policies that promote job creation and keep taxes low and that provide, really, the economic certainty that I think our business owners and investors need. It seems to me, at least, that now would be a really bad time to implement large tax increases on the people who create jobs and our entrepreneurs out there.

I want to just get your reaction to an issue that bears pretty heavily in the part of the country where I am from, and that has to do with the death tax, the estate tax. There is a lot of discussion about that and how much revenue it raises relative to the cost of compliance and other things.

But one of the things that we do know affects economic mobility is the ability to save money over time. For many families, their small business is their savings. For these families, the Federal estate tax, or as I referred to it, the death tax, makes it more difficult for savings and wealth to pass from one generation to the next. It is especially true in rural areas of the country.

According to the Department of Agriculture, farm real estate accounted for 84 percent of U.S. farm assets in 2009. For these farmers, who are land-rich and cash-poor and who have seen land valuations rise dramatically in many parts of the country, the death tax reverting to a top rate of 55 percent next year, coupled with an exemption amount of only $1 million, would be devastating.

If we want to help Americans save for the future, and if we want to improve economic mobility, we need to make sure that the Federal death tax does not result in the liquidation of businesses that have been built up over a lifetime through many years of hard work.

I guess I am just interested in your perspective on how that issue bears on this ability to transfer intergenerationally small businesses that would allow that next generation to achieve a higher standard of living. And particularly—I do not know if any of you can speak to this—from a rural perspective, farm and ranch families that I know of—in fact, I had someone mention to me just the other day, with the land values that we are seeing in many parts of the country today, you really can be land-rich and cash-poor and, when that time comes, end up having to liquidate a lot of your assets just to pay the IRS. That seems like a fairly counterproductive thing to do if you are interested in sustaining some of these businesses and creating economic opportunity for future generations.

Does anybody want to comment on that?

Dr. LEFGREN. I will comment for a moment. It is my recollection that the estate tax, even when the tax rates are higher, actually does not generate very much revenue because there are so many mechanisms that families have to estate plan prior to the passing. So in some ways, it is likely the case that the incentive effects of the estate tax, in terms of tax avoidance and that, are likely high relative to the financial benefits of increasing the tax.

In countries like Sweden, they actually have high tax rates on labor income and actually relatively low tax rates on capital, because of the incentive effects. However, it is not obviously clear to me why there is something special about farmers relative to other people, for example, people who own expensive homes that have been in the family for a generation. It is not clear to me that that is sort of solving the problem or that the inheritance tax is something that is an obstacle to mobility. But I think the revenue effects, however, are pretty small, so it is probably a 2nd-order issue in terms of——

Dr. STEUERLE. Senator Thune, can I suggest that most of the data that we examine here is for the broad swath of the population, and I do not know if we could find the estate tax to say that the top 1 percent of wealth holders—I do not know how much that would actually show up even in our statistics.

I mean, a lot of what we are talking about on intergenerational mobility particularly, is people near the bottom being able to rise up to the middle and even, say, top quartile, but not even necessarily the top 1 or 2 percent. I would suggest you might want to think about, if there is going to be a continuation of an estate tax at whatever rate, that it be divided into a capital gains at death and an estate tax.

So instead of, say, a 30-percent cap death estate tax, you might think of a 15-percent capital gains tax and a 15-percent estate tax, which I think actually ameliorates a number of problems, although it may not solve the problem for the farmer who has had huge amounts of capital gains.

Senator THUNE. Right. Good. All right. It is probably somewhat unique to more the middle of the country. I mean, it is not unique in the sense that you have a lot of small businesses that deal with this, but I think in terms of farm and ranch families who do work very, very hard, and in many cases because of the value of their operations—which at one time with land values were not what they are relative to today, but we have seen these land values increase dramatically.

So now you have what would probably be characterized by many as a relatively small farm that has a pretty high value, and you would experience a significant amount of tax liability when one family member dies and passes that on to the next generation, which is what we try to encourage where I am from. You want people to continue to stay in farming, ranching, and agriculture. This has become a real detriment to that and a real obstacle to that, but that may be, again, a factor that is somewhat unique to where I am from.

Dr. STEUERLE. And I think it is somewhat easy to exempt most of the farmers in that situation. I mean, depending on how we design it as well.

Senator THUNE. You could, if you designed it the right way. But as of January 1st of next year, the exemption level goes down to a million dollars and the top rate goes up to 55 percent. If you have a 1,000-acre farm at $5,000 an acre on that farm, you are at $5 million right there, and that does not include equipment or anything else.

Dr. STEUERLE. I think $1 million is very low. My calculations on the lifetime value of Social Security and Medicare benefits is they are close to $1 million for a couple, too.

Senator THUNE. Right.

Dr. STEUERLE. So we are getting up pretty close to middle-class assets, at least at some level.

Senator THUNE. All right. Thank you.

Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Thank you, Senator.

I might chime in with the remarks of the Senator from South Dakota. In my part of the country, that is a real issue, for the reasons that he indicated.

I wonder, what do we do about crime in cities, inner cities? There have been reports in the last several days about the murder rate going up in Chicago. The new mayor, Rahm Emanuel, is trying to address it, and doing a very good job. Chicago is a great city. But my sense is that, in a lot of these cases, if you are born into a part of a city where all you see is gang warfare, that is probably what you are going to end up doing, being a gang member.

I do not know how you break that cycle. What do you do in these neighborhoods? It is a crazy thing to say, but I have been home in my State of Montana for 10 days, and I came back yesterday, and all I heard was a bunch of sirens, cops chasing after people, and they got hold of somebody, about eight squad cars just a block from where I live. My gosh, we do not have this in Montana. But it is here, and it is in other cities around the country.

So, it is tough. How do you address mobility when you are born in the inner city and all you see is crime, a single parent, if you are lucky? How do you deal with that? Anybody?

Dr. LEFGREN. Can I?

The CHAIRMAN. Yes.

Dr. LEFGREN. This is something that I have done some research on. There is good work by Lance Lochner and others that looks at the impact of educational investments on subsequent criminal activity. So in the long run, encouraging the same investments that promote upward mobility actually leads to reductions in criminal behavior. There is also literature by Steven Raphael and David Mustard, who look at the impact of labor market opportunities on criminal behavior.

So a lot of providing labor market opportunities to these young people is also another medium- to long-run solution to—these are what you are going to want to do dynamically. In the short run, you have the options of increasing incentives and incapacitation through incarceration, except I think that, relative to other developed countries, we already have excessive levels of incarceration for many offenses.

The CHAIRMAN. Obviously this is a hearing of the Finance Committee on the tax code, but one thing that impressed me is 8, 9, 10 years ago I saw a local news program about how a principal in a garden-variety school on the East Coast—it was mixed races, nothing really to distinguish it from any other school, except it had very high drop-out rates and very low test scores. They were in a world of hurt at this school.

So the principal did something that took them 3 years to accomplish. It looked like a very good idea. Essentially, he figured out a way to have a parent or guardian of each student spend a couple of hours a week at that school. Maybe somebody was a playground monitor, maybe somebody knew a little bit about English or math, maybe somebody knew a little bit about shop or making something.

But anyway, after 3 years he was able to get a parent or guardian of every single student to spend a couple of hours a week at that school. Grades shot up, drop-out rates plummeted. My sense is it is because the school and the parents took ownership of the school and what was going on, knew other kids—kind of a family, if you will.

My sense is, the more schools do things like this, maybe earlier—I know it is easier at the mid-school age, but even at an earlier age, perhaps, you can address some of this needed sense of community at schools so kids have confidence, they know they have friends, they know somebody cares about them, and so forth.

Dr. NEWMAN. Mr. Chairman, I think one of the things we can actually justly be proud of in the United States over the last couple of decades is that crime rates have actually gone down very significantly in most of our cities.

The CHAIRMAN. I have seen that. Right. That is right.

Dr. NEWMAN. That does not mean that that will necessarily last forever. I think the wave of foreclosures that is leading to abandoned properties in cities like the one where I live now, Baltimore, or cities like Detroit, may well create a turn-around on that that we will not be happy to see.

But I think that we need to recognize a very small number of people can make a neighborhood dangerous for everyone else who lives there. It is very rarely the case that you have massive numbers of people involved in gang activity. You have a few, and they make life pretty miserable for everyone else.

But we do know that strong neighborhoods that have good, strong social backbones to them generally tend to police their own and become neighborhoods in which crime rates do not spread. So we need to look at what makes for stable neighborhoods, and all the institutions we have been talking about today—strong schools, strong families—contribute to neighborhoods that have strong social organization, and that is where you tend to see crime rates down, even if they are poor.

So I think it is important for us to recognize all of these things are interconnected. All these institutions and their stability are interconnected, and you do not see crime spread where you have families that have opportunity for strength, schools that are functioning, opportunities for young people other than crime.

Dr. STEUERLE. Senator?

The CHAIRMAN. Yes?

Dr. STEUERLE. Can I mention one tax provision I think that would affect the discussion here?

The CHAIRMAN. Yes, good. We have to get to tax here.

Dr. STEUERLE. By the way, I reconfirm what you said. The example you gave is one—if we could figure out ways—and it would vary widely from a community in Montana to a community in New York—to have an adult presence around most kids most of the time, most of the year—there are a lot of different ways to think about that—it makes a huge difference in what happens in their life. This actually starts at a very early age.

But the tax code provision I would refer to is wage subsidies. There is one group that is largely left out of our social welfare system. Our social welfare budget is largely oriented towards you and me as we get older. That is where all the money is going, we know that, on the entitlement side. But on the welfare side, it is for families with children, largely single parents with children. We tend to exclude the married families with children because their income starts rising just enough that they get excluded.

The low-wage male, the young male and female who is just starting out in life, typically is excluded from this system, with the one exception: if they go to prison, they will get a lot of government money, but not necessarily to help them.

I think there are ways to redesign our wage subsidies so we try to subsidize a little more, or reorient it so we subsidize a little more of the low-wage worker without requiring they be the one who raises the children, or they be the one who, on the side, helps raise the children as long as they do not marry.

The CHAIRMAN. Thank you. My time has really expired some time ago.

Senator Hatch, anything?

Senator HATCH. Well, thank you. I just want to thank all of our witnesses for being here. I am sorry I missed part of this, because I was on the floor. But this is an extremely interesting area.

I have some questions for you, Dr. Lefgren, but I think I will withhold them and submit them in writing so you can answer them for us, and for the rest of you as well. There are a number of questions that I would have liked to have had everybody on the panel give their answers to.

But I appreciate you holding this hearing, Mr. Chairman. I think it is an important one, and I will do what I can to help.

The CHAIRMAN. Thank you. Thank you, Senator.

This really is critical. First, thank you. Second, I urge you to keep thinking. When you are walking out of here and you are going home, gee, here is something else that we could be doing, something else I want that committee to know about and push them on. So, please stay involved, because this is really critical.

Thank you very much. The hearing is adjourned.

[Whereupon, at 4:07 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Boosting Opportunities for Future Generations through Tax Reform
As prepared for delivery

President Truman once said, "All of us want our children to have a better life than we had, and it should be the constant aim of each generation to make things better for the next."

As a father, I know how concerned parents can be about their children's future. Americans just want their children to have a fair shot at earning a good living and succeeding in life.

But more and more, American parents worry whether this dream can come true. These worries are well-founded, especially for parents who have not been able to climb the economic ladder as high as they would like.

I used to say that America was the land of greatest opportunity. We had more mobility and more opportunity than anywhere in the world. No more.

In the United States, a child born to a family in the top ten percent of earners is 23 times more likely to end up financially well-off than a child born in the bottom ten percent.

This doesn't mean that a child from a low-income family will never "make it." But it implies that they face strong headwinds, while a child from a more fortunate background benefits from a strong wind behind their back.

And American children from low-income families face stronger headwinds than low-income children in other countries do.

In a study of the U.S. and nine of our competitors, the United States comes in dead last in mobility.

A Danish child born in the bottom 20 percent of earners is almost twice as likely to make it to the top 20 percent as an American low-income child.

This lack of mobility means we're not capitalizing on all our citizens' talents. And we are betraying the ideals on which our country was founded.

Many of our foreign competitors are doing a better job advancing the American Dream and opportunity than we are.

So, what determines opportunity? And what can we do to ensure that all American children have a fair shot at the American dream?

To find opportunity, children need a high quality education. They need skills to be successful.

But an American child from the top income quarter is ten times as likely to go to college as a child from the bottom quarter.

In 1979, the United States led the world in the number of people who graduated from college. Now we are number 16 out of 34 countries – just above Estonia, Poland and Chile.

We used to be a leader. We've slipped to 16th.

To succeed, children also need to be healthy and cared for. They need mothers who are healthy during pregnancy. Lower birth weights result in children having lower lifetime earnings. They need parents who have the ability to provide for them. If their parents work, they need high-quality child care.

Congress has tried to improve opportunities for families and children through the tax code. There are numerous tax incentives to encourage work, education, healthcare and savings.

The earned income tax credit and the child tax credit give low-income parents an incentive to work and help them provide for their children. In 2010, the earned income tax credit lifted three million children out of poverty. And health reform will give more pregnant women access to quality health care.

But many incentives the tax system provides are upside down. They give the most help to those who need it the least.

Provisions like the exclusion for employer-provided child care provide more support for children with parents in high tax brackets than those with lower incomes.

For example, the most tax savings a family making $40,000 a year can receive from the exclusion is $750. But a family making $250,000 a year can receive twice this amount. And for children in low-income families, this break may provide no benefit at all.

Today's hearing will focus on economic mobility and how we can use the tax code to strengthen the American Dream.

It is an important issue that is very much on people's minds. The Washington Post and USA Today have stories today on the very study that one of our witnesses will discuss.

The tax system isn't the only way to improve opportunities, but it's an important way. We should use all the tools that we have.

So as we work to simplify the tax code, let us ensure every child has a fair shot at a richer and fuller life. And in the words of President Truman, let us help this generation make things better for the next.

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Economic mobility across the generations in the United States: comparisons, causes, and consequences*

Miles Corak

July 6, 2012

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Written Testimony to the United States Senate, Committee on Finance

July 10th, 2012 Hearing on

"Tax Reform: Drivers of Intergenerational Mobility and the Tax Code"

Introduction

Whether the degree of inequality in a society is "too high" or "too low" is hard to say, and therefore it is hard to imagine what the public policy implications should be. How did it arise? What will happen to it in the future? These seem to be reasonable questions to ask in trying to understand the implications for tax reform and other public policies.

Knowing the dynamics of inequality over the horizon of a working lifetime is certainly important in developing a fuller picture; but particularly important as well is a perspective over an even longer horizon, between two generations or more. How is inequality transmitted from parents to their children? Do low income families raise children who grow up to be low income adults and in turn raise the next generation of poor children? Or for that matter how likely is it that rich kids become the next generation of rich adults? Seeing a society from this perspective gives more context: it helps us to understand how inequality of outcomes came about, and how it will evolve.

*This submission is adapted from Miles Corak (2012), "Inequality from Generation to Generation: The United States in Comparison," in Robert Rycroft (editor), The Economics of Inequality, Poverty, and Discrimination in the 21st Century, ABC-CLIO, forthcoming. The original version is available at milescorak.com.

When our focus is on changes in inequality from generation to generation, that is when we are speaking about inter-generational mobility, we are able not only to describe how inequality is transmitted from parents to children, but just as importantly this description speaks to underlying values—like equality of opportunity—that in some sense might allow us to say that there is "too" much or "too" little inequality in society.

Indeed, "equality of opportunity", as opposed to "equality of outcomes", is a value that Americans hold dear. The idea that individual talent, energy, and motivation determine outcomes and accomplishments, as opposed to family background and status, is central to living the "American Dream." A poll conducted by the PEW Charitable Trusts in 2009 found that about three-quarters of Americans strongly held the view that the American Dream meant "being free to accomplish anything with hard work," and about 90% said hard work and having ambition were either essential or very important to getting ahead in life. (Economic Mobility Project 2009).

But there is a disconnect between the way Americans see themselves and the way the economy and society actually function. Many Americans may hold the belief that hard work is what it takes to get ahead, but in actual fact the playing field is a good deal stickier than it appears. Family background, not just individual effort and hard work, is importantly related to one's position in the economic and social hierarchy.

This disconnect is brought into particular relief by placing the United States in an international context. Children are much more likely as adults to end up in the same place on the income and status ladder as their parents in the United States than in many other countries. These comparisons beg the question as to why.

To understand the drivers of intergenerational mobility in the United States, and the differences between Americans and others, it is important to appreciate the workings and interaction of three fundamental institutions: the family, the market, and the state. But comparisons can also be misleading. The way in which families, labor markets, and government policy determine the life chances of children is complicated; the result of a particular history, societal values, and the nature of the political process. It might be one thing to say that the United States has significantly less intergenerational mobility than Denmark or Norway, but it is entirely another thing to suggest that these countries offer templates for the conduct of public policy that can be applied on this side of the Atlantic. There is no way to get from here to there.

A comparison between the United States and Canada may, however, be particularly appropriate. It illustrates how the configuration of the forces determining the transmission of inequality across generations differs in spite of the fact that both of these countries share many other things in common, particularly the importance and meaning of equality of opportunity and the role of individual hard work and motivation.

Intergenerational mobility in the United States and other countries

There are many ways to measure and describe the degree to which family background is related to the adult attainments of children. Sociologists have examined the degree to which children as adults have the same status among their counterparts as their parents did a generation earlier. "Status" is often measured on the basis of occupation or some related indicator of the position or degree of control an individual may have in the workplace.

For some decades there has also been a focus, particularly among economists, on earnings and income as the outcomes of interest. The most often used statistic in this literature is the "intergenerational elasticity in earnings", which is the percentage difference in earnings in the child's generation associated with the percentage difference in the parental generation. For example, an intergenerational elasticity in earnings of 0.6 tells us that if one father makes 100% more than another then the son of the high income father will, as an adult, earn 60% more than the son of the relatively lower income father. An elasticity of 0.2 says this 100% difference between the fathers would only lead to a 20% difference between the sons. A lower elasticity means a society with more mobility.

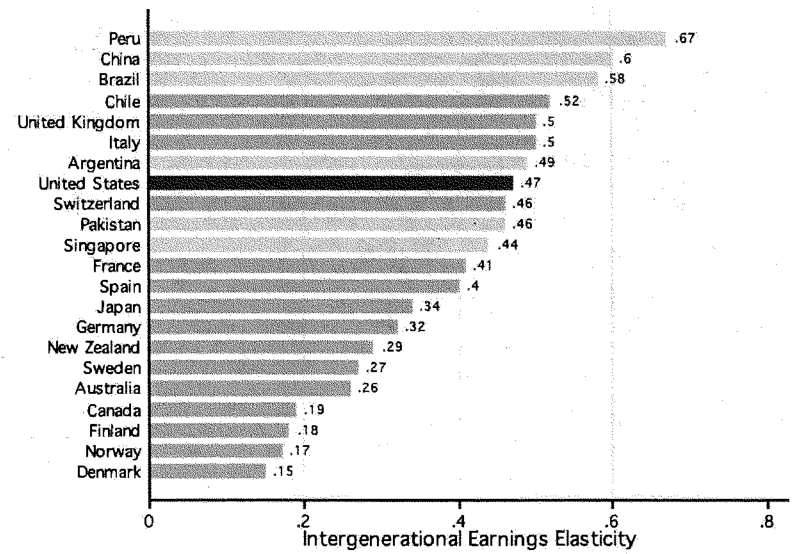
The primary focus of much of this research has been on the father-son relationship because it is the least complicated and, because of the availability of data, the most convenient to obtain reliable estimates from a large number of different countries. Comparisons involving daughters and mothers, or a focus on relationships that also account for marital choices and not just labour market choices, have also been studied. There are also studies addressing, among others, total income, self-employment income, assets, and receipt of government transfer payments like welfare and unemployment insurance.

We should be clear from the very beginning that the use of the intergenerational elasticity of earnings is an exercise of description, and in and of itself does not offer a story about the underlying causal forces. As such it does not lead to clear policy recommendations. We should also be clear that this is a much more difficult statistic to measure than those associated with inequality, and in fact there has been a good deal of controversy about these measurement issues. This is because of the data requirements and challenges of translating theoretical concepts into practical measures.

To accurately measure the intergenerational earnings elasticity requires estimates of the lifetime earnings prospects of both parents and their children in their adulthood. Because earnings tend to rise over the life cycle but annual earnings fluctuate a great deal, good estimates of lifetime earnings require having several years of earnings data during a period in the life cycle when individuals are established in their career jobs (when they are 40 to 50 or so years of age), and these estimates must be available for both the parent and the child. As such the members of a family have to be followed and connected to each other over a period that easily spans several decades.

A good deal is at stake in getting these measurement issues right: they have

Figure 1: Intergenerational mobility varies a good deal across countries, and the United States ranks among the least mobile of the rich countries



Note: Moving horizontally from left to right signifies less intergenerational mobility, that is a stronger tie between a son's adult earnings and the earnings of his father. Lightly shaded bars indicate countries that are not member states of the OECD, generally taken to mean lower income countries.
Source: Published estimates collected by the author and using the methods described in Corak (2006).

been shown to matter for the ultimate statistic, and hence description of how families and labor markets work. Corak (2006) suggests that the best estimate for the United States is somewhere between 0.4 and 0.6.

Figure 1 shows a 22 country comparison of intergenerational elasticity estimates. The estimates range from less than 0.2 in countries like Denmark, Norway, and Finland to a high of almost 0.7 in Peru. Part of the variation across the countries is due to the process of economic development, with lower income countries generally having a higher proportion of inequality transmitted across the generations. And part of the reason for some of the very high estimates have to do with the exclusion of particular groups from full participation in the labor market and society, be it some segments of the aboriginal population in Peru, and to some extent the rural population in China.

But there is more to this variation than the overall level of economic development or broad structural factors. If we restrict our attention to the rich countries there remains considerable variation, with the United States standing out, along with Italy and the United Kingdom, as the least inter-generationally mobile. In these countries the estimate is in the neighborhood of 0.5, being two or more times as large as the most mobile countries who are characterized by estimates of about 0.2 or even a bit less.

The natural question to ask is why, and relatedly what role can taxation and other public policies play?

The drivers of intergenerational mobility

To understand these differences we need to appreciate the possible underlying causes of generational mobility, and an important starting point is Solon (2004) who has adapted a standard perspective in the economics literature and made it appropriate for comparisons across countries. Very broadly speaking, the reasons for the differences in the intergenerational elasticity across countries has to do with the role of three fundamental institutions determining the life chances of children—the family, the labor market, the state—and the different balance struck between their influence across countries. Solon's model invites us to think of families differing in their capacities and resources to invest in their children, but also as facing different incentives to do so according to their socio-economic status and the social context in their country. While some of these capacities and incentives to invest in children may be genetic or due to family history and culture, others are influenced by how families interact and interface with the labor market and the design of public policies. It is these later influences that are related to public policy and choices.

Parents invest in and influence the adult outcomes of children in a whole host of ways, but these investments can have particularly important implications at certain stages of a child's life. Therefore, we should not understate the role of families, but at the same time we need also to appreciate the context within which they live and the social supports offered to them.

The argument is often made that a particularly important window of opportunity in a child's development occurs during the early years, up to about five years of age. This meshes with developments in the science of early brain development. The central idea is that the stimulation infants and young children receive from their environment influences their neural development and will ultimately define the outer limits of their capabilities. Children raised in families at the high end of the socio-economic scale are more likely to be exposed to a stimulating environment that leads to an advantageous path in life with respect to health, cognitive development and social skills. If the brain does not receive the requisite environmental stimulation at certain critical periods, the window of opportunity closes and development fails to occur. (Knudsen, Heckman, Cameron, and Shonkoff, 2006.)

This so-called "neural sculpting" occurs at different times for different brain functions, but timing is important. The point is that this process establishes the "initial conditions" of a life and sets the individual down a particular pathway, a pathway in which a series of cumulative experiences may set further constraints or present further opportunities. The series of steps leading through important transitional periods in life look something like this: socio-economic circumstances early in life (and even in the pre-natal period) → birth weight and cognitive/social/emotional development → readiness to learn → language development → behavioral problems in school and educational achievement → labor market success and job characteristics → stress, mental well-being, socio-economic status, success in family formation → parenting.

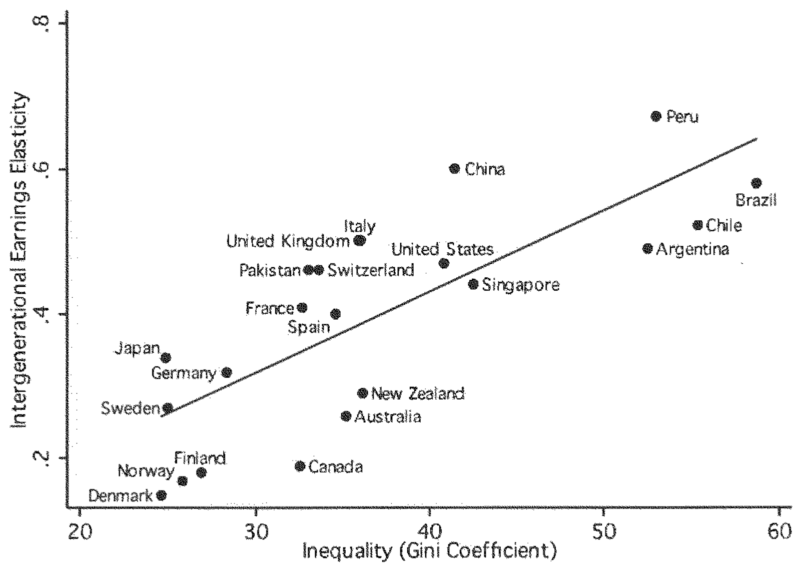
The intergenerational earnings elasticity is a summary relationship of the overall outcome of a whole series of gradients that appear at each of these steps. Parents influence child outcomes at each of these stages, but outcomes at any one stage have their roots in earlier stages and child's cumulative experience up to that point. Someone born to parents with low income faces a higher risk of less successfully transiting through these stages and of ending up in a precarious labor market situation, which in turn diminishes his or her capacity for positive parenting. This raises the odds of a generational cycle of poverty, but money is as much the result as the cause of the vicious circle.

For example, the child of a high income, dual-earner couple (with perhaps only one other child) may well be raised in an environment with more resources that improve his or her future adult prospects than the child of a single parent with limited education. These resources are both monetary and non-monetary. The advantaged household will certainly be able afford more things and activities for the child, but may also be more likely to spend more time with the child and offer linkages and contacts to the neighborhood and community that will both nurture and offer opportunities for growth and advancement. The support parents offer may extend well into adolescence by helping to direct their children through the labor market, offering advice and contacts as they get their first jobs and establish a foothold that will influence their career prospects. Consequently, we can expect the intergenerational elasticity to differ across countries for reasons associated with demographics, family formation, single parenthood, as well as parenting skills and time devoted to children.

As another example, an increase in the cost of human capital investment, such as in market-based provision of child care or health care, private primary schooling, or higher college tuition fees, will imply lower human capital investment. In a similar way a higher potential return to human capital will create an incentive for more investment. Solon (2004) takes the rate of return to education as an indicator of the degree of inequality in the labor market, and shows that societies with labor markets characterized by more cross-sectional inequality—that is, a higher return to education—will be less generationally mobile. This is because a higher income, dual earner family with fewer children not only has a higher capacity to invest in the education of their children than a single parent low income family, but also because the incentives to do so are greater. Inequality in demographics and labor markets in the here and now will have an influence on the degree of inequality in earnings in the next generation. Consequently we can expect the intergenerational elasticity to differ across countries for reasons associated with the costs and returns of investing in a child's human capital, the way in which the labor market works and how "good jobs" are obtained, and the income inequalities between parents.

But Solon (2004) also suggests that public policy can both accentuate and

Figure 2: More inequality at a point in time is associated with less generational earnings mobility in 22 countries with comparable estimates of the intergenerational elasticity between father and son earnings



Note: Moving horizontally from left to right signifies more inequality in earnings. Moving vertically from bottom to top signifies less intergenerational mobility, that is a stronger tie between a son's adult earnings and the earnings of his father. Source: Figure 1 for the intergenerational elasticity, and World Bank for estimates of the Gini coefficient around the year 2000.

dampen the influence of labor market inequality. He shows that generational mobility is promoted by "progressive" public programs, those that are of relatively more benefit to the relatively less well off. Two countries may spend the same fraction of their gross domestic product on education, but if this spending is directed to high quality early childhood, primary and secondary schooling it is likely to be of relatively more benefit to families lower in the socio-economic scale than if it was directed to the subsidization of tertiary education. In fact, this refers to more than just public transfers or publicly provided programs directed to children: it also includes all aspects of public actions that influence the relationship between families and the labor market. The structure of taxation and regulations is also part of the story.

In a rough way we can see the outcomes of these forces at work in Figure 2, which plots the intergenerational earnings elasticities presented in Figure 1 against a cross-sectional measure of inequality (the Gini Coefficient). More inequality at a point in time is associated with less generational mobility. Once again, this picture is one of association. The underlying causes relate to the process of child development and the role of socio-economic inequalities influencing it, but these forces may differ in their significance across these countries: in some early childhood development may be the decisive factor, while in others it may be limited access to quality tertiary education due to early tracking of students during the primary years, and others still it may be due to labor markets in which access to good jobs is determined by family contacts, discrimination, or outright nepotism.

Haskins and Sawhill (2009)offer a clear portrait of the life chances of American children as the outcome of the interaction between family background and resources, growing inequalities in the labor market, and changes in government policy. Their analysis offers the kind of detail and institutional backdrop to interpret these raw statistics. To appreciate which aspects of demography, of labor markets, and of government policy are central in determining different outcomes in a comparative framework would require an analysis with this kind of detail across many countries. This is no small challenge, but one comparison that may be both feasible and apt is that with Canada because the nature of the family and the structure of labor markets are broadly similar between these two countries.

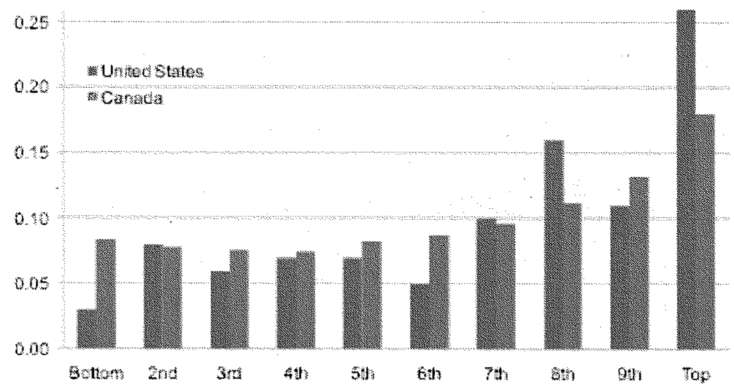
Families, labor markets, and public policy in the United States and Canada

The information in Figure 1 suggests that the intergenerational earnings elasticity of 0.47 in the United States is more than twice as high as the Canadian estimate of roughly 0.20, but this likely even understates the difference between the two countries. Corak (2010) suggests that the estimates calculated by Mazumder (2005a,b), which are as high as 0.61, are more directly comparable to estimates of about 0.23 produced with Canadian data by Corak and Heisz (1999): both studies using administrative data on virtually the same age cohorts of men at the same period of time.

This suggests that the intergenerational elasticity between father and son earnings is almost three times as high in the United States as it is in Canada. This difference is the result of different patterns in the degree of mobility at the two extremes of the earnings distribution. In both countries there is a considerable degree of mobility among the broadly defined middle earnings group, but both the sons of high and low earning fathers are more likely to grow up to be, respectively, high and low earning adults.

As Figure 3 illustrates, in the United States 26% of the sons born to fathers in the top 10 percent of the earnings distribution grow up to have earnings that place them in turn in the top 10%, and the majority of these sons are in at least top 30% of their earnings distribution, while only 3% fall to the bottom ten percent. There is also stickiness in earnings at the top in Canada, but not as great: 18% of top decile sons remain in the top decile, about 40% are in the top 30% and about 8% fall to the bottom. Similarly there is stickiness across

Figure 3: Earnings deciles of sons born to top decile fathers: Canada and the United States



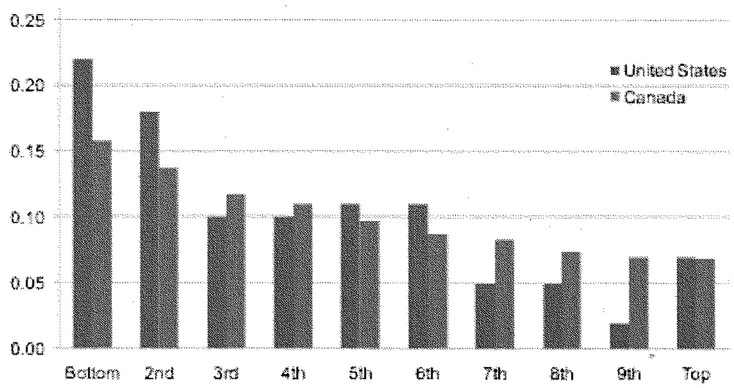
Source: Corak (2010).

the generations for sons raised by low earning fathers, and once again more so in the United States, where 22% of bottom decile sons remain in the bottom 10% as adults, and one-half remain in the bottom 30%, In Canada 16% remain in the bottom, while about 4 in ten remain in the bottom 30% of the earnings distribution.

In general there is somewhat more upward mobility from the bottom in Canada than in the United States, with Canadian sons born to fathers in the bottom third of the earnings distribution more likely to rise into the top half of their adult earnings distribution than their American counterparts (Figure 4). This is a particularly important difference, and in part reflects the fact that children in the bottom of the income distribution are less well off in an absolute sense in the United States than in Canada. Greater inequality in the American earnings distribution is reflected in the monetary circumstances of children. If Canadian children were placed in the overall American income distribution, their family income would tend to be considered as lower middle class, being disproportionately between the second and fifth deciles. About two-thirds of Canadian children would be found above the bottom tenth of the income distribution but no higher than the middle. When American children are placed in the overall income distribution they are more likely to be at the very bottom and the very top.

But this difference in monetary resources is also reflected in a host of indicators associated with non-monetary resources, particularly with family resources and other social and community supports. In Canada children are more likely to be living with a mother who is married, and more likely to be living with both biological parents. About three-quarters of Canadian children younger than 13 live with both biological parents, while in the United States this proportion is

Figure 4: Earnings deciles of sons born to bottom decile fathers: Canada and the United States



Source: Corak (2010).

about two-thirds. Further, in the United States mothers tend to be younger, with teenage births being more common. This is particularly so for lone mothers, where in addition to being younger and less educated they also have more children than their Canadian counterparts.

All of this implies that not just monetary resources, but also non-monetary resources—particularly those associated with the time parents spend with their children—are likely to be less enriching for the children of the disadvantaged in the United States. While it is difficult to obtain comparable information on time use, parenting style, and other non-monetary investments parents make in their children, Corak, Curtis and Phipps 2011 note that children in low income and lone parent families are less likely to be read to. This said, the proportion of low income children read to daily, at almost 55% in Canada versus about one-third in the United States, is significantly different.

The care and time devoted to children also depends upon how families interface with the labor market, and the alternative care arrangements available to their children. As suggested labor markets are more polarized in the United States, and there are different patterns of labor force participation in the two countries. "Parental participation in the labour market is both cause and effect of child care arrangements. The choice or need to work means that parents must find alternative arrangements for their children; the availability of care outside of the home offers opportunities to work or to work more hours." (Corak, Curtis and Phipps 2011, page 87).

In fact, Canadian mothers have higher labor force participation rates, but parents who are in the labor market in the United States work longer hours. In the United States mothers are more likely to work full-time or not at all, with about 40% of children having mothers who worked 40 or more hours per week. In Canada only about one-quarter of children are in this situation, there being a greater tendency for mothers to work part-time. In the United States lone mothers are more likely to be working than married mothers, with only one-fifth not working at all compared to almost one-third of married mothers. About one-half of lone mothers work more than 40 hours per week in the United States, but in Canada only about one-quarter do so.

As suggested, labor market participation is both cause and effect of the availability of alternative child care arrangements, so these differences are mirrored in differences in care arrangements for young children. Over one-half of all children up to two years of age are cared for exclusively by their parents in Canada, compared to four in ten in the United States. This difference likely reflects the very different maternity and parental leave available for working mothers of newborn children.

Parental benefits are much more generous in Canada with mothers of newborns who had sufficient work experience being provided with the opportunity to stay home for up to 25 weeks after the birth of their child during the 1990s, and with this package of benefits, administered by the federal government through the national unemployment insurance program, being extended to one year in 2001. Maternity benefits are much more limited in the United States. Parents are entitled to 12 weeks of leave without pay if they work in a company with more than 50 people, but with there being a tax deduction for daycare when it is used because of parental employment.

Corak, Curtis and Phipps 2011 conclude their much more extensive statistical review by stating that the family context in which children are raised in the United States is more challenging than in Canada, raising the risks that some children will not see the full development of their capabilities. American labor markets are also more unequal raising the stakes for child outcomes, both elevating opportunities and heightening risks. Finally, public policy is less "progressive," not compensating in the same degree for family background and labor market inequality. This also relates to a number of measures of human capital, including mental and physical health as well as those associated with education. Overall outcomes are on average higher in Canada, and there is less disparity.

For example, education outcomes that are measured both by the mothers' assessment of the child's performance and on tests administered to the child indicate significant differences in outcomes between these two countries. Canadian four year olds score significantly higher on comparable tests of school readiness (the Peabody Picture Vocabulary test). American mothers of school aged children at the bottom of the socio-economic scale are twice as likely to report that their children are performing below the middle or near the bottom. And according to other tests of mathematics and literacy skills young teens perform on average better in Canada than in the United States. While the schooling system does not seem to significantly narrow initial gaps, it remains unclear as to the extent to which they are amplified or what particular institutional designs and at what particular stages can contribute to narrowing them.

Some hints at reforms to promote generational mobility

At the broadest level we should understand cross-country differences in the transmission of inequality as arising from differences in the investments these societies make in their children as well as differences in the returns to these investments. This process reflects the workings of the family, the structure of labor markets and how families interact with them, and the role of public policy. Inequality at a point in time is both the outcome and cause of the degree to which economic status is passed across the generations.

The greater the capacity of families to invest in their children, both in monetary and non-monetary terms, the more likely children will develop the human capital to succeed in marriage and labor markets. The more equal the returns to education in the labor market, the lower the stakes and the more level the incentives to make these investments. And finally, the more progressive public policy—that is the more relative benefit it is to the relatively disadvantaged—the more level the playing field.

All of these factors come into play in understanding the differences in the degree of generational mobility between the United States and Canada, which is probably the most apt comparison from which to draw lessons for public policy.

It is unlikely that the degree of generational earnings mobility will change significantly in the United States, at least for the current generation of children growing into adulthood, without there being important changes in the circumstances of the least advantaged. These changes include demographic changes that increase the capacity of parents to invest in the early years of their children's lives—a decline in single parenthood, increases in parental education and age at first birth, and increases in both the quality and quantity of time invested in children during their pre-school and early school years.

Further, the very substantial increases in earnings inequality during the past few decades, which in part reflects stagnation in the earnings of those in the middle and particularly bottom half of the earnings distribution, also suggests that intergenerational mobility is unlikely to increase. This will be particularly the case if progressive reforms are not made to public policy. These include increasing the quality of schooling and health care for the disadvantaged, offering more support to parents raising young children—both monetary but also in terms of parental leave that allows more time to be spent with their children—and improving access to higher levels of education.

Tax reforms have a role to play in some of these changes. This includes increasing income support to those with low incomes, and as such would involve a discussion of the generosity of the the Earned Income Tax Credit. This program plays an important role by offering income support in a way that maintains work incentives. But a focus on income support through this program leaves open the question of the time stress that households face, and their capacity to support children in non-monetary ways. There is a need for more flexibility in work arrangements for families with young children, and also attention to the quality of care arrangements of children.

Policy reforms need also to consider the quality of schooling during the early and primary years. In many Canadian provinces the financing of schooling is more broadly based than in many US states, and the disparities in school and teacher quality across socio-economic groups is not as great. The province of Ontario, for example, is often cited as making important improvements in the quality and equity of schooling during the early and primary years. The financing of school boards is not tightly linked to a narrow and local tax base, and steps have also been taken to extend full day kindergarten to four and five year olds. The public system does have a certain amount of parental choice built into it, but in a way that limits "cream skimming". In addition there is only a very limited private component. The system also has built-in second chances, and relatively open access to higher education that includes both community colleges of a more technical and practical nature, and universities of relatively equal quality.

In contrast in the United States there is an implicit tracking in which socio-economic advantages and disadvantages are compounded as children move through the stages of schooling, reflecting sharper differences in quality at both the early and upper tiers. Parental choice plays a stronger role, and in the context of greater polarization in earnings and less progressive taxation leads to more sorting. As a result there is a relatively stronger tendency to send children through particular tracks, leading to particular post-secondary institutions, and ultimately to adult outcomes that more closely reflect family background.

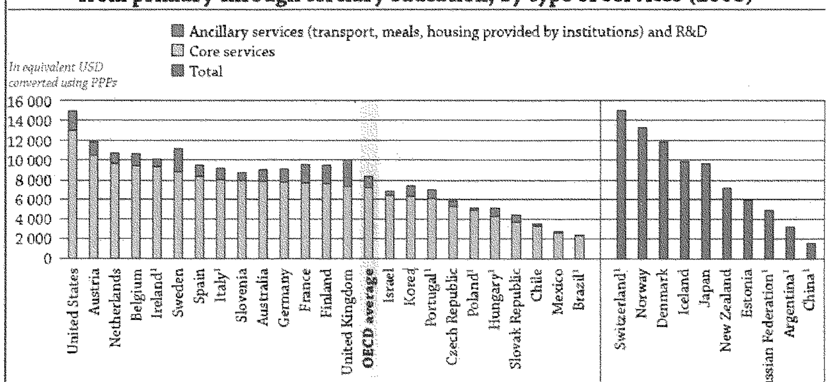
Senate Finance Committee Hearing
"Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve The American Dream"
July 10, 2012
Questions for Dr. Miles Corak

Questions from Chairman Baucus

1. **Education is one of the most important factors in providing every American with the opportunity to succeed. Our education system is one of the reasons that we have one of the most productive labor forces in the world, but not everyone seems to be benefiting. Why is our education system failing to achieve the same level of mobility that we see in other countries? How could the education system here in America do a better job of promoting mobility and opportunity?**

At almost $15,000 per student, America spends more on the schooling of its children and youth than almost all other rich countries. However, what matters for mobility is not just the amount of spending, but how the funds are allocated. The one sentence answer to Senator Baucus's first question is: the education system does not promote mobility to the extent that it could because it is of relatively more benefit to the relatively well-to-do.

Chart B1.1. **Annual expenditure per student by educational institutions from primary through tertiary education, by type of services (2008)**



1. Public institutions only.
Countries are ranked in descending order of expenditure per student by educational institutions for core services.

Source: OECD (2011), "How much is spent per student?", in Education at a Glance 2011: OECD Indicators, OECD Publishing. http://dx.doi.org/10.1787/eag-2011-16-en

The higher levels of spending in the United States are driven by much higher spending on tertiary education. For every dollar spent on primary education three dollars are spent on tertiary education, the highest of all other rich countries.

Further, tertiary spending is dominated by private sources of financing, which makes up over 60% of all spending on this level of education. America, in other words, is choosing to make higher education more of a priority, and in a way that is of relatively more benefit to the relatively well-to-do.

The demand for high quality college education among the relatively well off expresses itself in a demand for high quality primary and secondary schooling that offers a gateway to a good college education.

And while America also spends more on primary education per pupil than many other countries, significant inequalities in parental resources express themselves in the structure of the system, leading to variations in financing, quality, and access in a way that does little to level the playing field.

The Organization for Economic Cooperation and Development summarizes its research on this issue in this way:

> Currently the United States is one of only three OECD countries that on average spend less on students from disadvantaged backgrounds than on other students. ... Moreover, the most able teachers rarely work in disadvantaged schools in the United States, the opposite of what occurs in countries with high-performing education systems. (page 30)

On this basis the response to Senator Baucus's second question---"How could the education system here in America do a better job of promoting mobility and opportunity?"---might proceed in two steps: reforms to the financing of education, and reforms to the structure of the system.

Reforms to make education of relatively more benefit to the relatively disadvantaged should begin by replacing financing by local property taxes, or in some way supplementing it. This narrow base for school financing leads income inequalities between families and neighborhoods to be echoed in inequalities in the nature and quality of schooling.

Whether it is politically feasible to undertake such reforms at the State level is not a question I can address, but perhaps there are federal funding formulae that could be put into place so that more funds are directed to less advantaged neighborhoods, and paid for through a progressive mechanism.

These financial reforms should go hand-in-hand with making teaching a valued, more highly paid profession that over time attracts the best and brightest. It should also involve the use of school testing and evaluations not as a punitive instrument, but rather as a managerial tool for obtaining feedback, improving quality, and redirecting resources at the school level.

These financial and structural reforms should be the preconditions for structural reforms that include:

- a focus on the early years, involving high quality full-day kindergarten and pre-kindergarten;
- raising school leaving ages and requiring high-school graduation;
- the continued development of post-secondary technical/community colleges that offer employer-based training as an alternative to college education;

- and for those who pursue a college education a program of income-contingent student loans in which repayments are based on having a job, and the level of income earned.

While the Senator is certainly correct to suggest that the education system is the most important public policy determining social mobility, its role also illustrates the influence of labor market inequalities and both the monetary and non-monetary resources that families have to invest in their children. Public policy needs also to be concerned with supporting families, an issue the Senator raises in other questions.

[If you would like to explore the details, here are the sources I am drawing upon:

Diana Furchtgott-Roth, Louis Jacobson, and Christine Mokher (2009). Strengthening Community Colleges' Impact on Economic Mobility. Economic Mobility Project. Pew Charitable Trusts.

OECD (2012). OECD Economic Surveys, United States 2012. OECD publishing.

OECD (2011). OECD Education at a Glance 2011. OECD publishing.

OECD (2011). Lessons from PISA for the United States, Strong Performers Successful Reformers in Education. OECD Publishing.]

2. **The tax code has a number of provisions aimed at enhancing mobility. I mentioned a few in my opening statement, such as the Earned Income Tax Credit. Most of our programs to help mobility are targeted towards parents. Does it make sense to provide tax benefits to low-income families, which are claimed by parents, in order to increase opportunities for children? Or should we limit such help to in-kind benefits that can only be claimed by children? How can we make sure that programs intended to create opportunity are benefitting children?**

The United States is unique in the degree to which in-kind, as opposed to cash, benefits are used to address poverty and low income.

The perspective of economic theory would suggest that this is an inferior design since it is based upon the assumption that the designers of government programs know what is best for individuals. This sort of paternalism cuts against the general assumption economists make that individuals know their own interests, and are best placed to make choices that promote those interests. Giving them the cash offers the flexibility to adjust purchases according to these interests. In-kind transfers can also entail a social stigma that has a cost, and may as a result lower participation in the program.

But decision-making in a family of several persons, whose interests may not all be the same, is not so straightforward. The way in which family resources are spent and shared will depend, to put it bluntly, on the bargaining power of each member. There may be a real concern that the interests of children will not be fully reflected in this process.

There is empirical evidence to support the idea that the greater the financial independence of the mother, the greater the share of spending that goes to things like food, clothing, shelter that benefit children, and less to alcohol or tobacco. This is an "average" result, and obviously does not apply to all families. Yet it is reason enough for most governments to design cash transfers so that they are made in the name of the mother.

Even if this is done, the Senator's question may still reflect a broader concern associated the capacity of parents, and mothers, to make decisions in the best interest of their children. If there is evidence to support this concern then it should also be noted that a case can be made for cash transfers that are conditional on some activity deemed of benefit to the child: conditional cash transfers occupy that space between a pure cash transfer, and an in-kind benefit.

Just as the Earned Income Tax Credit is conditional on working, other types of cash transfers could be conditional on the child having---for example---been vaccinated, having been given regular medical or dental check-ups, having been engaged in athletic or other extra-curricular activities. The payment would offer an incentive to engage in these activities that policy makers see as as benefiting the child, while at the same time still giving the family the extra income to allocate as it wishes.

But it should also be clear that this still assumes that parenting in some families is a concern, and if there is validity to this then in a sense it calls for broader policies concerned with the well-being of parents and any disabilities or stresses they face, their parenting skills, and the connections they have or know about in the broader community.

Recent policy initiatives in the United Kingdom addressed to "social mobility" have, for example, moved in this direction: offering support, information, and education about best parenting practices and community resources, and downplaying the role of income transfers.

3. **There are provisions in the tax code to help children from working families to get ahead. For instance, the Earned Income Tax Credit gives families an incentive to work so they can provide for their children and help them succeed. But not every family takes advantage of provisions like the EITC. How can we make sure that even children from the hardest circumstances have a chance to succeed? Is there a role here for tax policy?**

The tax system is increasingly used in many countries to transfer cash benefits to families with children. These are not necessarily universal programs, a simple payment to a family according to the number of children and regardless of income. Rather, they are targeted according to the number of children, and overall resources.

The one sentence answer to the question is simply: yes, definitely there is a role for tax policy to address this concern.

The example I am most familiar with is the Canadian program introduced in the 1990s, which was designed to be integrated with other income support programs provided by the provinces in order to both reduce disincentives to work, and to increase the level of income support to the least well-off families.

A monthly payment is made to families with children: the more children in the household, the greater the payment; but the amount of the payment is lowered gradually the higher the families total income from all sources.

For the 2011-2012 period the Canada Child Tax Benefit / National Child Benefit worked like this for families with incomes below about $24,000 in the previous tax year:

Number of Children	Basic CCTB	NCBS	Total	Monthly Benefit
1st child	$1367	$2118	$3485	$290.41
2nd child	$1367	$1873	$3240	$270.00
3rd & each additional child	$1462	$1782	$3244	$270.33

Higher income families receive benefits, with the rate falling for successively higher income levels: lower for those with an income above the $24,183 threshold and still below $41,544; then lower still if total family income was between $41,544 and approximately $109,894; finally nothing for those above this upper limit.

The setting of these thresholds, and the associated rates would be a subject of policy choice according to the total resources available and how tightly targeted the funds should be.

4. **Mobility is about fairness, but it is also fundamental to economic growth. When everyone has an equal chance to succeed, then the ablest and hardest working Americans will rise to the top. How does the fact that we are lagging behind in mobility affect our economy? How does it affect our international competitiveness?**

The most important resource that rich countries have, that is at the very heart of the growth process, is the human capital of their citizens. Human capital---the skills, aptitudes, and abilities that are in some sense a matter of individual choice responsive to economic incentives---is central to economic growth, and in an era of continued technical change and globalization, increasingly so. The impact of human capital and education on economic growth has been extensively studied, and there is increasing awareness of the importance of the early years in setting children down a path of success in schooling. Professor Heckman of the University of Chicago is one economist who has stressed this point.

However, I am not aware of specific studies that directly link the degree of generational mobility to this literature, though implicitly the link is clear since children from lower socio-economic backgrounds are less likely to have a successful start in life.

It is certainly reasonable to suggest that promoting human capital development is essential to promoting economic growth, and this is more clearly so the greater the need for more intergenerational mobility at the lower end of the income distribution.

It should also be recognized that a lack of mobility can also impinge negatively on economic growth to the extent that it is influenced by the efficiency of the labor market. In particular if jobs are allocated on the basis of nepotism, for example, then the most talented will not have the opportunity to fully contribute to the productivity of the economy. But this also involves avoiding the build up of barriers to employment that might be put into place by the relatively well-to-do.

There is evidence to point out that the performance of some firms is compromised when the senior management positions, particularly the CEO position, are transmitted between family members. There is also evidence in countries other than the United States of a significant and disproportionate intergenerational transmission of employers. Sons born to top earning fathers are much more likely to work at the same employer as their fathers. To the extent that this is not productivity based it is likely to compromise firm performance, and efficiency. But I am not aware of research that has examined the degree to which this is important for economic growth.

[See for example the discussion in

Knudsen, Eric I., James J. Heckman, Judy L. Cameron, and Jack P. Shonkoff (2006). "Economic, neurobiological, and behavioral perspectives on building America's future workforce." *Proceedings of the National Academy of Sciences of the United States of America.* Vol. 103, no. 27 (July), pp. 10155-10162.

See also:

Bennedsen, Morton, Kasper Meisner Nielsen, Francisco Pérez-González, and Daniel Wolfenzon (2007). "Inside the Family Firm: The Role of Families in Succession Decisions and Performance." *Quarterly Journal of Economics*. Vol. 122, pp. 647-91.

Pérez-González, Francisco (2006). "Inherited Control and Firm Performance." *American Economic Review*. Vol. 96, pp. 1559-88.

Bingley, Paul, Miles Corak, Niels Westergard-Nielsen (2012). "Equality of Opportunity and the Intergenerational Transmission of Employers." In John Ermish, Markus Jantti and Timothy Smeeding (editors). *From Parents to Children: The Intergenerational Transmission of Advantage*. New York: Russell Sage Foundation.]

5. **Most analysts seem to agree that the mobility between generations is lower in the United States than it is in other wealthy countries, but the trend over time is less clear. How has mobility changed over time in the United States? What can we do to make sure that mobility is higher in the future?**

This is an important question for the same reason that international comparisons are important. Knowing where the United States stands compared to other countries is interesting because it helps us understand the underlying causes, and hence how public policy might influence outcomes.

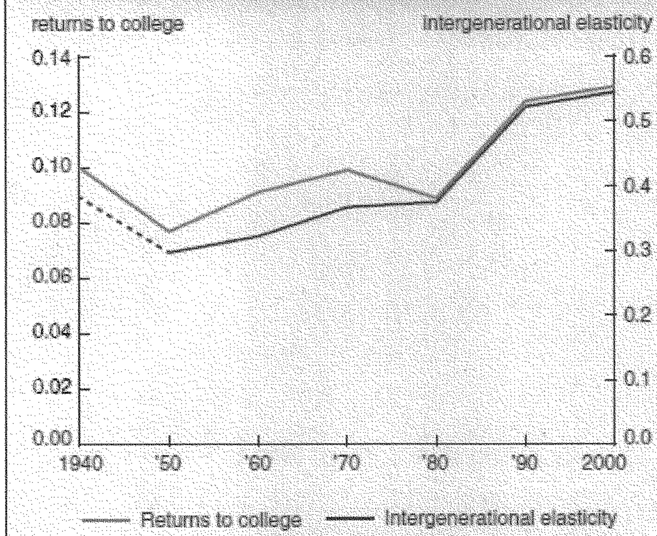
For the same reasons it is just as interesting, if not more so, to compare the United States not just to other countries, but to itself in a previous time.

The one sentence answer to Senator Baucus's first question is: generational mobility declined after 1980. The degree of generational earnings mobility, as measured by the percentage of family income advantage that is passed on to sons, was relatively constant during the 1950s, 1960s, and 1970s at between 30 and 40%, but then rose during the 1980s and remained relatively constant thereafter at over 50%.

Bhashkar Mazumder, senior economist with the Federal Reserve Bank of Chicago offers the evidence for this in an article called: "Is intergenerational economic mobility lower now than in the past?". This report summarizes Mazumder's more detailed research in a way that places the findings in the context of other research on the same topic, and, just as importantly, also relates his findings to an economic framework that allows us to make sense of the patterns.

In particular, he notes that while the degree of mobility varies, it varies in a particular way: the greater the return to college, the greater the degree to which economic advantages and disadvantages are passed on across generations.

1. Returns to college and intergenerational elasticity



NOTES: Units are percentage points. The intergenerational elasticity for 1950 to 2000 uses estimates from table 1, column 2 of Aaronson and Mazumder (2008). The 1940 estimate is projected based on the results from table 2, column 2.
SOURCES: Aaronson and Mazumder (2008); Goldin and Katz (1999).

In an article published in 2004, University of Chicago professor Susan Mayer and her co-author Leonard Lopoo state:

> ...intergenerational mobility can change for at least three reasons: (1) changes in the relative investments in rich and poor children; (2) changes in the payoff to the investments; or (3) changes in the returns to genetic or biologically transmitted characteristics. When inequality increases as it has in most rich democracies over the last two decades, we might expect an increase in the inequality of investments that rich and poor parents can make in their children, and hence a decline in intergenerational mobility.

Mazumder's juxtaposition of the patterns in the returns to college education and the degree of mobility are meant to reflect the workings of the first two reasons: a higher return to college implies more inequality, which in turn implies that relatively well-to-do parents have both more resources to invest in their children, and more incentive to do so.

If we are searching for the underlying causes of mobility this points us directly to the education system, the extent to which it helps level the playing field, and how ultimately the skills of new graduates interact with the requirements of new jobs to determine economic well-being and inequality.

But Mayer and Lopoo also state:

> However, parents are not the only source of investment in children. ... if governments make significant investments in children, the correlation between parents' and children's income is likely to decline. Federal and state government expenditures on behalf of children have increased greatly over the past thirty years in the United States.

So if we are searching for the underlying causes of mobility we need also to address other government programs, the extent to which this spending is of relatively more advantage to the relatively disadvantaged, and how effective it is in improving the prospects of children.

We are pointed in these directions in order to answer Senator Baucus's second question---What can we do to make sure that mobility is higher in the future?---as well as some of the other questions posed by the Senator and the other members of the Committee. My response to questions 1 and 3 offers some suggestions.

[If you would like to explore the details and nuance of these findings, here are the sources I am drawing upon:

Daniel Aaronson and Bhashkar Mazumder (2008). "Intergenerational Economic Mobility in the United States, 1940 to 2000." *Journal of Human Resources*. Vol. 43, No. 1 (Winter), pages 139-171.

Susan E. Mayer and Leonard M. Lopoo (2004). "What do trends in the intergenerational economic mobility of sons and daughters in the United States mean?" In Miles Corak (editor). *Generational Income Mobility in North America and Europe*. Cambridge UK: Cambridge University Press.

Bhashkar Mazumder (2012)."Is intergenerational economic mobility lower now than in the past?" *Chicago Fed Letter*. The Federal Reserve Bank of Chicago. April 2012, Number 297.]

6. **Most of the money that the United States spends to promote mobility is spent through the tax code. This is efficient because tax returns already provide information about income. However, these tax expenditures often help high income people even more than they help low income people. How can we make sure that tax policy helps mobility for people at the very bottom without giving tax breaks to people who don't need them? What provisions in the tax code are most effective at boosting intergenerational mobility?**

If I understand the question correctly I believe my response to Question 3 goes some way to answer the first part concerning how tax policy can be targeted to those at the bottom of the income distribution. The Canadian Child Tax benefit is an illustration of a relatively common practice in OECD countries of using the tax system to deliver targeted income support. Of course the exact thresholds at which the child payments and refundable tax credits are phased in and out would be a subject of consideration, reflecting the overall budget for the program and the desired degree of targeting.

It is difficult to definitively answer the question as to which measures of the tax code are of most benefit in promoting generational mobility. But the general principle should be what Gary Solon of Michigan State University has called "progressivity", that public policy should be of relatively more benefit to the relatively disadvantaged.

This is particularly important in the United States because the reason the average degree of mobility is lower than in other countries is because the poor are more likely to stay poor across generations, and the rich are more likely to stay rich. So if the tax system is to lean in the direction of promoting more mobility it should address the disparities at the two extremes by being more progressive. This involves higher marginal tax rates for higher income individuals, and a broadening of the tax base by treating a dollar as a dollar regardless of its source. At the same time these reforms need to be balanced by not introducing unacceptable disincentives that may have longer-term unintended consequences for work effort and saving.

7. **Dr. Corak states that the intergenerational earnings elasticity is twice as high in the United States as it is in Canada. These differences in mobility levels can be attributed to both monetary and non-monetary resources. What specific tax policies has Canada enacted to encourage mobility? What can we learn from these policies about the best policy for the United States?**

The reason that the average degree of relative mobility is about two to three times higher in Canada than in the United States have to do with the fact that there is a stronger tendency for the poor to remain poor in the US, and also for the rich to remain rich across generations. The differences between the two countries are not as significant for the broad population with middle level incomes.

If Canadian children were placed in the US income distribution they would appear, for the most part, as being lower-middle income: much less likely to be among the very rich (or for that matter in the upper half), but also much less likely to be among the poor. In the United States to be at the bottom of the income distribution means having a significantly lower absolute level of income than in Canada.

The most important role of the tax system is to put a floor on income poverty. My response to question 3 offers one important example that can be given consideration in the reform of the US tax system.

But the other difference between the two countries also has to do with the availability and access to high quality public goods associated with human capital development, particularly health care and education. To the extent that the tax system contributes to the funding of these policies in a way that is progressive it can also have an impact on mobility. The financing of education is particularly important in this regard. To the extent that the tax system can contribute to the stable funding of high quality schooling that is open to all regardless of family background it will serve to promote mobility.

It should be noted that the income tax system in Canada is somewhat more progressive than in the United States, though this varies from province to province. Also Canada has a consumption, or value-added tax. While such taxes are often considered as regressive, it does include a rebate to lower income families and individuals. It is not clear that these taxes directly influence mobility, but rather they offer the financial resources to make sustainable investments in human capital through broadly universal programs.

Finally, it should be noted that Canadian and American children differ—to some degree—in their family situation, with Canadian children being more likely to be living with both biological parents, and also spending more time with their parents. Children are also significantly less likely to have been born to a teenage mother in Canada. Families, and the quality of family life matters for intergenerational mobility. Some elements of the tax system in Canada permit more flexibility for parents to balance work and family life. There is a system of compensated parental leave through the unemployment insurance program that gives parents the opportunity to spend the first year after a birth caring for their newborn, and there are also tax credits given for day care expenses.

It is not clear what impact these particular policies have on generational mobility, but the underlying principle should be that if the tax system can promote healthy families it will also promote social mobility.

Questions from Senator Kerry

1. **One of the most obvious ways that higher income parents can give their children an advantage in life is by giving them money. Wealthy parents can also help their children take risks and afford a quality education. What does the research say about the importance of wealth for intergenerational mobility? How important is wealth relative to other factors, like education? What role do wealth transfer taxes and the estate tax play in promoting or inhibiting intergenerational mobility?**

The indicator that most research uses to gauge the "income" of parents and children is something called "permanent income". Research is not based on annual measures of income, but rather on the underlying earnings capacity of parents measured over their working life. This is closer to, but obviously not identical to wealth. However, in the few studies that have looked at the intergenerational transmission of wealth, the strength of the tie between parent and child wealth is similar to the strength of the tie between permanent income.

It is a challenge for research to specifically attribute causal impacts to the different factors that determine mobility. But clearly the degree of mobility is associated with the sources of parental income, and also with wealth. Some researchers have asserted that wealth matters above and beyond other causal factors like income, parental education, and occupation. In part, it does so by offering, as the question suggests, a type of insurance, permitting greater risks to be taken, but also because it offers a gateway to higher education. In particular, wealth works to reduce the risk of downward mobility.

It is probably fair to suggest that there is not a strong agreement in the research literature on the magnitude of the impact of wealth relative to other factors in determining mobility. One recent study suggests that it matters, but not as much as parental education.

Wealth, however, also likely matters at a societal level. Aside from its impact on the well-being of particular individuals in particular families, high concentrations of wealth certainly influence the nature of public institutions, public policy discourse, and disproportionate political influence. This is probably the best way to think about the importance of imposing wealth and estate taxes. These taxes help to level the playing field and as such influence over the longer turn the nature of institutions that impact on mobility. The OECD has recently recommended that the United States reform wealth and estate taxation, while being aware of the impact on savings decisions. It calls for reforms that reduce the degree tax avoidance, most clearly related to the treatment of capital gains, and a move to inheritance taxation rather than estate taxation.

[See

T. Fabian Pfeffer and Martin Hällsten (2012). "Mobility Regimes and Parental Wealth: The United States, Germany, and Sweden in Comparison." PSC Research Report No. 12-766. July 2012.

OECD (2012). OECD Economic Surveys: United States, June 2012. Paris: OECD.]

Questions from Senator Hatch

1. **In looking at data used to capture opportunities for upward mobility for Americans over time and mobility comparisons across countries, I wonder how you control for the many changes in the economic environment over time and differences in measures across countries. Surely, parents of children born in the 1960s or 1970s or 1980s faced far different economic policies, labor market dynamics, immigration dynamics, and global trade in labor and capital than those faced by their children. In the U.S., for example, it is difficult to deny that labor market experiences of females have changed markedly since the Second World War. Rewards to skill seem to have been changing due to technological changes. Entry of China and India into global trade has surely altered labor market dynamics and outcomes around the globe. And there is evidence that there has been growth in associative mating, with people marrying others who share similar occupations.**

When looking at intergenerational mobility, we look at comparisons between outcomes of parents and children. Yet the environments facing parents were often far different from those facing their children. In looking at income measures in the U.S. over time, some studies, including ones by Pew, measure income exclusive of non-wage benefits and certain government benefits like food stamps. Yet, over time, Americans have increasingly taken compensation growth in the form of non-wage benefits. Excluding them seems, to me, to exclude a lot of what has been happening in labor markets over the past few decades.

How can we extrapolate from historical evidence on parents versus children when people are raised in far different economic environments and possibly receive income in far different forms over time, to craft federal mobility policies for today and the near future?

It is very important to appreciate that there are several different ways in which we can discuss and analyze the extent of mobility across the generations. The Senator's question raises the importance of being clear as to just what we are talking about: not just measuring outcomes in a consistent way but also, and more importantly, recognizing that the economy and society have changed in fundamental ways across the span of a generation.

My sense is that the academic literature is based upon data that permits a comparison of apples to apples: it is based upon data sets that seek to maintain a consistency in the measurement of earnings over time. Though obviously some data do this better than others. The focus is usually on earnings and wage rates as determined through an employer-employee relationship. In this case it is appropriate to exclude government benefits. Other studies do focus on the intergenerational transmission of total income, and also on the transmission of government benefits.

It is the other dimension of the question that I think is more important for public policy makers to be clear about: "I wonder how you control for the many changes in the economic environment over time and differences in measures across countries." This an important concern, and addressing it helps us to appreciate just what we are talking about when the research is interpreted as saying that mobility is lower in the US than elsewhere. Part of this also involves the changing forms of compensation, and any non-wage benefits that form part of the compensation package.

Some of the changes alluded to in the question are factors that influence the degree of mobility, the rewards to skill is an important example, and assortative mating is another. As such they are the very subject of analysis of studies that examine the experiences of different cohorts of individuals, as the response to question 5 suggests.

It is important to draw a distinction between "absolute" mobility, and "relative" mobility. The claim that the US is less mobile than many other countries is a claim about "relative" mobility. It is legitimately measured, in spite of all the economic changes that have occurred over the course of a generation, because it refers to the extent to which a father's income is above or below the average income of his generation, and the extent to which a son's income is above or below the average of his cohort during his adulthood.

All of these important changes are controlled for in the sense that we are talking about the deviations of each generation from their own average. The averages of each generation are different and reflect all of the changes in economy and society that the question alludes to. These changes are captured in the averages, with the deviation from the average being the concern of indicators of relative mobility. Generally, with increased productivity and economic growth we would expect children to on average earn more than their parents did a generation ago. The question the literature has focused upon is: to what extent do we expect a child to be above the prevailing average if his or her father was above the average that prevailed a generation earlier. In the United States only 50% of a father's gap (above or below) the average income is closed in the son's generation; in Canada and many other countries 80% of this advantage or disadvantage disappears.

This is the predominant way of examining the degree of generational mobility in the academic literature in part because of the concerns the Senator raises in this question. But alternative measures are also interesting: are children---as a whole---making on average more or less than their parents? This refers to absolute mobility. An additional question of interest is whether children have a tendency to exceed or fall short of their parents' place in the income distribution?

There is less cross-country comparative evidence on these indicators, but I think it might be fair to say that the observation that the average standard of living has risen over time is a weaker assessment of mobility than the "relative" degree of mobility. Focusing on absolute mobility would also imply that individuals evaluate their well-being with reference to the experiences of a generation ago, rather than to the experience of their contemporaries.

The other very important part of this question concerns the extent to which the past can be a guide for future policy: "How can we extrapolate from historical evidence on parents versus children when people are raised in far different economic environments and possibly receive income in far different forms over time, to craft federal mobility policies for today and the near future?"

There are, after all, very long lags embodied in the research on intergenerational mobility. Most studies refer to a cohort of people who were born roughly in the early 1960s, went to the schools of the 1960s and 1970s, the colleges of the 1970s and 1980s, and began their careers by getting jobs in the labor markets of the 1990s. Is it reasonable to use this experience to guide public policy addressing the needs of the next generation of children?

Yes, it is, but only to the degree that we understand the underlying drivers of the mobility process. If we appreciate how labor markets have changed, how families have changed, and how public policy has changed then we can make reasonable suggestions on the challenges that more recent generations of children face, and the possibilities for public policy.

It is the interaction of these three social institutions---labor markets, families, and public policy---that drive the process. Labor markets are now more unequal than they were a generation ago, families are more diverse and time-stressed, and public policy is less progressive. All of these drivers suggest in the very least that mobility will not increase. We can also see this by looking at child outcomes at earlier stages in the development of our children: health in the early years, school readiness, literacy and math test scores in the middle years, high school drop out rates, and university completion rates are all indicators that can be used in the here and now to make reasonable suggestions on future developments, and policy options.

So the answer to the question is that to extrapolate from the experiences of the past we need to be aware of the nature of the changes that have occurred over time, and to examine how they are related to the underlying drivers of mobility.

2. **Currently in the U.S., debt and deficits are at levels we have not seen since the years surrounding World War II, when it was necessary to gather resources to defend democracy around the world. Currently in the U.S., we also have unsustainable promises embedded in our entitlement programs, such as Medicare and Social Security. We are observing, in real time in the euro zone, the consequences of failing to act to put fiscal policies on sustainable courses. Young people today in the euro zone, because of the massive debt overhang from profligate government overextensions, face little to no opportunities. There are no jobs to be found.**

   We have tragically seen a similar situation beginning here in the U.S., with unemployment remaining over 8 percent for 41 consecutive months through June, and youth unemployment close to 24 percent. Economists have found evidence that there are lifetime effects on income for young people entering their careers in a depressed labor market, like the one we have seen in the U.S. over the past three-and-a-half years.

I wonder if any in the mobility research community has considered how mobility opportunities for a young person depend on the debt position of that person's country when they are in their formative years. Given the outsized debt and the labor market sluggishness of the last three-and-a-half years in the U.S., I wonder whether it is more likely for young people to end up with opportunities for economic advancement that are inferior to those of their parents?

I am not aware of research specifically addressed to this topic---the impact of macro-economic debt positions on mobility. As the last sentence of the question makes clear this refers to the prospects for absolute mobility---the prospects of advancing on average above the standard of living of parents---in an era of a perceived slowdown in economic growth. It also refers to the extent to which this slowdown is related to the debt position of the country.

It is certainly possible that business cycles could have longer term consequences for young cohorts of workers. Generally the intergenerational mobility research looks beyond business cycle variations, focusing less on "temporary" fluctuations in parental and child income and more on long-run prospects. But it may be that the depth of the current recession should encourage an alternative perspective. In particular, to the extent that this recession has been wrapped up with the underlying wealth of families through the housing market, it may have longer term consequences.

We know that a stable and secure environment is important for child development and success in school. Children who tend to experience repeated residential moves, tend also to be at risk of less successful school transitions. In this sense the current recession may be more problematic in the longer term if it has also been associated with stressful moves associated with the loss of a home.

The recession is also more likely to be associated with a decline in permanent earnings to the extent that layoffs from long-tenure jobs are higher. This will also have long-term consequences for children.

And indeed, as the Senator implies, there is also evidence to suggest that entering the labor market for the first time as a young adult during a recession may have a scarring effect with long term consequences on career choice and earnings.

I am somewhat less clear on the relationship between generational mobility and debt levels/deficits. Certainly, what will be important in the coming years as the United States moves to reduce deficits and debts is how this burden is shared between the relatively advantaged and disadvantaged, and how it impacts on important institutions that determine the investment in the human capital of children, particularly education and health care. The more progressive these fiscal considerations are, the less likely mobility will be adversely affected.

My understanding of the situation faced by young people in Europe, their access to jobs, is associated with the structure of labor markets, and the degree of flexibility built into them. It is not clear to me how this is associated with the overall debt situation of these economies.

3. **Ms. Currier's testimony points to something called "social capital," such as neighborhood effects, as a driver of opportunities for mobility. It appears that the community in which you are raised can have important effects on you opportunities to move up the economic ladder. Yet while many communities would enjoy being something like Silicon Valley, most are not. Yet we see some communities resurrect themselves after industrial transformations brought on by global forces or technological change force them to alter their economic bases, while other communities struggle in poverty traps for many, many years. To some extent, results depend on community, city, and State leaders and policies, and not directly on federal policy. And I would note that the economic resurrections I have observed in some cities but not others cannot be explained away merely by identifying that everyone would have done better if they would simply have had more federal funds.**

   Can you tell me what, if anything, we know about things that make good neighborhoods, things that do not, and things that stand in the way of a community adapting to change in a nimble fashion. That is, what do we know about the mechanisms giving rise to births and decay of cities and communities, and what helps create dynamic centers of innovation, growth, and opportunities? What are the mechanics of local development, which could be a core feature of mobility provision?

I am afraid that I do not have the expertise to directly speak to this question, important as it is.

I would note, parenthetically, that the intergenerational mobility literature has found that it is factors inside the family that matter more than factors in the neighborhood. The literature reaches this conclusion by comparing the outcomes of siblings to those of neighbors. The correlation between the adult outcomes of siblings reflects both family and neighborhood influences, while the correlation between the outcomes of children raised in the same geographic area reflects just shared neighborhood experiences.

It turns out that there is a strong correlation between siblings, but very little between neighbors. This suggests that a good neighborhood reflects in an important way the characteristics of the families that live there. As such an important component of "social capital" has to do with the strength of families and the monetary and non-monetary resources they have to invest in their children. In this sense it may be that what makes a good neighborhood is associated with what makes a good family, and the extent to which they sort themselves into particular geographic areas.

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

Written testimony to the Senate Finance Committee

Erin Currier, The Pew Charitable Trusts

Chairman Baucus, Ranking Member Hatch, and Members of the Committee: Thank you for inviting me to testify today. My name is Erin Currier, and I manage The Pew Charitable Trusts' Economic Mobility Project. The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public and stimulate civic life.

The idea that all people have equality of opportunity regardless of their economic status at birth is at the core of the American Dream. The Economic Mobility Project examines the health and status of that dream by analyzing economic mobility – Americans' movement up and down the economic ladder within a lifetime and across generations. Our goal is to generate a nonpartisan fact base that informs policy makers and the public.

Rates of Intergenerational Economic Mobility

Today our project released *Pursuing the American Dream: Economic Mobility Across Generations,* the newest data available on intergenerational mobility in the United States. The report reveals a mixed picture of Americans' access to opportunity.[1]

On the one hand, measures of absolute mobility – how likely Americans are to have higher incomes, earnings, or wealth than their parents did at the same age – show a glass half full. For example, 84 percent of Americans have higher family incomes than their parents did at the same age (after adjusting for inflation and family size), and across all levels of the income distribution, this generation is doing better than the one that came before it. In fact, those at the bottom of the income ladder are the most likely to exceed their parents' income as adults—93 percent do so. Similarly, 50 percent of Americans exceed their parents' wealth, and 59 percent of sons exceed their fathers' earnings.

However, measures of relative mobility – where a person ranks on the economic ladder as a whole compared to where their parents ranked – show a glass half empty. That's because Americans raised at the top and bottom of the economic ladder are highly likely to stay where their parents were– a phenomenon called "stickiness at the ends."

For these analyses, the income distribution is divided into five equal parts, or quintiles. The data show that 43 percent of those who start in the bottom fifth of the income distribution remain there as adults, and an additional 27 percent only move up one rung. In other words, 70 percent of those raised in the bottom remain below middle-income as adults. Moreover, only 4 percent who start in the bottom make it all the way to the top, showing that the rags-to-riches story is more often found in Hollywood than reality. At the other end of the distribution, there is a similar story. Forty percent of those raised at the top of the income ladder remain at the top as adults, and two-thirds never fall even to the middle.

The data on African-Americans' relative mobility is even more stark. More than half of blacks (53 percent) raised at the bottom remain stuck there as adults compared to only a third of whites (33 percent). Blacks also are more downwardly mobile than are whites, particularly when it comes to those raised in middle-income families. Over half (56 percent) raised in the middle income quintile fall to the bottom or second rung as adults compared with just a third (32 percent) of whites.

To put the relative mobility numbers in perspective, if your parents' income ranking had absolutely no bearing on where you ranked as an adult, we would see 20 percent of people in each of these fifths, compared to the 40-some percent we see at the top and bottom ends overall. Again, this pattern is repeated when analyzing relative intergenerational mobility by earnings and by wealth: Family background is highly influential, and there is notable stickiness at the ends.

International Comparisons of Economic Mobility

Certainly the persistence of stickiness at the ends challenges the notion that the United States promotes equality of opportunity. This is further underscored, however, by international comparisons of economic mobility, which reveal that the United States has less relative mobility than Canada and many European countries, including France, Germany, and Sweden.[2, 3]

The Economic Mobility Project recently co-funded a series of multi-country studies on economic mobility, for which researchers in 10 countries investigated how socioeconomic advantage, as measured by parents' education, is transmitted over the course of one's life.[4]

The research revealed that in the United States, there is a stronger link between parental education and children's economic, educational, and socio-emotional outcomes than in any other country investigated. The research also found that family background begins affecting children's outcomes as early as they can first be measured, even by age 3, and the gaps between advantaged and disadvantaged children persist into adolescence and likely beyond.

However, while family background influenced children's mobility prospects in all countries, the very fact that the magnitude of the influence differed across countries suggests that policies and institutions can and do influence economic mobility. A persons' mobility outcome is not predetermined and understanding the drivers of economic mobility can enhance opportunity in America.

Mobility Drivers

Our project has commissioned a host of research to identify the factors that help push someone up the economic ladder or propel them down. These factors can be divided into three categories: human, financial, and social capital.[5]

- *Human capital* refers to the skills and attributes acquired by individuals that impact whether or not they are able to take advantage of economic opportunities, such as education and health.

- *Financial capital* refers to the financial assets that individuals acquire and leverage to get ahead, such as savings, home equity, and other investments.
- *Social capital* refers to the non-financial resources available to individuals through relationships to people and institutions, such as neighborhoods, families, and professional networks.

What follows are examples of EMP research on each of these categories.

Human Capital Example: Post-secondary Education

A host of research by the Economic Mobility Project has shown that a four-year college degree both promotes upward economic mobility from the bottom and protects against downward mobility from the top and middle. The wage premium associated with earning a college degree has risen dramatically over the last generation, and increased returns to education translate directly into upward mobility gains. For instance, almost one half (47 percent) of those raised in the bottom income quintile without a college degree remain stuck there as adults, compared to only 10 percent with a four-year college degree.[6] In fact, having a four-year college degree makes it more than three times as likely that someone raised in the bottom fifth of the family income distribution will rise all the way to the top fifth.

A college education additionally protects against downward mobility. Of those raised at the top of the income ladder, over half (51 percent) with a college degree remain at the top as adults compared to only a quarter of those without a college degree. Disparities also exist for those raised in the middle: only 22 percent of degree holders fall to a lower rung of the ladder compared to 39 percent of non-degree holders.

Unfortunately, young people raised in the bottom and middle of the income ladder are less likely to enroll in some form of postsecondary education, and less likely to graduate if they do.[7] Nearly 80 percent of children in the top income quintile enroll in college, and 53 percent eventually graduate. By contrast, just 34 percent of children in the bottom income quintile enroll, and a mere 11 percent graduate.

Financial Capital Example: Personal Savings

A second key driver of upward economic mobility from the bottom is personal savings.[8] When families are able to create their own safety nets, they are less likely to be derailed by financial emergencies and are more equipped to make mobility-enhancing investments, such as college, for themselves or their children. The Economic Mobility Project has found that 71 percent of children raised by high-saving, low-income parents moved up from the bottom quarter of the income distribution over a generation, compared to only 50 percent of children of low-saving, low-income parents.[9]

Social Capital Example: Neighborhood Poverty

In addition to promoting upward mobility from the bottom, our project's research has sought to identify the factors that force Americans down the economic ladder, especially when they were raised by parents who were economically secure. On that front, one of the most powerful drivers of downward mobility our project has identified is being raised in a high-poverty neighborhood.[10]

Specifically, Americans raised in the top three quintiles of the income ladder who spend their childhood in a high-poverty neighborhood versus a low-poverty neighborhood are 52 percent more likely to be downwardly mobile.

Of note, African American children are significantly more likely to be exposed to these types of neighborhoods than are white children: Two out of three black children (66 percent) born from 1985 through 2000 were raised in neighborhoods with at least a 20 percent poverty rate compared to just 6 percent of white children.

In fact, neighborhood poverty during childhood explains between a quarter and a third of the black-white gap in downward mobility. This constitutes a greater portion of the black-white downward mobility gap than the effects of parental education, occupation, labor force participation, and a range of other family characteristics combined.

Mobility-Enhancing Policy Solutions

In 2009 and again last year, the Economic Mobility Project comissioned nationally-representative public opinion polls to better understand how Americans thought about the

American Dream and their mobility prospects, and to gauge the public's views on government intervention in this area. In both polls, respondents were remarkably optimisitic. Despite the remaining economic uncertainty, in 2011, over two-thirds (68 percent) said they have achieved or will achieve the American Dream at some point in their lives, and the same percentage believed they were in control of their economic situations.[11] This confidence may in part be driven by Americans' belief in personal responsibility: Respondents overwhelmingly cited "hard work" and "ambition" as the two most important factors driving whether a person gets ahead economically.

At thc same time though, Americans were united in their belief that the government has a role to play in promoting economic mobility. An overwhelming 83 percent wanted the government to provide opportunities for the poor and middle class to either improve their economic situations, prevent them from falling behind, or both. This feeling cut across party lines, with 91 percent of Democrats, 84 percent of independents, and 73 percent of Republicans agreeing.

In fact, the government actually does spend a sizable amount of money to promote economic mobility. However, because the vast majority of those investments are delivered through the tax code, the benefits largely acrue to middle- and upper-income families, arguably those least in need of the mobility boost.[12]

Consider the current investment made to promote savings and asset building. In FY2010, the federal government devoted nearly $130 billion to incentivize contributions to retirement, health, and education savings vehicles.[13] As data from our project has demonstrated, this spending has the potential to be highly influential and effective for enhancing economic mobility at the bottom of the income distribution. Unfortunately though, very few of those benefits go to low-income households, because they often don't earn enough money to owe income taxes. As an example, in 2004, among those participating in retirement plans, those in the lowest income quintile received just 0.2 percent of the federal tax benefits (an average of $6 per tax filer), while those in the highest income quintile received 70 percent of the benefits (an average of $1,838 per tax filer).[14]

In light of these data, the Economic Mobility Project's Principals – a group of bipartisan thought leaders from a host of well-respected think tanks in Washington, DC – in 2009 drafted a set of policy recommendations to enhance economic mobility in the US.[15] They framed their recommendations as follows:

> *Our shared goal is to improve upward mobility for everyone, with a particular emphasis on lower-income Americans, those who face the most difficulty in moving up the income ladder. We are calling for nothing less than a fundamental shift toward government policies that are mobility-enhancing, and a more targeted allocation of existing mobility expenditures towards low- and moderate-income families.*

Conclusion

Americans do still believe in the American Dream, and they also believe that our nation is and should be exceptional in its ability to promote opportunity for all citizens, regardless of family background. Nonetheless, Americans are increasingly concerned about their children's economic chances and believe that policy makers can and should act more effectively to enhance the mobility prospects of low- and middle-income Americans.

The good news is that an emerging body of research provides insight into the drivers that influence economic mobility and serves as a starting point for dialogue and action on how to promote economic opportunity for all Americans.

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[1] Economic Mobility Project. 2012. *Pursuing the American Dream: Economic Mobility Across Generations.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[2] Isaacs, Julia, Isabel Sawhill and Ron Haskins. 2008. *Getting Ahead or Losing Ground: Economic Mobility in America.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[3] As of yet, international comparisons of absolute mobility have not been published. The Economic Mobility Project is currently funding the first ever study of these compairsons.
[4] Pew Economic Mobility Project. 2011. *Does America Promote Mobility As Well As Other Nations?* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[5] Butler, Stuart, William Beach and Paul Winfree. 2008. *Pathways to Economic Mobility: Key Indicators.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[6] Economic Mobility Project. 2012. *Pursuing the American Dream: Economic Mobility Across Generations.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.

[7] Haskins, Ron, Harry Holzer, and Robert Lerman. 2009. *Promoting Economic Mobility By Increasing Postsecondary Education.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[8] Cramer, Reid, Rourke O'Brien, Daniel Cooper, and Maria Luengo-Prado. 2009. *A Penny Saved is Mobility Earned: Advancing Economic Mobility Through Savings.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[9] The analysis lined up parents in order of their personal savings rates between 1984 - 1989 and divided them into the top half of savers (high-savers) and the bottom half of savers (low-savers).
[10] Sharkey, Patrick. 2009. *Neighborhoods and the Black-White Mobility Gap.* Washington, DC: Economic Mobility Project. The Pew Charitable Trusts.
[11] Pew Economic Mobility Project. 2011. *Economic Mobility and the American Dream: Where Do We Stand in the Wake of the Great Recession?* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[12] Carasso, Adam, Gillian Reynolds, and C. Eugene Steuerle. 2008. *How Much Does the Federal Government Spend to Promote Economic Mobility and For Whom?* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[13] Cramer, Reid, Rourke O'Brien, Daniel Cooper, and Maria Luengo-Prado. 2009. *A Penny Saved is Mobility Earned: Advancing Economic Mobility Through Savings.* Washington, DC: Economic Mobility Project, The Pew Charitable Trusts.
[14] Ibid.
[15] The Economic Mobility Project's principals represent the American Enterprise Institute, the Brookings Institution, the Heritage Foundation, the New American Foundation, and the Urban Institute.

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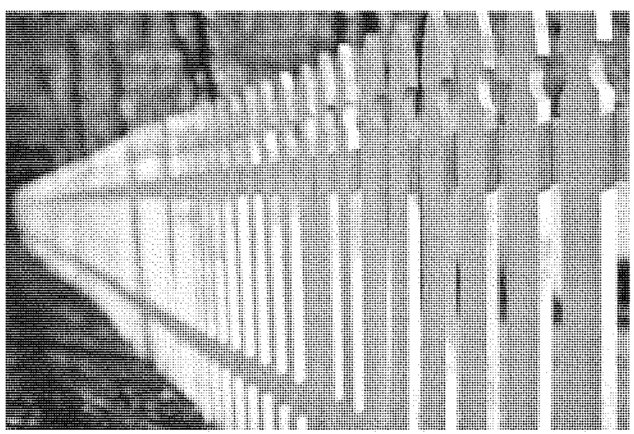
Pursuing the American Dream:

Economic Mobility Across Generations



THE PEW CHARITABLE TRUSTS | ECONOMIC MOBILITY PROJECT

JULY 2012

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public and stimulate civic life.

By forging broad, nonpartisan agreement on the facts and drivers of mobility, the Economic Mobility Project fosters policy debate and action on how best to improve economic opportunity and ensure that the American Dream is kept alive for future generations.

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THE PEW CENTER ON THE STATES

The analysis and recommendations included in this report are solely those of The Pew Charitable Trusts and do not necessarily reflect the views of outside reviewers.

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This report is intended for educational and informational purposes.

For additional information on The Pew Charitable Trusts and the Economic Mobility Project, please visit www.economicmobility.org or email us at info@economicmobility.org.

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Introduction and Key Findings

The ideal that all Americans have equality of opportunity regardless of their economic status at birth is the crux of the American Dream and a defining element of our national psyche. This study investigates the health and status of that dream by analyzing economic mobility—Americans' movement up and down the economic ladder—during the past generation. *Pursuing the American Dream: Economic Mobility Across Generations* is an update to the Economic Mobility Project's (EMP) foundational work, *Getting Ahead or Losing Ground: Economic Mobility in America*, originally released in 2008.[1]

This chart book moves the project's work forward in two ways. First, the income mobility estimates have been adjusted for family size to account for shifts in family demographics across generations.[2] Second, the analyses now include mobility estimates of personal earnings and family wealth in addition to family income. Using Panel Study of Income Dynamics (PSID) data through 2009, the study provides the most current estimates of mobility and the first estimates that overlap with the recession.

Pursuing the American Dream looks closely at the mobility experiences of Americans on different rungs of the economic ladder, divided into five equal parts or quintiles. The study measures mobility in two ways. *Absolute mobility* measures whether a person has more or less income, earnings, or wealth than his or her parents did at the same age.[3] *Relative mobility* measures a person's rank on the income, earnings, or wealth ladder compared to his or her parents' rank at the same age.

Descriptive information on how the distribution of income and wealth has changed between the parents' and children's generations also is included. While information about aggregate changes across generations does not capture the unique experience of any one parent-child pair, it does provide important context about how the economic environment in which people strive to climb the ladder has changed over the past generation.

Considering both absolute and relative mobility together and in the context of changing distributions is essential to understanding the full picture of opportunity in America.

Family Income

The vast majority of Americans have higher family incomes than their parents did.[4]

- Eighty-four percent of Americans have higher family incomes than their parents had at the same age, and across all levels of the income distribution, this generation is doing better than the one that came before it.
- Ninety-three percent of Americans whose parents were in the bottom fifth of the income ladder and 88 percent of those whose parents were in the middle quintile exceed their parents' family income as adults.

Americans raised at the bottom and top of the family income ladder are likely to remain there as adults, a phenomenon known as "stickiness at the ends."

- While a majority of Americans exceed their parents' family incomes, the extent of that increase is not always enough to move them to a different rung of the family income ladder.
- Forty-three percent of Americans raised in the bottom quintile remain stuck in the bottom as adults, and 70 percent remain below the middle. Forty percent raised in the top quintile remain at the top as adults, and 63 percent remain above the middle.
- Only 4 percent of those raised in the bottom quintile make it all the way to the top as adults, confirming that the "rags-to-riches" story is more often found in Hollywood than in reality. Similarly, just 8 percent of those raised in the top quintile fall all the way to the bottom.

Family Wealth

Half of Americans surpass their parents in terms of family wealth.[5]

- Fifty percent of Americans have greater wealth than their parents did at the same age.
- Seventy-two percent of Americans whose parents were in the bottom fifth of the wealth ladder and 55 percent of those whose parents were in the middle quintile exceed their parents' family wealth as adults.

There is stickiness at the ends of the wealth ladder.

- Sixty-six percent of those raised in the bottom of the wealth ladder remain on the bottom two rungs themselves, and 66 percent of those raised in the top of the wealth ladder remain on the top two rungs.

Mobility by Race

Blacks have a harder time exceeding the family income and wealth of their parents than do whites.

- Sixty-six percent of blacks raised in the second quintile surpass their parents' family income compared with 89 percent of whites.
- Only 23 percent of blacks raised in the middle surpass their parents' family wealth compared with over half (56 percent) of whites.

Blacks are more likely to be stuck in the bottom and fall from the middle than are whites.

- Over half of blacks (53 percent) raised in the bottom of the family income ladder remain stuck in the bottom as adults, compared with only a third (33 percent) of whites. Half of blacks (56 percent) raised in the middle of the family income ladder fall to the bottom two rungs as adults compared with just under a third of whites (32 percent).
- Half of blacks (50 percent) raised in the bottom of the family wealth ladder remain stuck in the bottom as adults, compared with only a third (33 percent) of whites. More than two-thirds of blacks (68 percent) raised in the middle fall to the bottom two rungs of the ladder as adults compared with just under a third of whites (30 percent).

Mobility by Education

A four-year college degree promotes upward mobility from the bottom and prevents downward mobility from the middle and top.

- Almost one-half (47 percent) of those raised in the bottom quintile of the family income ladder who do not earn a college degree are stuck there as adults, compared with 10 percent who do earn a college degree. Similarly, 45 percent without a college degree are stuck in the bottom of the family wealth ladder compared with 20 percent with a degree.
- Having a college degree makes a person more than three times more likely to rise from the bottom of the family income ladder all the way to the top, and makes a person more than four times more likely to rise from the bottom of the family wealth ladder to the top.
- Thirty-nine percent raised in the middle of the family income ladder who do not get a college degree fall from the middle, compared with less than a quarter (22 percent) of those with a degree. Similarly, 39 percent raised in the middle of the family wealth ladder who do not earn a degree fall down the wealth ladder, compared with 19 percent with a degree.

Chart Book

Family Income

Family income is one of the most common ways economic mobility is measured. Family income includes all taxable income (such as earnings, interest, and dividends) and cash transfers (such as Social Security and welfare) of all family members.[6] These estimates are adjusted for inflation and for family size.

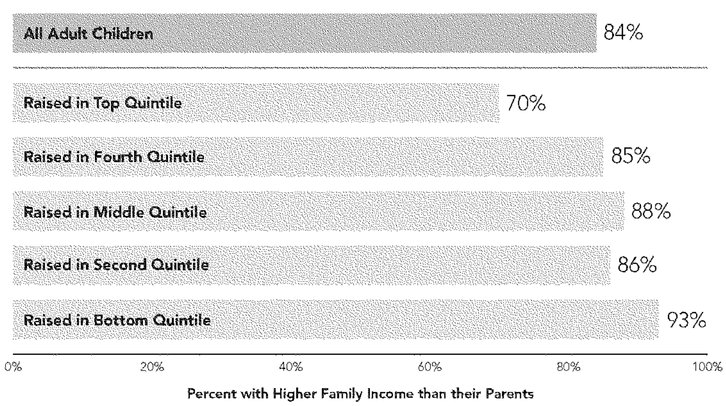
Americans' absolute mobility by family income shows a glass half full.

Eighty-four percent of Americans have higher family incomes than their parents did, and across all levels of the income distribution, this generation is doing better than the one that came before it. In fact, those at the bottom of the income ladder are the most likely to exceed their parents' income as adults—93 percent do so.

Figure 1

Eighty-four Percent of Americans Exceed their Parents' Family Income

Percent with family income above their parents, by parents' quintile

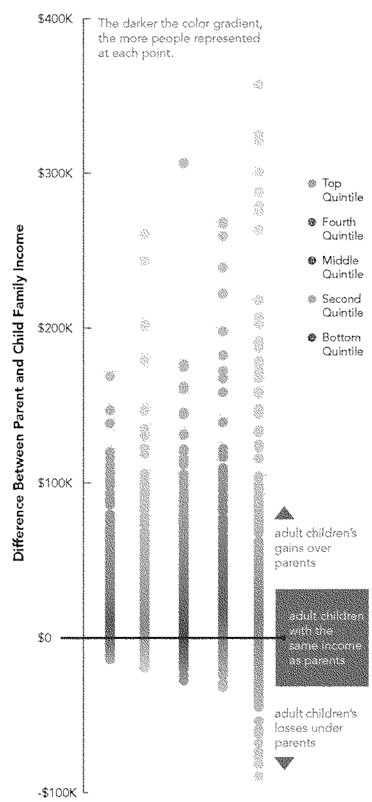


Note: Income is adjusted for family size.

Figure 2

The Size of Absolute Mobility Gains and Losses Differs Across the Income Ladder

Change in family income, by parents' quintile



Notes: Income is adjusted for family size. Six observations above $400,000 and two observations below -$100,000 were removed from the analysis for scaling purposes.

However, the *magnitude* of income changes varies across the income distribution.

At all levels, Americans are likely to exceed their parents' family incomes, but the extent of their income growth varies by quintile. Americans raised in the bottom who surpass their parents' incomes do so by the smallest absolute amounts, while Americans raised in the top who surpass their parents' incomes do so by the largest absolute amounts. Figure 2 displays changes in Americans' family income compared with their parents', depending on the income quintile in which they were raised. Adult children whose family income is no different from their parents' are shown at the $0 mark.

Americans' relative mobility outcomes by family income show a glass half empty.

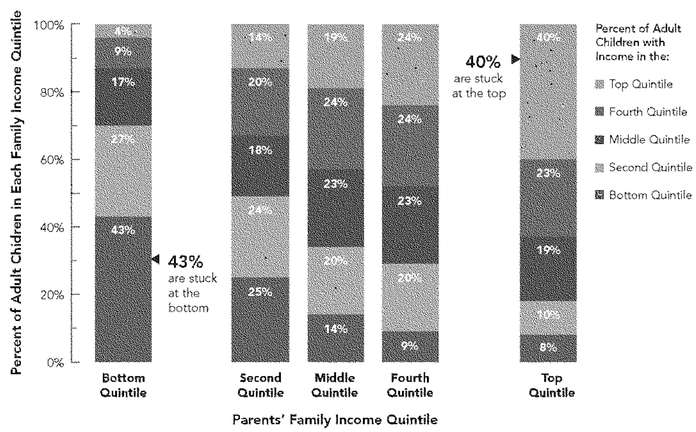
Americans raised at the top and bottom of the income ladder are likely to remain there themselves as adults. Forty-three percent of those who start in the bottom are stuck there as adults, and 70 percent remain below the middle quintile. Only 4 percent of adults raised in the bottom make it all the way to the top, showing that the "rags-to-riches" story is more often found in Hollywood than in reality. At the other end of the ladder, 40 percent of those raised in the top stay there as adults, and 63 percent remain above the middle quintile.

This lack of relative mobility is called "stickiness at the ends" because those at the ends of the income distribution tend to be stuck there over a generation. By contrast, those raised in the middle income quintile come closer to experiencing mathematically perfect mobility, in which they are equally likely to end up in each quintile of the distribution.

Figure 3

Americans Raised at the Top and Bottom Are Likely to Stay There as Adults

Chances of moving up or down the family income ladder, by parents' quintile



Note: Numbers are adjusted for family size.

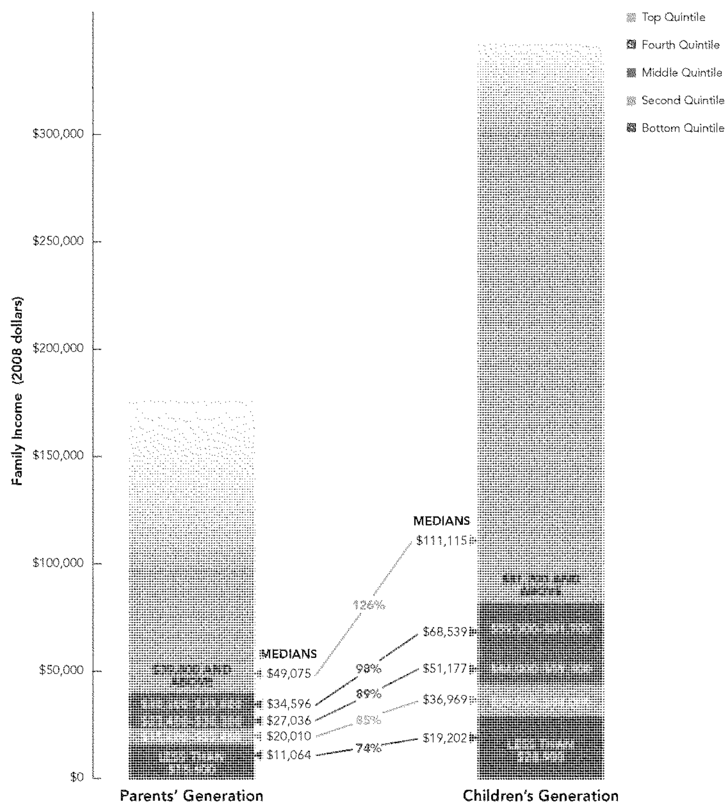
Why do more Americans experience upward absolute mobility than upward relative mobility?

The rungs of the income ladder have widened during the past generation, reflecting economic growth at all levels, but especially at the top. Median income in the bottom income quintile increased by 74 percent between the two generations, compared with 126 percent in the top income quintile (see Figure 4). The difference between the size of the rungs between the two generations means that while the vast majority of Americans exceeded their parents' family incomes, the extent of that increase—particularly at the bottom—was not always enough to move them to a different rung of the income ladder.

Figure 4

Growth Has Occured at Every Rung of the Ladder But Has Been Largest at the Top

Change in the overall income distribution from parents' generation to children's generation



Notes: Numbers are adjusted for family size. Each quintile contains 20 percent of the weighted sample. The dashed line represents the 95th percentile of the PSID sample.

Analyzing both absolute and relative mobility is necessary for understanding mobility in America.

Looking at both absolute and relative mobility demonstrates why the picture of mobility in America shows a glass both half full and half empty.

On the one hand, more than one-third of Americans are upwardly mobile, defined here as experiencing gains in both absolute and relative mobility. Thirty-five percent of Americans have higher income and move up at least one rung on the ladder relative to their parents. Moreover, a minority of Americans—only 16 percent—are downwardly mobile, defined here as experiencing downward absolute mobility and having static or downward relative mobility (i.e. either remaining in the same quintile or moving down).

However, gains in absolute mobility are not always enough to propel Americans up the ladder. Thirty-six percent of those who start in the bottom experience absolute mobility gains but are still stuck in the bottom quintile as adults. Moreover, across the distribution, 20 percent of Americans are "falling despite the rising tide"—they make more money than their parents did, but have actually fallen to a lower rung of the income ladder. Another 29 percent have higher family incomes but are at the same place on the income ladder as their parents were.

Absolute income gains combined with relative stickiness at the ends underscore why looking at both absolute and relative mobility is so critical for understanding opportunity in America.

Figure 5

Most Americans Experience Absolute Upward Mobility but Few Experience Relative Upward Mobility

Chances of experiencing both absolute and relative mobility, by parents' quintile

Adult Children	Parents' Family Income Quintile: Bottom Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Top Quintile	All Families
Upwardly mobile Higher income and up 1 or more quintiles	57%	51%	43%	24%	N/A[1]	35%
Riding the rising tide Higher income and same quintile	36%	24%	23%	24%	38%	29%
Falling despite the rising tide Higher income and down 1 quintile	N/A[2]	11%	21%	36%	32%	20%
Downwardly mobile Lower income and lower/same quintile	7%	14%	12%	15%	30%	16%

Notes: Numbers are adjusted for family size. Numbers in each column may not sum to 100 percent due to rounding.

[1] Those in the top quintile cannot meet this definition of "upwardly mobile" because there is no quintile above the top quintile.

[2] Those in the bottom quintile cannot meet this definition of "falling despite the rising tide" because there is no quintile below the bottom quintile.

Examining earnings mobility provides a deeper understanding of income mobility.

Personal earnings are a component of family income based on one family member's salary or wages from employment. Personal earnings provide greater insight into the importance of employment-based wages for economic mobility.[7]

The measures below compare sons in the children's generation to fathers in the parents' generation. This is the most accurate "apples to apples" comparison that can be done intergenerationally because women's labor force participation rates have grown dramatically during the past generation. Comparing daughters' earnings to their mothers' earnings could overstate the gains made by women in the past generation, while comparing daughters' earnings to their fathers' could understate women's gains.

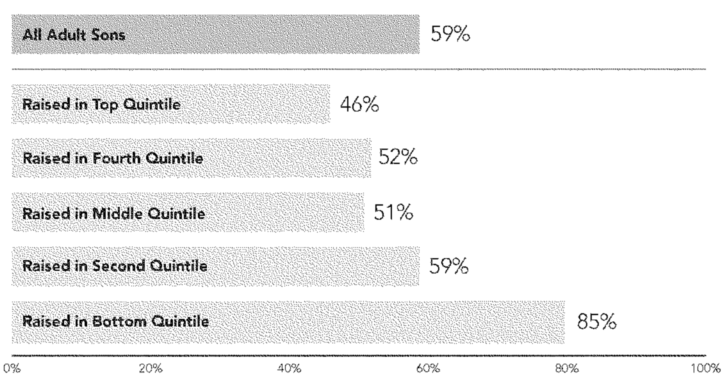
Most sons are meeting or exceeding their fathers' earnings in absolute terms.

Overall, 59 percent of sons earn more than their fathers did at the same age, and only in the top quintile do less than half of sons exceed their fathers' earnings. Among sons raised in the bottom, 85 percent exceed their fathers' earnings. Sons raised in the middle and fourth earnings quintiles are about equally likely to make more than their fathers as they are to make less.

Figure 6

Most Sons Meet or Exceed the Earnings of their Fathers

Percent with personal earnings above their fathers, by fathers' quintile



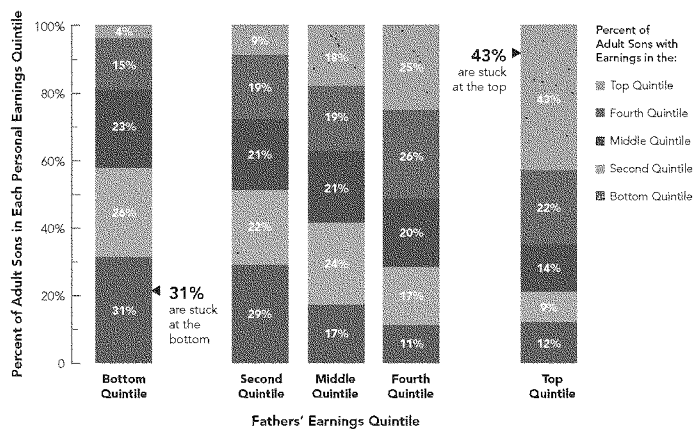
Sons raised by top earners are the most likely to be top earners themselves.

Even though sons raised in the top are the least likely to surpass their fathers' earnings, they are the most likely to stay in their fathers' place on the earnings ladder. Among sons raised in the top quintile, 43 percent remain in the top themselves, and another 22 percent have earnings above the middle quintile. At the other end of the ladder, more than half of sons raised in the bottom do not make it to the middle: 31 percent remain in the bottom and another 26 percent move only to the second quintile. Still, 42 percent of sons whose fathers were in the bottom group of earners make it to the middle quintile or higher with their own earnings.

Figure 7

Sons Raised in the Top Are the Most Likely to Stay in their Fathers' Earnings Group

Chances of moving up or down the personal earnings ladder, by fathers' quintile



Mobility is a family enterprise.

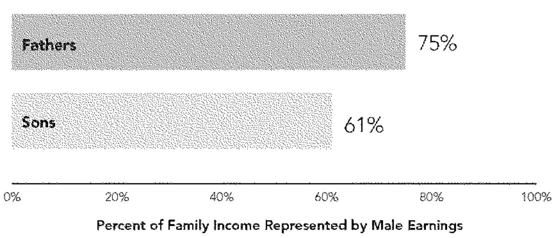
One of the most striking changes that has occurred between the fathers' and sons' generations has been the degree to which women, specifically married women, have increased their participation in the labor force. Concurrent with this shift has been a slowdown in men's earnings gains and thus the reduction of men's contributions to overall family income. In the parents' generation, fathers' earnings constituted three-quarters of total family income. Today, men's earnings still constitute the majority of total family income, but their share has dropped to 61 percent.[8] In other words, for many families, experiencing upward *family income* mobility requires a couple's combined earnings.

Another trend to consider when examining the different patterns for income and earnings mobility is that men and women are increasingly partnering with those who are more like them than not, meaning high earners are forming unions with other high earners. Consequently, the family income of a combined high-earning couple is markedly higher than that of a low-earning one, contributing to the "stickiness at the ends" seen in family income measures.

Figure 8

Men's Earnings in the Parents' Generation Contributed More to Family Income

Average proportion of family income represented by male earnings



Family Wealth

The following analyses display mobility outcomes by *family wealth*, adjusted for inflation and age.[9] Family wealth includes total assets minus total debts.[10] Examples of assets include the value of checking or savings accounts, real estate, stocks, vehicles, private annuities or IRAs, and farms or businesses. The wealth measures also include home equity because of its importance to wealth accumulation.

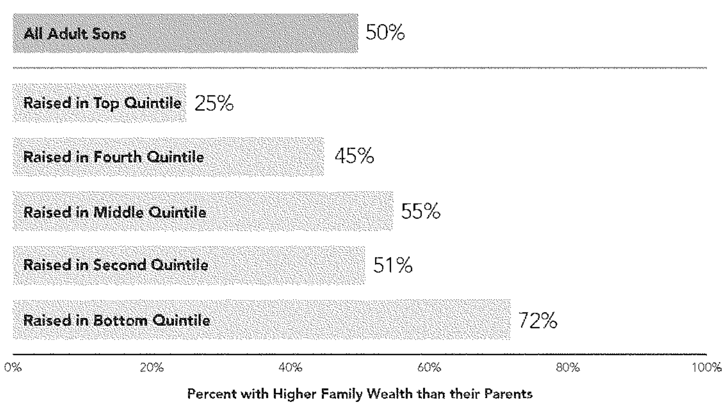
Half of Americans surpass their parents in terms of absolute wealth mobility.

Fifty percent of Americans have more wealth than their parents did at the same age, ranging from 72 percent of those whose parents were at the bottom of the wealth ladder to just a quarter of those whose parents were at the top.

Figure 9

Half of Americans Exceed their Parents' Family Wealth

Percent with family wealth above their parents, by parents' quintile

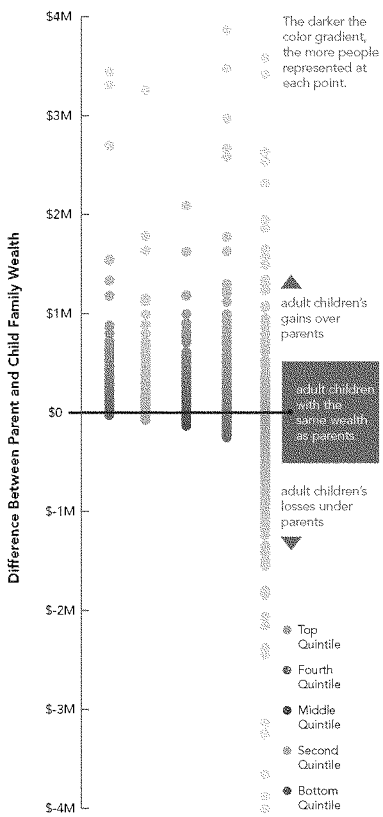


Note: Wealth is adjusted for age and includes home equity.

Figure 10

Americans Raised in the Top Have the Most Variation in Wealth Relative to their Parents

Change in family wealth, by parents' quintile



Note: Wealth is adjusted for age and includes home equity. Four observations above $5,000,000 and five observations below -$5,000,000 were removed from the analysis for scaling purposes.

Americans raised in the top of the wealth distribution have the most variation in wealth relative to their parents.

Those raised in the top quintile of the wealth ladder have the greatest range in their own wealth quintile as adults, with many holding fewer assets than the previous generation (shown in Figure 10 by the concentration of wealth losses below the $0 line). Of course, those whose parents were at the top of the wealth distribution face the highest bar to exceed their parents' wealth, at $270,218 or more.

By contrast, Americans raised at the bottom of the wealth ladder are the most likely to have more wealth than their parents did, in part because their parents had few or no assets. In the parents' generation, the bottom wealth quintile contained people with less than $31,110 in wealth. Of note, 5.6 percent of those in the parents' generation reported having less than $1,000 in family assets, demonstrating that the bar for surpassing the previous generation's wealth was much lower still in some families.

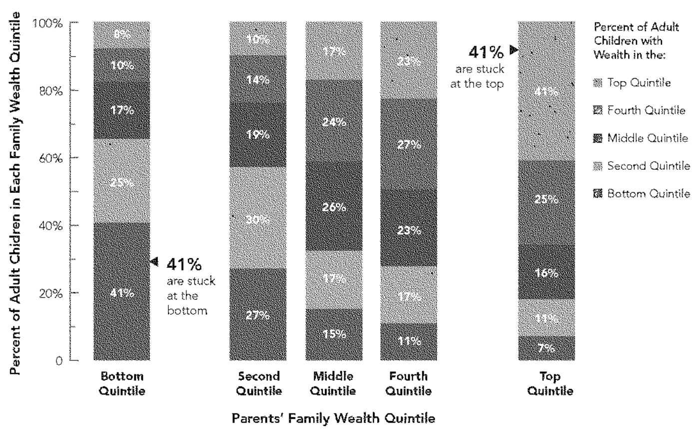
Relative wealth mobility reveals clear stickiness at the ends.

As with family income, the magnitude of absolute mobility gains and declines does not always translate into changing positions on the wealth ladder. Americans whose parents were at the top and bottom of the wealth ladder are likely to be at the top and bottom themselves. Forty-one percent of those raised in the bottom are stuck there as adults, and 66 percent never make it to the middle rung. Similarly, 41 percent of children whose parents were in the top of the wealth distribution remain there as adults, and 66 percent never fall to the middle or below.

Figure 11

Family Wealth is Sticky at the Top and Bottom of the Ladder

Chances of moving up or down the family wealth ladder, by parents' quintile



Note: Wealth is adjusted for age and includes home equity.

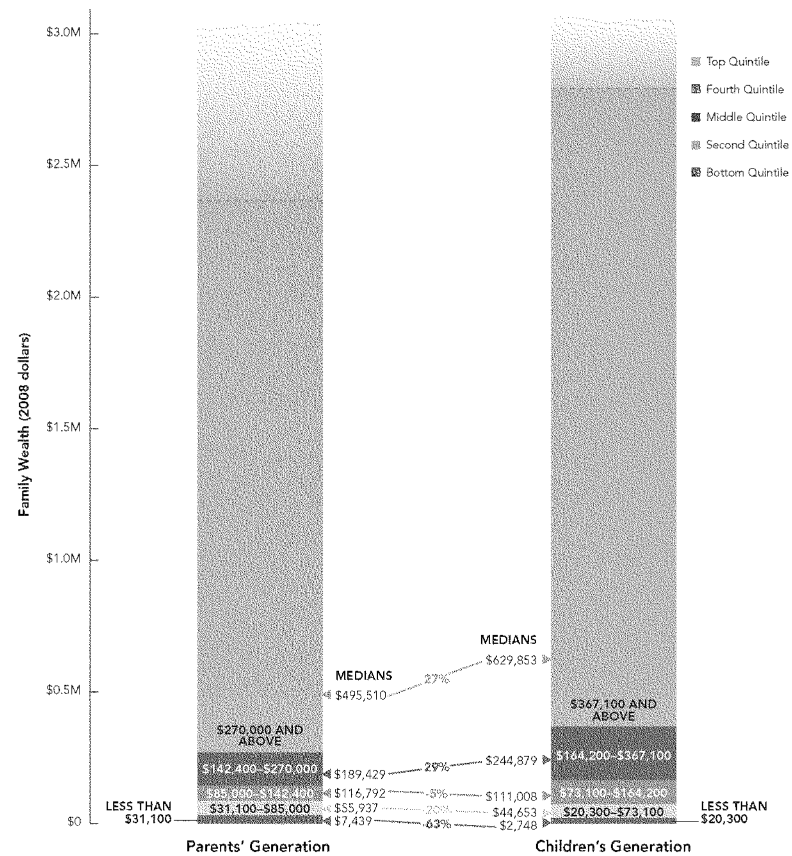
The bottom three rungs of the wealth ladder have compressed during the past generation.

As with family income mobility, investigating the changing shape of the overall wealth distribution over time puts the absolute and relative wealth mobility findings in context (see Figure 12). During the past generation, the amount of wealth held by people at each rung of the ladder has diverged: Wealth has decreased at the bottom and middle and has increased at the top two rungs of the ladder. The wealth compression is especially notable at the bottom: Median wealth for those in the lowest wealth quintile decreased from just under $7,500 in the parents' generation to less than $2,800 in the children's generation. Conversely, at the top of the wealth distribution, median wealth increased from just under $500,000 in the parents' generation to almost $630,000 in the children's generation.

Figure 12

Wealth Has Declined at the Bottom and Middle and Risen at the Top

Change in the overall wealth distribution from parents' generation to children's generation



Notes: Wealth is adjusted for age and includes home equity. Each quintile contains 20 percent of the weighted sample. The dashed line represents the 95th percentile of the PSID sample.

Mobility by Race

The mobility estimates reported in the prior sections focus on all Americans; however, when further analyzed by race, striking differences emerge.[11]

Blacks are much more likely to be raised at the bottom of the family income and wealth ladders than are whites.

Before reviewing differences in mobility by race, it is important to note that the percentage of blacks and whites raised at the top and bottom of the income and wealth ladders differs dramatically. Just over two-thirds (65 percent) of blacks were raised at the bottom of the income ladder compared with only 11 percent of whites. The same pattern exists for family wealth: 57 percent of blacks were raised at the bottom, but only 14 percent of whites were. At the other end of the income and wealth ladders, almost one-quarter (23 percent) of whites were raised at the top versus only 2 percent of blacks.

In fact, the percentage of black families at the top two rungs of the family income and wealth ladders is so small that median and absolute mobility estimates cannot be calculated with statistical certainty. Therefore, the absolute mobility and median wealth figures report mobility estimates for blacks only on the bottom three rungs of the ladder.

Figure 13

Blacks Are More Likely to Start in the Bottom of the Income and Wealth Distributions

Percentage of Americans raised in each quintile, by race

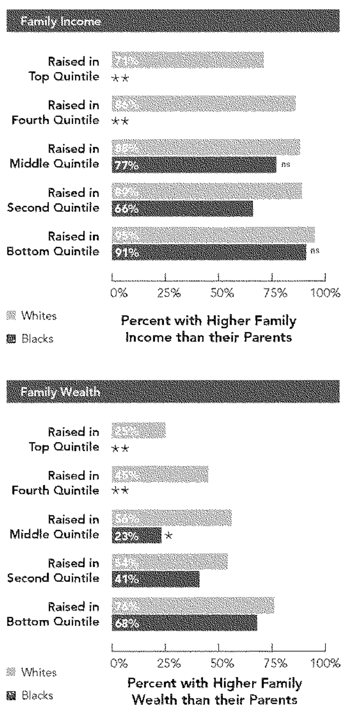
	Family Income		Family Wealth	
	Black	White	Black	White
Raised in Top Quintile	2%	23%	2%	23%
Raised in Fourth Quintile	7%	23%	6%	22%
Raised in Middle Quintile	8%	22%	7%	23%
Raised in Second Quintile	18%	21%	28%	19%
Raised in Bottom Quintile	65%	11%	57%	14%

Notes: Income is adjusted for family size. Wealth is adjusted for age and includes home equity. Numbers in each column may not sum to 100 percent due to rounding.

Figure 14

Blacks Have a Harder Time Exceeding their Parents' Family Income and Wealth than Whites

Percent with family income and wealth above their parents, by race and parents' quintile



Notes: Income is adjusted for family size. Wealth is adjusted for age and includes home equity.

* Interpret data with caution due to small sample size.

** Too few observations to report estimates.

ns: The difference between blacks and whites is not statistically significant at the p<.05 level.

Blacks have a harder time exceeding their parents' family income and wealth than whites.

A gap in absolute mobility exists between blacks and whites for both family income and wealth. For family income, a majority of all Americans exceed their parents; however, blacks have lower absolute mobility gains than whites.[12] The black-white absolute mobility gap for family income is largest at the second rung of the ladder—89 percent of whites surpass their parents' income compared with 66 percent of blacks.

While many fewer Americans surpass their parents' wealth than surpass their parents' income across the distribution, a majority in the bottom three quintiles do. However, when further analyzed by race, only 23 percent of blacks raised in the middle exceed their parents' wealth compared with 56 percent of whites. Only in the bottom do a majority of blacks surpass their parents' wealth, but a black-white gap of 8 percentage points still exists.

Blacks are more likely to be stuck in the bottom and more likely to fall from the middle of the family income and wealth ladders than are whites.

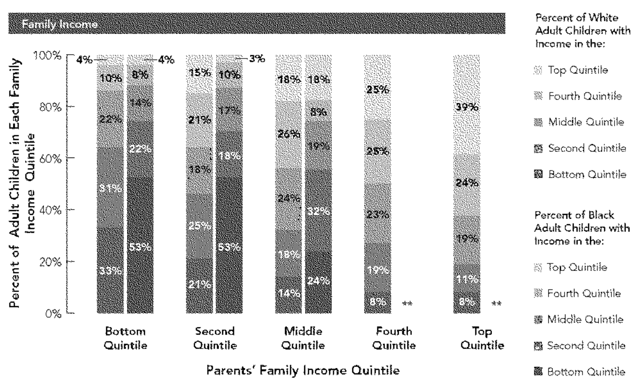
A significant black-white gap also exists for relative mobility. More than half of black adults (53 percent for family income and 50 percent for family wealth) raised at the bottom remain stuck there as adults, but only a third of whites (33 percent for both) do.

Blacks also are more downwardly mobile than whites. For family income, over half (56 percent) raised in the middle fall to the bottom or second rung as adults, compared with almost a third (32 percent) of whites. For family wealth, more than two-thirds (68 percent) of blacks raised in the middle fall to the bottom or second rung as adults, compared with just under a third (30 percent) of whites.

Figure 15

Blacks Are More Likely to Stay in the Bottom and Fall from the Middle

Chances of moving up or down the family income ladder, by race and parents' quintile



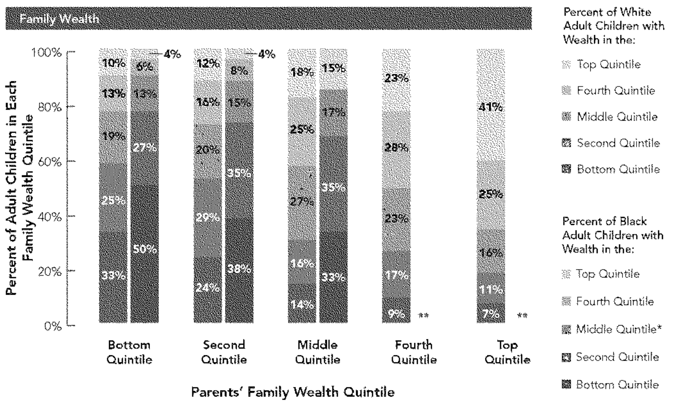
Note: Income is adjusted for family size.

** Too few observations to report estimates.

Figure 15 (Continued)

Blacks Are More Likely to Stay in the Bottom and Fall from the Middle

Chances of moving up or down the family wealth ladder, by race and parents' quintile



Note: Wealth is adjusted for age and includes home equity.

* Interpret data with caution due to small sample sizes.

** Too few observations to report estimates.

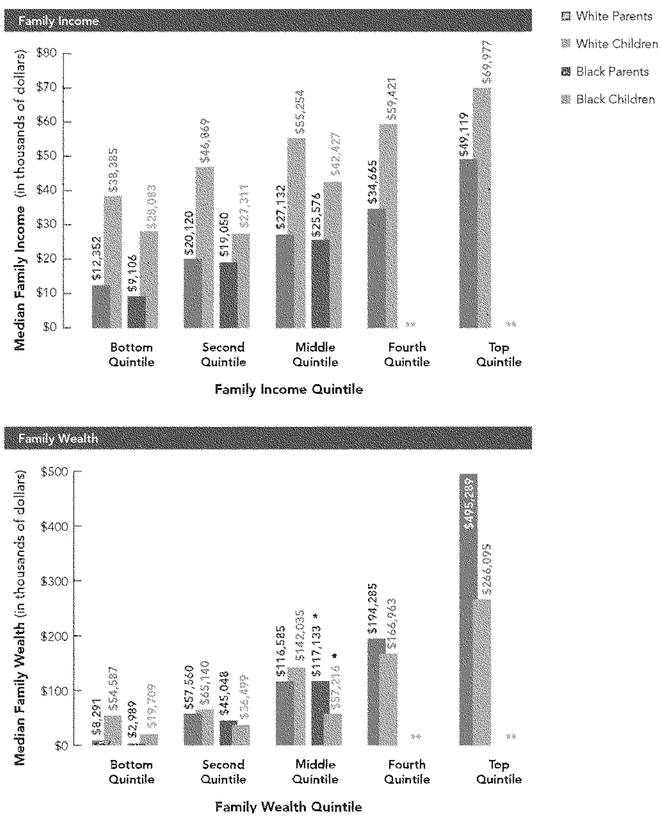
Median family income and wealth is higher for whites than for blacks at all levels of the income distribution.

Shifting away from parent-child pairs and looking only at median income and wealth levels across the two generations sheds light on why there is such a stark black-white mobility gap (see Figure 16). Median family income for blacks is just over $29,000, compared with more than $55,000 for whites, and median family income is lower for blacks than for whites at every rung of the ladder for which there are reliable estimates. Blacks also have less family wealth than do whites, and the racial wealth gap increases sharply between the bottom and the middle.

Figure 16

Whites Have Higher Family Income and Wealth Across the Distribution

Median family income and wealth, by quintile



Notes: Income is adjusted for family size. Wealth is adjusted for age and includes home equity.

* Interpret data with caution due to small sample size.

** Too few observations to report estimates.

Mobility by Education

Having a college degree improves Americans' chances of surpassing their parents' family income and wealth.

Having a college degree has long been viewed as one of the most promising ways to climb the economic ladder, and for good reason. The wage premium associated with a college degree rose dramatically during the past generation, and increased returns on education directly translate into upward absolute mobility gains.[13] For example, 88 percent of those with a college degree exceed their parents' family income, compared with 83 percent without a college degree (see Figure 17).[14]

College degree holders also have greater absolute wealth mobility than non-degree holders. Overall, 57 percent of college graduates have more assets than their parents, compared with less than half (46 percent) of those without a college degree. The greatest gains in absolute wealth during the prior generation were for college degree holders raised in the bottom wealth quintile; 85 percent have more wealth than their parents. For those raised in the fourth wealth quintile, the advantage of a college degree is most notable: nearly two-thirds (64 percent) of college graduates have more wealth than did their parents, compared with just one-third (34 percent) of non-graduates.

Figure 17

College Graduates Are More Likely to Exceed their Parents' Family Income and Wealth

Percent with family income and wealth above their parents', by education and parents' quintile

Notes: Income is adjusted for family size. Wealth is adjusted for age and includes home equity.
ns: The difference between those with and without a college degree is not statistically significant at the p<.05 level.

Earning a four-year college degree promotes upward mobility from the bottom and prevents downward mobility from the middle and top of the family income and wealth ladders.

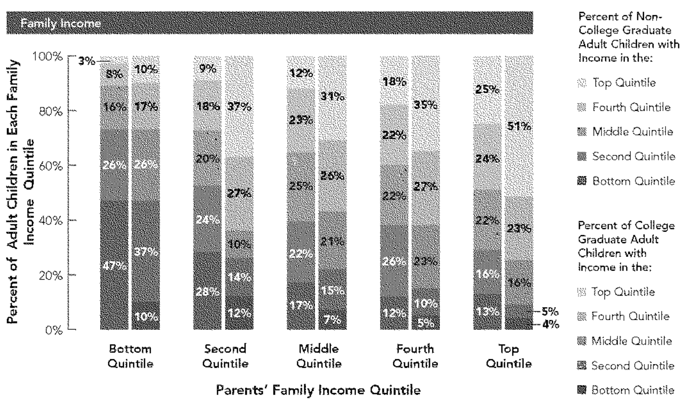
A college degree makes individuals much less likely to become stuck at the bottom of the family income and wealth ladders. For those raised at the bottom of the family income ladder, almost one half (47 percent for family income) without a college degree are stuck there as adults, compared with 10 percent with a college degree. Similarly, 45 percent without a degree are stuck at the bottom of the family wealth ladder, compared with 20 percent with a degree. Having a four-year degree also makes one more likely to rise from the bottom of the ladder all the way to the top—over three times more likely for family income and over four times more likely for family wealth.

A college education additionally protects against downward mobility. At the top of the family income ladder, over half (51 percent) of those with a college degree raised at the top stay there compared with a quarter of those without a college degree. Thirty-nine percent without a college degree fall from the middle compared with only 22 percent with a degree. Similar patterns exist for family wealth.

Figure 15

College Graduates Are More Upwardly Mobile from the Bottom and Less Likely to Fall from the Top and Middle

Chances of moving up or down the family income ladder, by education and parents' quintile

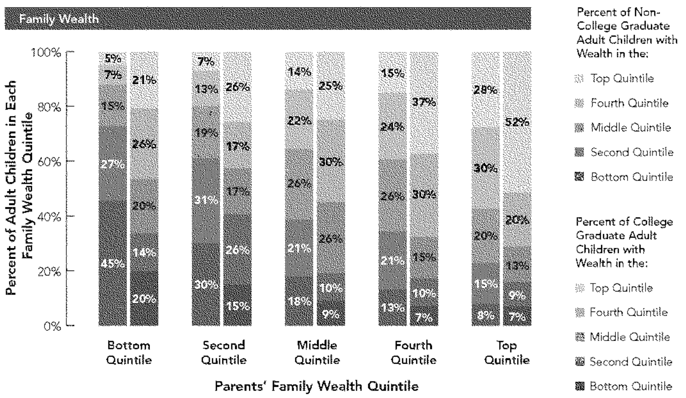


Note: Income is adjusted for family size.

Figure 18 (Continued)

College Graduates Are More Upwardly Mobile from the Bottom and Less Likely to Fall from the Top and Middle

Chances of moving up or down the family wealth ladder, by education and parents' quintile



Note: Wealth is adjusted for age and includes home equity.

Conclusion

The best available data on economic mobility provide a mixed view. While a majority of Americans exceed their parents' family income and wealth, the extent of their absolute mobility gains are not always enough to move them to a different rung of the economic ladder. Furthermore, the persistence of the black-white mobility gap undercuts the ideal of equality of opportunity, a concept central to the idea of the American Dream.

The findings highlight the importance of better understanding key drivers of economic mobility—including postsecondary education, savings and asset building, and neighborhood poverty—for policy makers seeking to promote and protect the American Dream for generations to come. To learn more about economic mobility drivers and read the complete catalog of Economic Mobility Project research, visit www.economicmobility.org.

Appendix

Data and Sample

All analyses in this chart book use data from the Panel Study of Income Dynamics (PSID), a longitudinal data set that has followed families from 1968 to the present. The PSID has been conducted continuously since 1968; annually from 1968 to 1997 and biannually between 1997 and 2009. The PSID is unique among data sets because it continues to follow family members even after they split off from their original households to form separate households. This quality makes it well-suited to study intergenerational economic mobility because data for both parents and children are available at comparable points in their adult life courses. Consequently, it is one of the richest data sets available in the United States that follows multiple generations within families over time.

The original PSID core sample is composed of two parts. One part includes an oversample of low-income households, or the Survey of Economic Opportunity (SEO) sample. The other part includes a cross-sectional national sample, or the Survey Research Center (SRC) sample. Both parts of the PSID sample were included in the analysis. It should be noted that two-thirds of the families in the SEO sample were dropped in 1997 from the PSID, so the two-thirds also are excluded from the analysis within this chart book.[15] Although the PSID added supplemental samples in the 1990s, including a sample of immigrants and a sample of Latinos, these samples are not a part of the analyses in this chart book because they lack historical family and economic data originating with the PSID in 1968.

Economic mobility in this study is examined through the lens of intergenerational mobility. Intergenerational mobility looks at how Americans are faring economically relative to how their parents fared at a comparable age by analyzing data from both parents and children within the same family. In this study, the sample was restricted to those families where the head of household had a child under the age of 18 in his or her household in 1968.[16] In the children's generation, 95 percent of the sample consisted of children of the head of household. The remaining 5 percent included other related children, such as grandchildren. For simplicity's sake, the samples are referred to as children and parents.

Because the unit of analysis in this study is the adult child, the statistics are weighted using the children's most recently available weight as of 2009. The survey weights of each child were computed by the PSID survey designers to statistically adjust for the likelihood of sample selection and non-random attrition from the study. The application of weights in these analyses helps to reduce possible bias in the sample, but does not guarantee that bias is completely eliminated.

The data are analyzed using the total sample and also by race, education, and sex. Race is measured using the head of the household's reported race in 1968. If race is missing, reported race up to 1972 is used. Only white and black respondents are included due to small sample sizes for other racial/ethnic groups.[17] The sample includes a slightly larger proportion of whites (57 percent) compared with blacks (43 percent).

Education is measured according to whether the child is a college graduate. Children are determined to be college graduates if they reported that they had been in school for at least 16 years or more, between 2001 and 2009. Fewer than a quarter (23 percent) of children are college graduates, and education is missing for only 6 percent of the sample.

Economic Status Measures

Three forms of intergenerational economic mobility are examined in this chart book: income mobility, earnings mobility, and wealth mobility. The following sections describe the sample used for each set of analyses and the specific methodological considerations for each indicator. For all measures, both the parent and the child must have at least three years of data to be included in the analysis. All economic status measures were inflated to 2008 dollars using the CPI-U-RS and CPI-U-X1.

Family Income

Income is defined as the total income derived from the taxable income (such as earnings, interest, and dividends) and cash transfers (such as Social Security and welfare) of the head, spouse, and other family members. The PSID definition of family used in this analysis includes single-person families and unmarried cohabiting couples who share resources, in addition to families related by blood, marriage, or adoption. Family income does not include the value of non-cash compensation such as employer contributions to health insurance and retirement benefits, nor does it include the effect of taxes or non-cash benefits such as food stamps. All values less than or equal to zero are coded as $1.

The sample for the analysis of family income includes 2,736 children of the original PSID families who were between the ages of zero and 18 in 1968 and were tracked into adulthood.

For the parents, income is computed as the mean value of total family income taken in 1967, 1968, 1969, 1970, and 1971. Average age of the children's parents during this five-year time period was 40.9. Five-year averages are used as a proxy for lifetime income.

For the children, income is computed as the mean value of total family income taken in 2000, 2002, 2004, 2006, and 2008. Because the PSID shifted from annual to biennial data collection in the mid 1990s, the five years of data are collected over an eight-year interval. The average age of the adult children from whom income data were collected was 45 at the time of survey interview (2000 to 2008).

Estimates of economic mobility that use family income have been adjusted for family size.[18] The reason to adjust family income for family size is based on the notion of "economies of scale." In other words, families require more resources to support additional members but not on the same scale that would be required to support one individual living alone.

These analyses use a well-established method of adjusting for family size, often termed the "square root scale," that divides family income by the square root of the size of the family. This method assumes that a household of four people has needs that are twice that of an individual living alone.[19] Suppose two different households reported income in the previous year of $50,000, but one household was an individual living alone and another household was a family of four. The household of one would have an adjusted family income of $50,000 to devote to the individual's consumer needs. The household of four would have an adjusted family income of $25,000 ($50,000 divided by two, or the square root of four). This method is a way of equalizing family income by acknowledging that additional family members require additional expenses. This is particularly important when comparing generations, because family sizes, on average, have gotten smaller during the past 40 years.[20]

Personal Earnings

Earnings are defined as all labor earnings, such as wages and salary, bonuses, overtime, tips, and commissions. Earnings are a subset of family income. While family income includes all earnings from all family members as well as money from other sources ranging from investments to cash transfers, earnings constitute what one individual contributes to family income from his or her employment alone. Unlike family income, individual earnings were not family-size adjusted because they constitute one person's contribution to the whole. Therefore, family income and individual earnings should not be compared in this study because of this difference in family-size adjustments.

The sample for the analysis of individual earnings includes 1,014 sons of the original PSID fathers who were between the ages of zero and 18 in 1968 and were tracked into adulthood. This study examines the earnings of sons relative to their fathers in order to have comparable intergenerational mobility estimates. Mothers and daughters are not included in the earnings analyses because the dramatic increase in women's labor force participation in a generation's time would be conflated with intergenerational mobility.

For fathers, earnings are measured as the mean value of the head taken in 1967, 1968, 1969, 1970, and 1971. For sons, earnings are measured as the mean value taken in 2000, 2002, 2004, 2006, and 2008. If the son was the head of the household, the head's labor earnings for each year were used. If the son's relationship status was reported as spouse, the spouse's labor earnings in the particular year were used.

Family Wealth

The PSID first collected information on the wealth of respondents in 1984. Wealth is the respondent's estimate of the value of his or her home equity, farm or business, checking and savings accounts, other debt, other real estate, stocks, vehicles, and other assets. Although wealth is measured in the PSID in terms of family holdings, wealth is not often easily accessed, nor readily distributed amongst all family members. For these reasons, wealth is not family-size adjusted in this study.

The sample size for the analysis of wealth includes 2,277 children of the original PSID families who were between the ages of zero and 18 in 1968 and were tracked into adulthood.

Because wealth was first collected in 1984, parents' wealth is measured in that year only. For the children, wealth is measured as the mean value taken in 2001, 2003, 2005, 2007, and 2009.

The limited availability of wealth data for parents produced differences in the mean ages for the parents and children. The average age of parents when wealth is measured was 55, and the average age of children was 46. To address the effects that an age gap in wealth measurement might have on intergenerational comparisons of wealth, age adjustments were performed on the data to make the parent and child generation wealth data more evenly matched. The adjustments are created by estimating a wealth-age profile based on a pooled sample of the parents and children. In particular, the natural log (ln) of wealth is regressed on a quartic in age, and the residual from this regression is saved for each observation. The ln wealth value is predicted for each parent and child at an age of 40. The age-adjusted wealth measure is the exponentiated value of the sum of the predicted wealth measure and the residual from the regression model. For those with a negative wealth or no wealth, an age-adjusted wealth value equal to zero is assigned.

Endnotes

1 *Getting Ahead or Losing Ground: Economic Mobility in America* was funded by the Pew Economic Mobility Project in 2008. Julia Isaacs, Isabel Sawhill, and Ron Haskins of the Brookings Institution wrote the report based on analysis conducted by Thomas DeLeire of the University of Wisconsin-Madison and Leonard Lopoo of Syracuse University. This 2012 update was written by the Pew Economic Mobility Project based on analysis again conducted by Dr. DeLeire and Dr. Lopoo.

2 See the Appendix for details about the Panel Study of Income Dynamics (PSID) data and the family size adjustment methodology used in this report. Note that family size adjustments were not made in the 2008 report *Getting Ahead or Losing Ground*; therefore, direct comparisons between the two reports are not possible.

3 Measures of family income are adjusted for family size and inflation. Measures of earnings are adjusted for inflation. Measures of wealth are adjusted for inflation and age. See the Appendix for more details.

4 "Family income" includes all taxable income (such as earnings, interest, and dividends) and cash transfers (such as Social Security and welfare) of all family members. All mobility metrics on family income are adjusted for inflation and family size.

5 "Wealth" measures include home equity and are adjusted for inflation and age.

6 Family income does not include the value of non-cash compensation, such as employer contributions to health insurance, nor does it include the effect of taxes or non-cash benefits such as food stamps.

7 Personal earnings and family income are both inflation-adjusted, but only family income is adjusted for family size. Direct comparisons of income and earnings are not advised for this reason. See the Appendix for details.

8 The family income data used in this figure is not adjusted for family size in order to determine the share of non-family size-adjusted earnings that constituted the total.

9 These data are adjusted for age because the PSID first collected information on the wealth of respondents in 1984, resulting in a higher average age for parents compared with children. See the Appendix for more information.

10 Some of the families in this study had negative wealth when home equity was included because they had more debt than they had assets. In this data, 2.4 percent of the parent generation and 5.3 percent of the child generation had more debt than assets.

11 Data limitations prevent this analysis from including races or ethnicities other than whites and blacks. See the Appendix for more information.

12 Only at the second income rung are these differences statistically significant.

13 All income differences are significant, except at the bottom rung.

14 Of note, the difference between the absolute income mobility of non-college and college graduates would be more pronounced had family-size adjustments not been made. In the current generation, family sizes are larger on average for those with a college degree compared with those without a college degree. This may be because college degree holders delay

childbearing in the pursuit of education, increasing the likelihood that their families have children present in their households later in life, when the mobility analyses are conducted. As a result, family size adjustments may understate the family income advantage of a college degree because the family income of college graduates is divided over a larger number of family members.

15 The PSID dropped this sample for budgetary reasons.

16 Heads in the parent generation may be represented more than once depending on how many children they had in the data.

17 The PSID was designed in 1968 to study the dynamics of poverty. As an indirect consequence, the survey had a large sub-sample of black respondents. To compensate for the absence of Latinos and immigrant groups who emigrated to the United States after 1968, additional samples were added in 1990 (see Martha Hill, "The Panel Study of Income Dynamics: A User's Guide," Vol. 2 (1991), http://psidonline.isr.umich.edu/Guide/ug/psidguide.pdf). Because this study incorporates data from the parent generation in 1968, or before the additional Latino and immigrant samples were added, there are not enough data in the sample to explore mobility among Latinos.

18 PSID respondents report their income from the previous year because it is more accurate to report based on the last complete calendar year. Family size is measured at the time of survey. So, the previous year's income is adjusted given family size at the time of survey.

19 For additional information, see the Organization for Economic Development write-up "What Are Equivalence Scales?" that compares the different methods for adjusting family income for family size (http://www.oecd.org/dataoecd/61/52/35411111.pdf).

Senate Finance Committee Hearing
"Boosting Opportunities and Growth Through Tax Reform:
Helping More Young People Achieve the American Dream"
July 10, 2012
Questions for Ms. Erin Currier

Questions from Chairman Baucus

1. Education is one of the most important factors in providing every American with the opportunity to succeed. Our education system is one of the reasons that we have one of the most productive labor forces in the world, but not everyone seems to be benefiting. Why is our education system failing to achieve the same level of mobility that we see in other countries? How could the education system here in America do a better job of promoting mobility and opportunity?

   Response: Research from the Economic Mobility Project shows that having a four-year college degree promotes upward mobility from the bottom of the economic ladder and prevents downward mobility from the middle and top of the economic ladder. Yet, many young people raised in low- and middle-income families never enroll in postsecondary education, or do not graduate if they do.

   Lower rates of college attendance and completion at the bottom of the economic ladder stem from differences in both academic preparation and college savings. Families who have less money to send their children to college also have fewer resources to invest in pre-college education. Addressing both factors is essential to addressing the income gap in college-going.

   For instance, public investments in early childhood education and high-quality K-12 education are critical to promoting children's human capital development early in life and ensuring all children and youth have access to effective educational programs and opportunities to excel. Helping families and students build personal savings that can be used for post-secondary education, and providing students with better access to financial supports to help pay for college, would also improve our education system's effectiveness at promoting mobility and opportunity.

2. The tax code has a number of provisions aimed at enhancing mobility. I mentioned a few in my opening statement, such as the Earned Income Tax Credit. Most of our programs to help mobility are targeted towards parents. Does it make sense to provide tax benefits to low-income families, which are claimed by parents, in order to increase opportunities for children? Or should we limit such help to in-kind benefits that can only be claimed by children? How can we make sure that programs intended to create opportunity are benefitting children?

   Response: Research from the Economic Mobility Project demonstrates that the economic security of parents is strongly associated with children's access to opportunities, reinforcing the importance of efforts like the EITC that provide tax benefits to low-income families. Family income is a significant determinant of children's future mobility prospects. Nonetheless, external to their families, low-income children interface with a diverse range of institutions and community actors that can make a difference in their future success. Efforts that focus on providing all children with access to high-quality education and safe and stable neighborhoods are also critical to enhancing their upward mobility.

3. There are provisions in the tax code to help children from working families to get ahead. For instance, the Earned Income Tax Credit gives families an incentive to work so they can provide for their children and help them succeed. But not every family takes advantage of provisions like the EITC. How can we make sure that even children from the hardest circumstances have a chance to succeed? Is there a role here for tax policy?

   Response: Ensuring all families have access to information about the tax benefits that already exist is one step that would help children from working families get ahead. This is particularly important for low-income Americans who do not owe taxes and may not be aware of their eligibility for refundable tax credits. Providing Americans with more financial literacy education, beginning very early in life, would increase participation in programs designed to help disadvantaged children.

   In addition to ensuring all Americans are educated about existing tax benefits, research by Eugene Steuerle, Adam Carasso, and Gillian Reynolds for the Economic Mobility Project has suggested the need to assess the distribution of benefits provided by current tax expenditures. Many of the mobility-enhancing tax provisions that currently exist disproportionately benefit middle and upper-income families. A bipartisan group of advisors to the Economic Mobility Project has called for a "portfolio shift" to better target existing mobility-enhancing investments toward individuals and families who face the most difficulty moving up the ladder.

4. Mobility is about fairness, but it is also fundamental to economic growth. When everyone has an equal chance to succeed, then the ablest and hardest working Americans will rise to the top. How does the fact that we are lagging behind in mobility affect our economy? How does it affect our international competitiveness?

   Response: Our country benefits when all Americans have the opportunity to develop their talents and skills to their fullest and most productive potential. When a child's access to education and opportunity is determined by factors over which they have no control, the incentive to learn and strive is greatly diminished. The strength of our economy and international competiveness depends on investing in the human capital development of all Americans.

5. Most analysts seem to agree that the mobility between generations is lower in the United States than it is in other wealthy countries, but the trend over time is less clear. How has mobility changed over time in the United States? What can we do to make sure that mobility is higher in the future?

Response: The Economic Mobility Project has not conducted any analysis of whether intergenerational economic mobility (i.e. income growth across generations) has changed over time. This is largely due to data limitations. The most accurate analysis of economic mobility relies on longitudinal data that tracks real parent-child pairs. One of the most comprehensive data sets used for mobility research, the University of Michigan's Panel Study of Income Dynamics, was started in 1968. So, while it provides robust data for the current generation of adults and their parents, comparable information does not exist for previous generations.

A study by Greg Acs and Seth Zimmerman for the Economic Mobility Project did examine whether intragenerational economic mobility (i.e. income growth within a lifetime) changed between 1984 and 2004. They found that both relative and absolute mobility rates remained stable over those two decades.

Other researchers external to the Economic Mobility Project have similarly used synthetic cohorts and economic models to estimate changes in economic mobility over time, but the findings are not consistent across studies.

It's important to note that irrespective of whether our current mobility levels are lower than in the past, there is an emerging consensus that the United States has less upward mobility from the bottom in relative terms than American ideals would suggest. Research has demonstrated a host of factors that influence economic mobility and can support policymakers in improving mobility in the future. Key mobility drivers identified by the Economic Mobility Project's research include postsecondary education, savings and asset building, and neighborhood poverty.

6. Most of the money that the United States spends to promote mobility is spent through the tax code. This is efficient because tax returns already provide information about income. However, these tax expenditures often help high income people even more than they help low income people. How can we make sure that tax policy helps mobility for people at the very bottom without giving tax breaks to people who don't need them? What provisions in the tax code are most effective at boosting intergenerational mobility?

Response: A key component of making sure that tax policy helps mobility for people at the bottom is evaluating the current mobility expenditures that already exist and assessing whether investments are appropriately targeted toward individuals and families who face the most difficulty moving up the ladder. As previously referenced, research by Eugene Steuerle, Adam Carasso, and Gillian Reynolds for the Economic Mobility Project published in 2008 (and based on 2006 data) found that approximately "72 percent of mobility expenditures, or $540 billion, is delivered mainly through employer-provided work subsidies, aids in asset accumulation, and savings incentives that flow mainly to middle and upper-income households."

Effectively retargeting these expenditures will require ensuring that Americans who do not owe income tax are not excluded from receiving mobility-enhancing benefits; for example, building upon efforts such as the EITC which is delivered through a refundable tax credit.

Provisions in the tax code should also be assessed in terms of whether they increase incentives for low- and moderate- income families to save and accumulate assets.

7. Dr. Corak states that the intergenerational earnings elasticity is twice as high in the United States as it is in Canada. These differences in mobility levels can be attributed to both monetary and non-monetary resources. What specific tax policies has Canada enacted to encourage mobility? What can we learn from these policies about the best policy for the United States?

   Response: I defer to Dr. Corak on what tax policies Canada has enacted to encourage mobility.

Question from Senator Kerry

1. One of the most obvious ways that higher income parents can give their children an advantage in life is by giving them money. Wealthy parents can also help their children take risks and afford a quality education. What does the research say about the importance of wealth for intergenerational mobility? How important is wealth relative to other factors, like education? What role do wealth transfer taxes and the estate tax play in promoting or inhibiting intergenerational mobility?

   Response: Research from the Economic Mobility Project shows that Americans whose parents were at the top and bottom of the wealth ladder are likely to be at the top and bottom of the wealth ladder themselves. For instance, 61 percent of those raised in bottom never rise to the middle of the wealth ladder, and 66 percent raised in the top of the wealth ladder never fall to the middle. This "stickiness at the ends" mirrors that of the income distribution, and demonstrates that family wealth (and lack thereof) strongly influences children's future prospects.

   While education is one the largest drivers of upward intergenerational mobility from the bottom, it does not fully compensate for the impact of family wealth on children's mobility prospects. College graduates whose parents are in the bottom of the wealth ladder have a 21 percent chance of rising to the top of the wealth ladder as adults. In contrast, college graduates whose parents are at the top of the wealth ladder have a 52 percent chance of being at the top of the wealth ladder as adults.

   The Economic Mobility Project has not conducted any research on wealth transfer taxes or the estate tax. However, our project has published research showing that only one-fifth of all households receive some type of wealth transfer at some time. Thus, the majority of families obtain their wealth through their own enterprising activities. In other words, as Senator Kerry correctly notes, wealthy parents largely produce wealthy children by leveraging their wealth to support their children's human, social, and financial capital development.

Questions from Senator Hatch

1. In looking at data used to capture opportunities for upward mobility for Americans over time and mobility comparisons across countries, I wonder how you control for the many changes in the economic environment over time and differences in measures across countries. Surely, parents of children born in the 1960s or 1970s or 1980s faced far different economic policies, labor market dynamics, immigration dynamics, and global trade in labor and capital than those faced by their children. In the U.S., for example, it is difficult to deny that labor market experiences of females have changed markedly since the Second World War. Rewards to skill seem to have been changing due to technological changes. Entry of China and India into global trade has surely altered labor market dynamics and outcomes around the globe. And there is evidence that there has been growth in associative mating, with people marrying others who share similar occupations.

   When looking at intergenerational mobility, we look at comparisons between outcomes of parents and children. Yet the environments facing parents were often far different from those facing their children. In looking at income measures in the U.S. over time, some studies, including ones by Pew, measure income exclusive of non-wage benefits and certain government benefits like food stamps. Yet, over time, Americans have increasingly taken compensation growth in the form of non-wage benefits. Excluding them seems, to me, to exclude a lot of what has been happening in labor markets over the past few decades.

   How can we extrapolate from historical evidence on parents versus children when people are raised in far different economic environments and possibly receive income in far different forms over time, to craft federal mobility policies for today and the near future?

   Response: The Pew Economic Mobility Project's research on mobility across generations does not control for changes in economic environments across time – in part because comparing children's economic status to their parents provides one way to assess the impact of these very changes on Americans' access to opportunity. The examples of the trends captured, including increased female labor force participation, higher labor market rewards for education and skills, and more associative mating have all influenced the mobility prospects of Americans and should be reflected in the mobility outcomes reported.

   In regard to the definition of income used in the Economic Mobility Project's research, the decision to measure pre-tax income was not a methodological one on the part of our project but is rather reflective of the way Americans are asked about their incomes in the Panel Study of Income Dynamics (PSID), the longitudinal dataset upon which much of our research relies. In surveys of this kind, asking families to report on their pre-tax income is academic best practice; it likely yields the most accurate information since most people don't know their post-tax income. Government agencies, such as the US Census Bureau, also ask about pre-tax income when conducting surveys.

   When conducting cross-national research on mobility, it is standard practice to adjust for inflation and purchasing power parity to ensure an appropriate apples-to-apples comparison across countries.

2. Currently in the U.S., debt and deficits are at levels we have not seen since the years surrounding World War II, when it was necessary to gather resources to defend democracy around the world. Currently in the U.S., we also have unsustainable promises embedded in our entitlement programs, such as Medicare and Social Security. We are observing, in real time in the euro zone, the consequences of failing to act to put fiscal policies on sustainable courses. Young people today in the euro zone, because of the massive debt overhang from profligate government overextensions, face little to no opportunities. There are no jobs to be found.

   We have tragically seen a similar situation beginning here in the U.S., with unemployment remaining over 8 percent for 41 consecutive months through June, and youth unemployment close to 24 percent. Economists have found evidence that there are lifetime effects on income for young people entering their careers in a depressed labor market, like the one we have seen in the U.S. over the past three-and-a-half years.

   I wonder if any in the mobility research community has considered how mobility opportunities for a young person depend on the debt position of that person's country when they are in their formative years. Given the outsized debt and the labor market sluggishness of the last three-and-a-half years in the U.S., I wonder whether it is more likely for young people to end up with opportunities for economic advancement that are inferior to those of their parents?

   Response: EMP has not conducted any research on the connection between mobility opportunities for young people and the debt position of that person's country.

3. Your testimony points to something called "social capital," such as neighborhood effects, as a driver of opportunities for mobility. It appears that the community in which you are raised can have important effects on you opportunities to move up the economic ladder. Yet while many communities would enjoy being something like Silicon Valley, most are not. Yet we see some communities resurrect themselves after industrial transformations brought on by global forces or technological change force them to alter their economic bases, while other communities struggle in poverty traps for many, many years. To some extent, results depend on community, city, and State leaders and policies, and not directly on federal policy. And I would note that the economic resurrections I have observed in some cities but not others cannot be explained away merely by identifying that everyone would have done better if they would simply have had more federal funds.

   Can you tell me what, if anything, we know about things that make good neighborhoods, things that do not, and things that stand in the way of a community adapting to change in a nimble fashion. That is, what do we know about the mechanisms giving rise to births and decay of cities and communities, and what helps create dynamic centers of innovation, growth, and opportunities? What are the mechanics of local development, which could be a core feature of mobility provision?

   Response: Research by Patrick Sharkey for the Economic Mobility Project has shown that growing up in a high-poverty neighborhood increases Americans' risk of experiencing downward mobility and explains a sizable portion of the black-white downward mobility gap. Moreover, the report's analysis also suggested that black children who experience a reduction in their neighborhood's poverty rate have greater economic success in adulthood than black children who experience poverty rates that increase or are stable.

This research reinforces the importance of investing in economically distressed neighborhoods to provide residents with more pathways to opportunity. A bipartisan group of advisors to the Economic Mobility Project recommended making and evaluating investments in communities that provide comprehensive interventions—including education and parenting support—such as those employed in the Harlem Children's Zone and the President's Promise Neighborhood Initiative's grantees.

4. Dr. Newman's testimony identifies the Earned Income Tax Credit, or EITC, as an effective tool to help support low-income earners. As I understand it, there is evidence that the EITC has led to positive effects on labor force participation, mostly among single mothers, but smaller negative effects on hours of work for people already in the labor market and for secondary workers. Of course, the EITC combines with other low-income support programs that have been pieced together over time. The result is a mishmash of low-income support programs, with various phase-outs and cliffs from eligibility criteria that can lead to marginal tax rates for low-income households far higher than those on higher-income earners. Sometimes, the very act of marriage can lead to combined incomes that trigger such a high marginal tax rate for potential low-income households that the programs actually serve as a deterrent to family formation, which many believe is important for the provision of nurturing households and ultimate economic mobility of children.

   Dr. Steuerle has written that "Income maintenance programs tend to be moderately more directed toward those with lower incomes. At times, however, these programs may impede economic mobility by discouraging work and saving, especially for those with the fewest resources."

   I wonder if you have insights on ways to redesign the low-income support structure to remedy the high marginal rates and disincentives to work, save, and form families, possibly even at no net cost on the budget.

   Response: Research by Daniel Cooper and Maria Luengo-Prado for the Economic Mobility Project has shown the power of savings to boost the mobility of low-income Americans and their children. While the Federal Government does use tax policies to incentivize savings, very few of these benefits go to low-income families. Furthermore, asset limits in public assistance programs discourage savings among low- and moderate-income families—those whose economic mobility is most likely to benefit from personal savings. One way to redesign the low-income support structure would be to remove disincentives to savings in public assistance programs and to encourage savings via the tax code particularly for low-income Americans.

5. Your testimony identifies the budget squeeze that we face as interest on our ballooning debt, along with unsustainable growth in the promises embedded in our entitlement programs will

choke off any ability for spending on children and low-income support programs. In thinking about the federal government's role in promoting mobility, it seems to me that we inhibit mobility opportunities for our children and grandchildren the more we pile up unsustainable debt and the longer we wait to address the unsustainable promises made to current and future generations in our entitlement programs.

Recent experiences in the euro zone should serve as a stark reminder to us that our current path threatens to create a lost generation, who have few opportunities to enter the labor force and get a job, have been saddled with government debt, and who will face un-mended entitlement promises. Of course, activists and redistributionists who care little to nothing about economic growth and incentives would suggest the simple cure is simply to raise taxes. Yet, as the euro zone countries have experienced, that becomes impossible once unsustainable debt throws an economy into deep contraction, with an ever-shrinking base upon which to levy taxes.

Dr. Steuerle, do you believe it is possible to think about significantly restructuring or expanding federal policy to support low-income households in attempts to bolster mobility without dealing with our unsustainable entitlement promises in Medicare, Medicaid, and Social Security programs?

Response: I defer to Dr. Steuerle on this question.

United States Senator Orrin G. Hatch
Senate Finance Committee
Hearing on "Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve the American Dream"
Opening Statement
July 10, 2012

Thank you, Mr. Chairman, for holding today's hearing, and welcome to all of our witnesses.

Today's hearing will consider opportunities for American families to provide upward mobility for their children. Research on intergenerational mobility often seems to raise as many questions as it answers. For example, do opportunity and mobility depend more on nature or nurture? What should be our target in terms of opportunity and mobility? What federal policy tools should we consider?

While it makes for a good bumper sticker, it is not even clear that a system of perfectly equal opportunity and mobility is desirable. The former Soviet bloc attempted to achieve perfect equality, but at the expense of personal liberty and the economic incentives necessary if a society is to enjoy productivity growth along with the rewards of producing goods and services.

A dynamic economy depends on the willingness of individuals to go to school, study, gain skills, work, take risks, and innovate. Because such activities are inherently risky, people will engage in them only if they expect to be rewarded. Incentives matter and we should not be surprised that even if we have equal opportunity, however measured, we will still observe unequal outcomes.

My understanding of the literature on economic mobility leads me to believe that human capital is an essential part of the process. The evidence suggests to me that the most important way to provide those opportunities is for parents to invest in early childhood development and education, and to provide a stable family structure in which those investments can be nurtured.

The question is: can the federal government, with its crude policy levers, enhance those opportunities for some without unduly damaging opportunities for others to succeed? It may do little good to simply redistribute more money into broken federal education programs, if that spending is funded by more crippling taxes that prevent investment, creation of capital, savings, and economic growth. Our history of success in public provision of education is poor. There appear to be no measurable improvements in educational outputs associated with pouring more and more government funds into education, despite decades of trying.

The evidence seems to suggest mostly that it is easy for governments to spend money badly.

Our history of providing resources to lower-income households has also not always been admirable. We have had periods during which resources were provided with little or no attention to incentives, which led to tragic cycles of dependence on government. We still have federal programs which, while well intentioned, impose marginal effective tax rates of 100 percent or more on low-income households facing a mishmash of eligibility phase-outs and cliffs. Some programs interact to financially punish family formation, serving to crush opportunities for people to nurture their children and provide them with opportunities.

One thing seems clear and immediate to me today. Continuing to run up our federal debt and burdening our children and theirs with mountains of bills to pay off is a sure path to declining opportunities for all Americans, present and future. Circumstances in Europe, where young generations face ever-dwindling opportunities, should serve as a wake-up call. We need to act on our debt and deficits now.

In addressing opportunities created or destroyed through federal tax and spending policies, I believe it is important to keep in mind the distinction between more and better. To some, more taxes and spending, without attention to adverse incentive effects, seems always to be the answer. I believe that we need to think also about how the government can do its job better. Mr. Chairman, I think we can agree that a clear path toward the better seems to be fundamental tax reform, where we look carefully at what works, what doesn't work, and how we can fix the latter.

Today's panelists will offer insights from research on intergenerational mobility. Our witnesses will discuss research efforts which have uncovered correlations between outcomes of parents and children over time and across countries. And we will hear ideas about the underlying mechanisms in the economy or society that either enhance or suppress opportunities. Unfortunately, there is little hard data available to guide federal policies.

While I welcome insights that our panelists can provide from their research on mobility, I hope that we will be careful about our abilities to make inferences of causality from sometimes crude correlations. The questions being addressed are very difficult, and the evidence is still under development.

Mr. Chairman, thank you for holding today's hearing. I look forward to the testimony of our witnesses.

Lars Lefgren, Associate Professor of Economics, Brigham Young University

Testimony to the Senate Finance Committee, July 10, 2012

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

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

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

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

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

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

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

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

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

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

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

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

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

In the United States, primary and secondary school is provided free of cost, though the quality of education is more variable in the United States than in Sweden (See Nicaise et al. 2005). Access to publicly provided preschool through programs such as Head Start is available to some, but not all, families. Individuals have access to low cost community and state colleges and also have access to loans and grants to cover remaining expenses. For well-prepared students, the United States has the best university system in the world.[7]

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[5] See http://www.bls.gov/cps/minwage2010.htm accessed on July 6, 2012.
[6] See Handler et al. (2005).
[7] Times Higher Education, a London based organization, reports that seven of the top ten universities in the world are located within the US. See http://www.timeshighereducation.co.uk/world-university-rankings/2011-2012/top-400.html accessed on July 6, 2012.

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

In conclusion, it is unclear what the right level of intergenerational income mobility ought to be. Tax and labor market policies designed to foster an egalitarian wage distribution and high levels of intergenerational mobility distort incentives for efficient educational investments, occupational choices, and effort levels. In this regard, congress must thoughtfully consider the tradeoffs between economic efficiency and inequality. However, the failure to foster the educational development and success of all of America's children stunts the economic potential of many citizens, lowers our collective national wealth, and increases intergenerational inequality in a manner that most Americans, I believe, would consider unfair.

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

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

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

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Senate Finance Committee Hearing
"Boosting Opportunities and Growth Through Tax Reform:
Helping More Young People Achieve The American Dream"
July 10, 2012
Questions for Dr. Lars J. Lefgren

Questions from Chairman Baucus

1. Education is one of the most important factors in providing every American with the opportunity to succeed. Our education system is one of the reasons that we have one of the most productive labor forces in the world, but not everyone seems to be benefiting. Why is our education system failing to achieve the same level of mobility that we see in other countries? How could the education system here in America do a better job of promoting mobility and opportunity?

   Response

   One challenge/strength of the U.S. educational system is the large degree of decentralization. This is true in terms of how education is financed, how teachers are hired, and how the curriculum is established. A consequence of this decentralization is that public schools are commonly excellent in higher income areas with a strong tax base, motivated students, and supportive parents. In lower income areas, however, decentralization leads to substantial academic disadvantage.

   In many cases, financial equalizations have led to the level of spending in high poverty urban areas to be comparable to that in higher income areas. However, urban schools still have tremendous difficulty hiring and retaining excellent teachers and administrators. They also lack the social support that exists in well functioning upper income school districts. The money they have, even with finance equalization, may not be sufficient to deal with the extreme challenges they face.

   Another place for improvement lies in the area of early childhood education, which is critical to the long run development. Many middle and upper income families provide a rich nurturing childhood environment but this is not as widespread for the children of disadvantaged families. Other developed countries provide high quality daycare for preschool children. Existing literature in the US documents the benefits of programs such as Head Start, which could be expanded and improved.

2. The tax code has a number of provisions aimed at enhancing mobility. I mentioned a few in my opening statement, such as the Earned Income Tax Credit. Most of our programs to help mobility are targeted towards parents. Does it make sense to provide tax benefits to low-income families, which are claimed by parents, in order to increase opportunities for children? Or should we limit such help to in-kind benefits that can only be claimed by

children? How can we make sure that programs intended to create opportunity are benefitting children?

Response

Work by Dahl and Lochner (2008) documents the impact of family income on childhood outcomes. Unrestricted cash transfers to families with small children can have beneficial effects, not only because of the resources that trickle down to children but also because of reduced stress levels. However, programs that provide subsidized breakfast, lunch, and snack or childhood health insurance programs probably yield the largest benefit per-dollar to children. I would like to again reemphasize the importance of early childhood education for the long run welfare of children.

3. There are provisions in the tax code to help children from working families to get ahead. For instance, the Earned Income Tax Credit gives families an incentive to work so they can provide for their children and help them succeed. But not every family takes advantage of provisions like the EITC. How can we make sure that even children from the hardest circumstances have a chance to succeed? Is there a role here for tax policy?

Response

If the goal is to increase the take up rates of specific programs, perhaps it would be possible to change defaults in terms of eligibility. For example, if families declare a child on their tax forms, IRS computers could adjust declared refunds to ensure that all financial benefits for which a family is eligible are received. The IRS could also send out mailings to families suggesting that they are eligible for childcare subsidies through a flexible spending account or other program.

4. Mobility is about fairness, but it is also fundamental to economic growth. When everyone has an equal chance to succeed, then the ablest and hardest working Americans will rise to the top. How does the fact that we are lagging behind in mobility affect our economy? How does it affect our international competitiveness?

Response

Helping every child achieve their full potential is conducive to economic growth and equality. However, some programs that may increase mobility can be, in principle, detrimental to economic growth. For example, distortions in the labor market may reduce the link between effort or ability and economic success. In ongoing research, I am examining how such distortions increase mobility but at some economic cost. I am fundamentally sympathetic to concerns about fairness and the desire that every child reaches his or her potential. More research is need, however, to understand the particular drivers of economic mobility, and which improve economic development as well as economic mobility.

5. Most analysts seem to agree that the mobility between generations is lower in the United States than it is in other wealthy countries, but the trend over time is less clear. How has

mobility changed over time in the United States? What can we do to make sure that mobility is higher in the future?

Response

The short answer is that we don't know. The data requirements to obtain reliable estimates of intergenerational mobility are sufficiently high that estimates based on very old data tend to be unreliable. The best modern estimates are possible because they rely on large longitudinal surveys or government tax records. Again, more research is needed to better understand the drivers of mobility and which can be most profitably influenced by public policy.

I think that efficient educational, nutrition, and health policy for our young people is a key to improve economic mobility and efficiency.

6. Most of the money that the United States spends to promote mobility is spent through the tax code. This is efficient because tax returns already provide information about income. However, these tax expenditures often help high income people even more than they help low income people. How can we make sure that tax policy helps mobility for people at the very bottom without giving tax breaks to people who don't need them? What provisions in the tax code are most effective at boosting intergenerational mobility

Response

I am sympathetic to your desire to target subsidies to those who would benefit most. However, programs such as Social Security and Medicare are among the most important programs for reducing poverty among the elderly. The key to their longevity is the universal participation of all households. I think the most robust institutions for increasing the collective welfare of all, including the poorest members of society, are those in which we all have a stake.

7. Dr. Corak states that the intergenerational earnings elasticity is twice as high in the United States as it is in Canada. These differences in mobility levels can be attributed to both monetary and non-monetary resources. What specific tax policies has Canada enacted to encourage mobility? What can we learn from these policies about the best policy for the United States?

Response

I'm not sufficiently familiar with the tax policy in Canada to provide an answer that would be useful. I encourage you to communicate with Dr. Corak, who will likely be able to provide an excellent answer.

Question from Senator Kerry

1. One of the most obvious ways that higher income parents can give their children an advantage in life is by giving them money. Wealthy parents can also help their children take risks and afford a quality education. What does the research say about the importance of wealth for intergenerational mobility? How important is wealth relative to other factors, like education? What role do wealth transfer taxes and the estate tax play in promoting or inhibiting intergenerational mobility?

   Response

   Wealth taxes can certainly increase mobility by reducing the incomes of the children of wealthy families. Depending on how the money is spent, however, it's not clear that such policies will do a lot increase the upward mobility of disadvantaged families. It's also the case that, in the U.S., estate taxes generate relatively little revenue because of families' ability to transfer wealth through a variety of channels while the parents are alive.

   In Sweden, taxes on labor income are very high. Taxes on investment income and wealth are extremely low, however. In this setting, the actual impact of a parents' money is smaller on child outcomes than the impact of a parents' non-financial influence through channels such as education, culture, and genetics. (see Lefgren, Lindquist, and Sims, 2012).

   In my opinion, the most important policy tool for increasing mobility is ensuring that we make adequate and efficient investments in the health, nutrition, and education (particularly early education) of our young people.

Questions from Senator Hatch

1. Your research looks into possible mechanisms through which intergenerational mobility operates. I believe that if we are to try to tailor federal tax and spending policies toward enhancing mobility for specific groups, we should have a good idea on what those mechanisms are before we simply redistribute in order to feel good about ourselves. Some would simply argue that giving more resources to lower-income households is the way to go. Yet without knowing where to direct those resources, and the incentive effects of benefit provision along with how you fund those benefits, it is not clear to me that we would be generating overall improvements in the economy or opportunities. And it appears to me that it would at least be useful to have an objective in mind with respect to what we targets we want mobility-enhancing efforts to hit.

   Among people studying intergenerational mobility, is there an agreed upon optimal amount of mobility toward which we should strive? And, do we know what mechanisms to focus on with federal policies?

Response

Currently the literature on mobility is nearly all descriptive. There is virtually no research that provides a framework for us to know what an economically efficient level of mobility should be. In research that I'm currently working on, we explore how distortions in the labor market can increase observed economic mobility while reducing average incomes. Consequently, it is not clear that higher levels of observed mobility indicate that a society is better off than ones with lower levels. I do believe, however, that efficient education, health, and nutrition policies for young people can increase upward mobility and economic growth.

2. In looking at data used to capture opportunities for upward mobility for Americans over time and mobility comparisons across countries, I wonder how you control for the many changes in the economic environment over time and differences in measures across countries. Surely, parents of children born in the 1960s or 1970s or 1980s faced far different economic policies, labor market dynamics, immigration dynamics, and global trade in labor and capital than those faced by their children. In the U.S., for example, it is difficult to deny that labor market experiences of females have changed markedly since the Second World War. Rewards to skill seem to have been changing due to technological changes. Entry of China and India into global trade has surely altered labor market dynamics and outcomes around the globe. And there is evidence that there has been growth in associative mating, with people marrying others who share similar occupations.

   When looking at intergenerational mobility, we look at comparisons between outcomes of parents and children. Yet the environments facing parents were often far different from those facing their children. In looking at income measures in the U.S. over time, some studies, including ones by Pew, measure income exclusive of non-wage benefits and certain government benefits like food stamps. Yet, over time, Americans have increasingly taken compensation growth in the form of non-wage benefits. Excluding them seems, to me, to exclude a lot of what has been happening in labor markets over the past few decades.

   How can we extrapolate from historical evidence on parents versus children when people are raised in far different economic environments and possibly receive income in far different forms over time, to craft federal mobility policies for today and the near future?

   Response

   Looking at mobility requires large amounts of detailed data over decades. Consequently, it's not possible to say in real time how the mobility of today's children will differ from that of their parents. With additional data, one could use information on non-wage sources of income to see if that changes the picture. These data are probably hard to come by. I doubt, however, this would change the fundamental picture when comparing mobility rates across countries.

3. Currently in the U.S., debt and deficits are at levels we have not seen since the years surrounding World War II, when it was necessary to gather resources to defend democracy around the world. Currently in the U.S., we also have unsustainable promises embedded in our entitlement programs, such as Medicare and Social Security. We are observing, in real

time in the euro zone, the consequences of failing to act to put fiscal policies on sustainable courses. Young people today in the euro zone, because of the massive debt overhang from profligate government overextensions, face little to no opportunities. There are no jobs to be found.

We have tragically seen a similar situation beginning here in the U.S., with unemployment remaining over 8 percent for 41 consecutive months through June, and youth unemployment close to 24 percent. Economists have found evidence that there are lifetime effects on income for young people entering their careers in a depressed labor market, like the one we have seen in the U.S. over the past three-and-a-half years.

I wonder if any in the mobility research community has considered how mobility opportunities for a young person depend on the debt position of that person's country when they are in their formative years. Given the outsized debt and the labor market sluggishness of the last three-and-a-half years in the U.S., I wonder whether it is more likely for young people to end up with opportunities for economic advancement that are inferior to those of their parents?

Response

To my knowledge, there is no academic research on that topic. I certainly agree that responsible fiscal policy is essential to ensure that our children have the same economic opportunities that we do. It is also plausible that the children of disadvantaged households might be more affected by a financial crisis than children of the wealthy. If this were true, then keeping one's financial house in order would be crucial for increasing economic opportunity and mobility in the future.

4. Ms. Currier's testimony points to something called "social capital," such as neighborhood effects, as a driver of opportunities for mobility. It appears that the community in which you are raised can have important effects on you opportunities to move up the economic ladder. Yet while many communities would enjoy being something like Silicon Valley, most are not. Yet we see some communities resurrect themselves after industrial transformations brought on by global forces or technological change force them to alter their economic bases, while other communities struggle in poverty traps for many, many years. To some extent, results depend on community, city, and State leaders and policies, and not directly on federal policy. And I would note that the economic resurrections I have observed in some cities but not others cannot be explained away merely by identifying that everyone would have done better if they would simply have had more federal funds.

   Can you tell me what, if anything, we know about things that make good neighborhoods, things that do not, and things that stand in the way of a community adapting to change in a nimble fashion. That is, what do we know about the mechanisms giving rise to births and decay of cities and communities, and what helps create dynamic centers of innovation, growth, and opportunities? What are the mechanics of local development, which could be a core feature of mobility provision?

Response

This is not in my specific area of expertise. However, in my view, the comparative advantage of the US going forward is likely to be focused in industries which require high levels of human capital. For example, in areas such as Silicon Valley and New York City, highly educated workers in the technology and finance sectors generate tremendous economic activity that supports a large service sector employing workers in a variety of occupations. The successful transition of Pittsburgh from a steel town to a technology hub was likely possible because of the presence of highly skilled workers coming from, and affiliated with, institutions such as Carnegie Mellon and Pittsburgh Universities. I recognize that it is not possible for every area to have a world class university in it, however, increasing the skill of workers in a locality and making an area attractive to such workers is likely to have a large economic payoff for that area.

The areas which have been successful in maintaining and increasing the manufacturing base have been those with limited union presences and a willingness of federal, state, and local governments to invest in the physical infrastructure necessary to be economically competitive. Increasing the number of workers with adequate numeracy, literacy, and analytical skills will be essential for ensuring that productivity is high enough to be competitive with lower wage workers in foreign countries.

Another point that has been made by Lant Pritchett in a development context, much economic adjustment ideally comes through migration. It is probably efficient to promote policies in which workers move to those communities where they have the most opportunity. This occurred in agriculture, where over the past century the percent of workers employed in agriculture has declined from about 50 percent to about 2 percent. In some cases, perhaps the role of public policy should be to allow some areas to gracefully shrink easing the economic disruption to those who remain.

Katherine S. Newman, James B. Knapp Dean of the Arts and Sciences,
Johns Hopkins University
Testimony to the Senate Finance Committee, July 10, 2012

Hearing on "Drivers of Intergenerational Mobility and the Tax Code"[1]

I am pleased to have this opportunity to contribute to your deliberations about the ways in which the tax code might facilitate upward mobility. To do so, I draw on several decades of research I have contributed on the nation's working poor, especially in New York, as well as a wealth of data gathered by economists and others who have studied the pathways of other countries whose mobility rates exceed our own. My aim is to consider what kind of investments promote mobility and how difficult it is for working people below the poverty line to make them. I offer some thoughts on how the tax code might assist them and what we see in the experience of other countries that should give us confidence these investments might pay off in greater levels of inter-generational mobility, particularly for Americans at the bottom of the income ladder.

Education and Inter-generational Mobility for Children of the Working Poor

It is by now axiomatic that upward mobility depends on educational attainment. Even in the current recession, unemployment is far lower among college graduates than high school graduates and drop outs are vastly over represented among the nation's poor. The wage premium to higher education is substantial. Accordingly, ensuring that the children of the working poor complete high school and attend college or seek some kind of advanced training is the best recipe for fostering upward mobility.

Staying on that track is very sensitive to the quality of early childhood education. Low wage jobs leave families with few resources to invest in the next generation and hence among the families I studied, childcare options were meager in supply, erratic, and poor in quality. In the 14 years I followed working poor and near poor families in Harlem and the outer boroughs of New York City[2], my observations of their child care arrangements nearly always left me

[1] *"The opinions expressed herein are my own and do not necessarily reflect the views of The Johns Hopkins University."*

[2] Katherine Newman. 1999. No Shame in My Game: The Working Poor in the Inner city. New York: Knopf and Russell Sage. Katherine Newman. 2006. Chutes and Ladders: Navigating the Low Wage Labor Market. Boston: Harvard University Press and Russell Sage Foundation. Katherine Newman and Victor Chen. 2007. The Missing Class; Portraits of the Near Poor in America. Boston: Beacon Press.

concerned about the fate of the next generation. The most common source of child care for the working poor was a relative or a neighbor, often with four or five other children to mind. The best of these settings would see young children scribbling in coloring books once in awhile, but very often, they were left to entertain themselves while the grown-ups in the room watched television and ignored their presence. Rarely were the children mistreated. They were fed, kept warm in the winter, and out of harm's way. Their mothers knew they were safe, which is not unimportant in the troubled neighborhoods where they live. Yet I rarely observed attempts to engage these children, much less to introduce them to the kinds of cognitive stimulation that more fortunate children routinely receive in formal daycare or early childhood education programs. Unregulated family day care is all that the working poor and near poor are likely to be able to afford. Under these conditions, young children often end up poorly prepared for school and lag behind their more advantaged counterparts which leaves them at risk for poor performance in later grades and dropping out in their teenage years.

One example from my fieldwork may illustrate the problem. Danielle Wayne (pseudonym), the divorced mother of three children, returned to the workforce during the course of my research.[3] Her older children, ages 8 and 10 were doing well in school, having benefitted from her undivided attention and engagement in their schools when they were young and she was supported by public assistance and erratic contributions from her ex-husband. Danielle's youngest child, a two year old named Safiya, had a very different experience. When Danielle went to work, she took Safiya to her ex mother in law to be looked after during the day. At a cost of $50 a week, this was the maximum she could afford and she was grateful to this sixty year old grandmother for accepting the child.

I visited Safiya and her grandmother to see how this two year old was spending the day. Her day care is a two bedroom apartment in public housing in the center of Harlem. Carla Wayne, Safiya's grandmother, had three children to look after. The day I arrived, the TV was set to the Jerry Springer show and the kids were glancing up to see topless women. One of Carla's own daughters, a woman in her mid-30s was sitting on the couch in a stupor. She explained to me that she had four teenage children of her own, but was no longer living with them. Carla

[3] This case is discussed at length in Katherine S. Newman and Victor Chen. 2007. The Missing Class: Portraits of the Near Poor in America. Boston: Beacon Press. Pp 87-90.

explained later that her daughter has a serious drug problem and had nowhere else to turn for shelter.

An hour into my visit, two men in their late twenties showed up and made their way to the bedroom at the back, next to the one the children use as a play space. The unmistakable scent of marijuana drifted out from the room where they were hanging out. Every so often, Carla would ask the oldest kid in her care, an 8 year old in third grade, whether she was getting her homework done. She sometimes summons the energy to take Safiya to the park. But for the most part, the best we could say about this childcare situation is that it is custodial. And it is taking a toll on two year old Safiya. At an age where children in early childhood education are playing active games, learning how to be in groups, starting to recognize colors, Safiya had a two word vocabulary: "No" and "Shuddup!" That's it. She never said another thing to me or anyone else. In the setting where she was spending more than 8 hours a day, it is not likely she is going to learn more. And that is not going to put her in a good position to enter kindergarten ready to learn.

Benefits of Early Childhood Education: What the Evidence Shows

How do we avoid this kind of unproductive pathway? In the United States, the Head Start program was a critical intervention that proved its mettle in longitudinal studies that showed greater educational attainment, higher earnings[4] and lower risk of incarceration among white and black adults who were enrolled in the program as children.[5] It was never a universal

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[4] Rucker Johnson's analysis of the Panel Study of Income Dynamics shows" significant beneficial effects of Head Start participation on educational attainment and reductions in the likelihood of grade repetition. The results indicate that Head Start participation reduces the annual incidence of incarceration between ages 18-29 by 5 percentage points for black males. [Johnson] also [found] significant improvements in adult health status associated with Head Start participation, and increases in men's annual earnings and wages." Head Start alone is clearly not enough. Johnson found " the estimated Head Start impacts on educational attainment and men's earnings and wages [were] greater when1) Head Start spending is higher, and 2) when children subsequently attend schools with higher per-pupil spending during their adolescent years (ages 12-17). The impacts were less pronounced and, at times, non-existent when Head Start spending per 4-year old was below average and/or children attended poorly-funded schools during their adolescent years." Rucker Johnson. "School Quality and the Long Run Effects of Head Start." http://socrates.berkeley.edu/~ruckerj/RJabstract_LRHeadStartSchoolQuality.pdf

[5] Jens Ludwig and Deborah Phillips. 2008. Long-Term Effects of Head Start on Low-Income Children. Annals of the New York Academy of Sciences. 2008. http://home.uchicago.edu/~ludwigj/papers/NYAS-

program and hence although it improved outcomes for those who were touched by it, Head Start was not extensive enough to move the national needle.

In other countries, the extension of universal or large scale programs for preschool has become fairly common and their experience reaffirms the importance of this opportunity. Christopher Ruhm from the University of Virginia and Jane Waldfogel at Columbia University have provided the most comprehensive examination of the long term impact of exposure to early childhood education in countries where publicly funded and universal preschool beginning at the age of three or four is now normative.[6]

They summarize studies that followed children through to adulthood in order to measure the impacts. They find:

- Significant impact of "preschool density" for children 1-6 on completed schooling and earnings at 22-30 in **Denmark**, with larger effects for disadvantaged children.[7]
- Positive impact of preschool on grade repetition, test scores, high school graduation and adult wages in **France**. Here too, "these effects are particularly large for children from disadvantaged or intermediate [SES] backgrounds." [8]
- More years in school, higher rates of college attendance and labor market participation in **Norway**. Effects were largest for children of low educated mothers.

These studies are able to move all the way from early childhood educational experience to adult outcomes. Ruhm and Waldfogel review a series of additional studies that look at outcomes for adolescents and find that in **Germany, India, Norway, Sweden, and Uruguay**, Kindergarten attendance raises school enrollment and achievement, especially for immigrant

[6] Christopher Ruhm and Jane Waldfogel. 2011. "Long Term Effects of Early Childhood Care and Education." Discussion Paper No. 6149, Institute for the Study of Labor (IZA, Bonn).
[7] Paul Bingley and Niels Westergaard-Nielson. 2012.. "Intergenerational Transmission and Day Care in Denmark." In Ermich, John et al (Eds) Inequality from Childhood to Adulthood: A Cross-National Perspective on the Transmission of Advantage. New York: Russell Sage Foundation.
[8] Christelle Dumas and Arnaud LeFranc. 2012. "Early Schooling and Later Outcomes: Evidence from Pre-School Extension in France." In Ermich, John et al (Eds) Inequality from Childhood to Adulthood: A Cross-National Perspective on the Transmission of Advantage. New York: Russell Sage Foundation

children for whom exposure to the language of the host country is positive affected by entering school early, providing the maximum time for them to acclimate.[9]

We lack studies of this kind, for the most part, in the United States because we are new to the availability of universal early childhood education. What we do have tends to date from the late 1990s and the availability of longitudinal data (ECLS-K). Magnuson et al (2007a and 2007b) show that "children, particularly those who are disadvantaged, attending pre-kindergarten in the year before [formal] kindergarten, enter school with better math and reading skills." [10]

The Impact of the Tax Credits and Income Supplements on Educational Performance

These studies are telling us that early childhood education makes a positive difference in educational performance in later years. What can the tax code contribute to this equation? The most important contribution it makes to educational outcomes for low income families occurs via the Earned Income Tax Credit. [11] Gordon Dahl and Lance Lochner[12] examined the impact of increases in the Earned Income Tax Credit on the math and reading achievement of 5,000 children, matched to their mothers, in the National Longitudinal Survey of Youth. They find that a $1000 increase in income generated by an increasingly generous EITC "raises combined children's math and reading test scores by 6% of a standard deviation in the short run" and show that "the gains are larger for children from disadvantaged families…"[13] Indeed, their analyses suggest that Black and Hispanic children, kids in single parent households, and those born to low

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[9] Christopher Ruhm and Jane Waldfogel. 2011. "Long Term Effects of Early Childhood Care and Education." Discussion Paper No. 6149, Institute for the Study of Labor (IZA, Bonn). Pp12-14.

[10] These findings are not altogether salutary though because the same studies show children coming from pre-K have higher levels of behavior problems. Nonetheless "the largest benefits are observed for children from families with low levels of education or from disadvantaged neighborhoods."

[11] Summarized in the Center for Budget and Policy Priorities report by J. Charite, I. Dutta-Gupta and C. Marr, "Studies Show Earned Income Tax Credit Encourages Work and Success in School and Reduces Poverty." June 26, 2012. http://www.cbpp.org/files/6-26-12tax.pdf

[12] Gordon Dahl and Lance Lochner (2008). "The Impact of Family Income on Child Achievement: Evidence from the Earned Income Tax Credit." National Bureau of Economic Research Working Paper 145999. Cambridge, MA.

[13] Dahl and Lochner, p. 2

educated mothers show the greatest improvement in test scores as a consequence of the additional income flowing into their households through this tax credit.[14]

Similarly, economist Raj Chetty and his colleagues analyzed administrative data for children in grades 3-8 from a large urban school distinct and the tax records for families in the district and argued that "additional income from the EITC and the CTC leads to significant increases in students' test scores." [15]

Others have found similar impacts of income increases for poor households on par with the amounts typically received via the EITC. [16] Economist Greg J. Duncan of the University of California, Irvine and his colleagues, Pamela Morris (New York University/ MDRC) and Chris Rodrigues (Columbia University), analyzed ten anti-poverty and welfare-to-work experiments and found a consistent pattern of better school results for children in programs that provided more income. Each $1,000 increase (in 2005 dollars) in annual income (the equivalent of a full Child Tax Credit for one child) sustained over two to five years led to modest but statistically significant increases In young children's school performance on a number of measures, including test scores. While the study did not specifically analyze the EITC's impact, the researchers noted that their results are most germane to "income-boosting policies that link increases in income to increases in employment — like the EITC."[17]

The Great Smoky Mountains Study of Youth echoes these findings and adds strength to them because it lasted so long. The study began in 1993 and gathered longitudinal data on children.[18] Because the researchers were interested in the developmental pathways of children in poverty, they oversampled American Indians from the Eastern Band of the Cherokee.

Three years after the study began, a casino owned by the tribe opened. All adult members of the tribe were eligible to receive a portion of the profits from gambling and starting in 1996, the funds began to flow into the households of the Cherokee to the tune of

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[14] Ibid, p. 18

[15] Summarized in the Center for Budget and Policy Priorities report by J. Charite, I. Dutta-Gupta and C. Marr, "Studies Show Earned Income Tax Credit Encourages Work and Success in School and Reduces Poverty." June 26, 2012. http://www.cbpp.org/files/6-26-12tax.pdf

[16] ibid

[17] Discussed at length in Charite et al. 2012.

[18] The children were ages 9, 11 and 13; they were followed annually until they turned 16 and then re-interviewed at 19 and 21.

approximately $4000 annually. This "exogenous shock" made it possible to examine the impact of increasing income on children's outcomes and the results are impressive: at age 21, children in the poorest households saw an additional year of education and the chances of committing a minor crime decreased by 22% for 16 and 17 year olds.

What all of this research is telling us is that the injection of resources into households either through the EITC or through income increases that mimic what the EITC provides for low income households is paying off in the increased educational performance of children. The knock on benefits of that improved track record surface later in the labor market and hence in inter-generational mobility.

What can we do to improve the chances that children from low income households will stay that course? Specifically, what can the tax code provide that improves the odds? Part of the answer is already with us: enlarge or at least preserve the Earned Income Tax Credit and the Child Tax Credit, both of which put resources in the hands of parents. There is a lot of debate about why this works, or rather what the pathway is from higher household income to improved educational and earnings outcomes. Candidates include more money to spend on children's education, greater household stability, parents who are less stressed and hence do a better job raising their children, better health outcomes which prevents the disruptions to adult employment that can derail children and/or interrupt children's own attachment to school. My guess is that all of these factors matter.

To this point, I have emphasized the value of the EITC in improving mobility through the route of educational attainment, which leads to greater stability in employment and hence greater earnings. The Congressional Budget Office points to the importance of maintaining the fruits of that mobility in retirement.[19] Relying on administrative earnings data from the Social Security Administration and existing estimates of the effect of the EITC on employment and earnings growth, these economists simulated the impact of an EITC expansion on the future Social Security retirement benefits of less-educated women. Their results point to the beneficial impact of the EITC on the proportion of less educated women who would qualify for Social Security and an increase in the monthly benefit amounts to which they would be entitled. They conclude that, "the existence of the EITC contributes to the financial security of affected women as they age and retire." Accordingly,

[19] Dahl et al 2012. The Earned Income Tax Credit and Expected Social Security Retirement Benefits Among Low income Women. Working Paper Series, Congressional Budget Office.

investments we make as a nation in the EITC both enhance mobility prospects and help to maintain their value even after workers leave the labor force.

When the states follow the lead of the federal government, the benefits of the EITC are amplified. As you know, about half of the states have EITC's of their own, as do select counties and cities. Only some of them have made these credits refundable and it is among those states that we see the most productive outcomes in terms of morbidity, mortality, educational attainment, and crime.[20] The recession has placed state budgets under heavy pressure and constitutional requirements for balanced budgets and/or public clamor to avoid debt has led a number to propose or enact cuts in their EITC provisions or other tax credits (e.g. renter's credits) of great importance to low income households. Virginia, Georgia, New Jersey, Iowa, Wisconsin, Michigan, Kansas and North Carolina, have moved in this direction in recent months.[21] Quite apart from the consequences of these changes for poverty rates, we can expect in the long run that inter-generational mobility will be negatively affected. Anything that can be done to encourage states to find other ways to address their revenue needs, approaches that do not reach into the pockets of low income households will reap benefits in terms of the pathways of those who have the unfortunate luck to be passing through childhood in an era of austerity.

Tax Incentives for Education

Beyond this, however, what other instruments might be of value? I would argue that to the extent that the tax code can incentivize parents to choose high quality early childhood education over other child care options, particularly informal and unlicensed care, this will pay off in the long run. Child care varies tremendously in quality and the biggest payoff in terms of school readiness is likely to come in those programs that maintain favorable adult/child ratios and aim to prepare children for the school experience. If we were able to develop a certification system that would identify programs that met accepted standards of early childhood education and reward parents through the tax code for choosing them, we would be more likely to see

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[20] See Katherine S. Newman and Rourke O'Brien. 2011. Taxing the Poor: Doing Damage to the Truly Disadvantaged. Berkeley: University of California Press.

[21] Nicholas Johnson and Erica Williams. 2010. Some States Scaling Back Tax Credits for Low-Income Families Measures Would Increase Poverty, Slow Job Growth. Center for Budget and Policy Priorities. May 3. http://www.cbpp.org/cms/index.cfm?fa=view&id=3172

positive consequences for school readiness. Increasingly, children from affluent families are turning up in Kindergarten having already logged several years in childcare programs that adapt them to the classroom experience, expose them to numbers and letters, and prepare them to concentrate and participate in ways that advantage them when school begins. Poor children who have been provided with child care may not be exposed to this kind of enrichment.

It is not likely that the tax code is the appropriate instrument for increasing the supply of affordable, early childhood programs of high quality. For this, other policies will be needed. Public support for moving the age of entry to public school down to age three or four is growing, given the increase in dual earner households. Where this policy is concerned, we can take comfort from the literature on the experience of other countries that are well ahead of us. It suggests that we will be doing our children, and the prospects of intergenerational mobility, a service if we pursue a similar course. Since increasing the age range of public school children would benefit the ever growing population of working parents on the prowl for affordable solutions, support for this kind of investment by states and municipalities is worthwhile, but not the province of the individual income tax system.

Finally, we should not focus our attention on young children alone, even if that is where we see the largest long term payoff. There are two other age groups that merit the support that tax credits could foster: teenagers and young parents. Anything we can do to encourage teens to stay in school and perform at higher levels will pay off in inter-generational mobility. Accordingly, mimicking early childhood education "credits" for teenagers is worthy of consideration. Millions of inner city teens are on their own in the hours after school. Investing in high quality after school programs, particularly those that support academic work through tutoring or enrichment would help to foster mobility through increased attachment to education. If we accept the principle that providing tax incentives for parents to pursue high quality early childhood education, or college attendance for that matter, there is no reason why the same logic should not apply to tax support for middle and high school enrichment programs in the after school hours.

Studies of the long term benefits of a college education among young parents, especially mothers, on the mobility prospects of their children point as well to the importance of adjusting the country's tax code vis a vis higher education. As Attewell and Lavin have shown in their book, Passing the Torch[22], first time college students from low income backgrounds raise their children differently than people from the same kinds of families who do not attend college. They become more familiar with the benefits of museums, reading aloud, doing homework, visiting the zoo, and a host of other middle class habits that were often foreign to them from their own childhoods. Rubbing shoulders with people from more affluent backgrounds, low income mothers who went to college learned another way of raising kids and employed that knowledge to the task of rearing their own. What difference did this make over the long haul? Attewell and Lavin tracked a large sample of low income mothers who were the first in their families to attend college in the early 1970s and then examined the educational outcomes of their children decades later. Using a control group of mothers that did not finish college, they were able to measure the impact of college completion by low-income mothers on the mobility of their adult children. There were substantial improvements in children's educational performance measured from elementary school through college.

How could the tax code foster greater likelihood of college attendance among low income women? The American Opportunity Tax Credit, which refunds up to $2500 for undergraduate education is a very important instrument for low income individuals and families supporting their children in college. This provision is scheduled to expire at the end of this year and should be renewed and expanded if we want to see more families repeat the intergenerational mobility story twenty years from now. Similarly, the Life Time Learning Credit, which enables students to deduct 20% of their tuition payments, should be increased. We often think of these provisions as facilitating mobility for the adults who attend college, and they do. But when we look at the ways in which a parent's college education changes the trajectory of their children, we see that it delivers benefits to the next generation down as well.

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As others in this hearing have pointed out, the United States is no longer the frontrunner in inter-generational mobility. There are many reasons for this slowdown, but one contributory factor may be our failure thus far to invest on a universal basis in early childhood education.

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[22] Paul Attewell and David Lavin. 2007. Passing the Torch: Does Higher Education Pay Off for the Next Generation? New York: Russell Sage Foundation (Rose Monographs).

Ever since James Heckman's seminal work on the subject[23], it has been established that preschool remains the most cost effective instrument for insuring higher levels of educational attainment in adulthood. This, in turn, is the best predictor of positive employment and earnings trajectories. Investments of this kind level the playing field. Without them, family background is more likely to dictate the destiny of the next generation.

[23] James Heckman. 2008. "Schools, Skills, and Synapses." Economic Inquiry 46(3): 289-324; James Heckman et al. 2010. "The Rate of Return to the HighScope Perry Preschool Program." Journal of Public Economics 94(1-2): 114-128.

Statement of

C. Eugene Steuerle

On

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

Finance Committee
U.S. Senate

July 10, 2012

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

Mr. Chairman and Members of the Committee:

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

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

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

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

- First, we have a budget for a declining nation. Independent of deficits or government size, our budget promotes consumption ever more and investment, particularly in the young, ever less.

- Second, once households reach a poverty level of income, we provide relatively high disincentives to work and saving for those with fewer means, inducing behavioral patterns that can become reflected across generations.

- Third, while we spend substantial sums on both mobility and social welfare, we allocate these monies in ways that favor mobility for those with higher incomes, while promoting consumption but discouraging mobility for those with lower incomes. This discrepancy can be seen especially in policy toward housing and pensions and saving, where well over $500 billion a year in government asset-building subsidies are generally unavailable to lower-income households.

Budget for a Declining Nation

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

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

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

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

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

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

Discouraging Work, Saving, and Other Behaviors That Promote Mobility

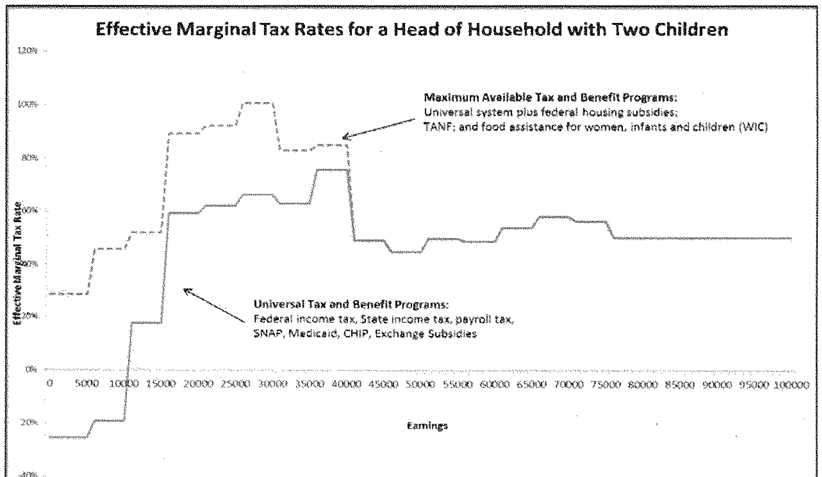
A difficult and controversial aspect of any social welfare budget is its disincentives to work and save. One of the main ways that part of the population rises in status relative to others is that it works harder and saves a higher portion of the returns on its wealth. Think of a simple case where a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

Tax and spending policy can help or hinder that effort. Higher levels of welfare are more likely to discourage work, for instance, than are higher amounts spent on education or job subsidies, although these, too, must be carefully designed. This is especially true after a base level of consumption is established—for example, after a nutritional diet and good preventive health are established. Some effects can be quite unintended. For instance, as health costs rise, lower-income families face greater disincentives for work since a larger portion of their paycheck might go to buy health insurance they could otherwise receive from government programs.

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

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

Figure 1



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

Promoting Mobility

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

Notes

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

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

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

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

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

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

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

Senate Finance Committee Hearing
"Boosting Opportunities and Growth through Tax Reform: Helping More Young People Achieve the American Dream"
July 10, 2012
Questions for Dr. Eugene Steuerle

Questions from Chairman Baucus

1. Education is one of the most important factors in providing every American with the opportunity to succeed. Our education system is one of the reasons that we have one of the most productive labor forces in the world, but not everyone seems to be benefiting. Why is our education system failing to achieve the same level of mobility that we see in other countries? How could the education system here in America do a better job of promoting mobility and opportunity?

   A: Our educational system is largely organized the same way as it was over a century ago, with less upgrades than other industries for the advances of information technology, a school day and year that revolves around getting home to do the farm chores and bring in the summer crops, and an emphasis on age 5 and older even when research is pointing to the advantages of earlier interventions. In my view, some of the most important reforms would be to measure progress for every child, provide greater although more options for parents and students to move to alternative systems, and devote more resources to earlier interventions.

2. The tax code has a number of provisions aimed at enhancing mobility. I mentioned a few in my opening statement, such as the Earned Income Tax Credit. Most of our programs to help mobility are targeted towards parents. Does it make sense to provide tax benefits to low-income families, which are claimed by parents, in order to increase opportunities for children? Or should we limit such help to in-kind benefits that can only be claimed by children? How can we make sure that programs intended to create opportunity are benefitting children?

A: All government programs involve benefits and costs, so the trick as always is to try to maximize the former and minimize the latter. Children's benefits should often go with children, regardless of family structure and without significant means testing that puts very high marginal tax rates on additional income in the family. The current system of means testing tends to put extraordinary marriage penalties on low- and moderate-income households. As we move toward the future, investing in education and early childhood interventions stand high on the list of opportunities that would benefit the child and family without providing additional disincentives to work and marriage.

3. There are provisions in the tax code to help children from working families to get ahead. For instance, the Earned Income Tax Credit gives families an incentive to work so they can provide for their children and help them succeed. But not every family takes advantage of provisions like the EITC. How can we make sure that even children from the hardest circumstances have a chance to succeed? Is there a role here for tax policy?

   A: For work incentives such as the Earned Income Tax Credit, I think an extension to low-wage workers in general is in order. I have suggested, for instance, dividing the current EITC into two parts: one that operates pretty much like the current system but at a lower rate, and one that goes to low wage workers.[1] For single heads of household with low earnings, the two combined credits (one dependent upon low wages and children, one merely dependent upon low wages) would approximately equal the current one. However, the second credit would extend support to other low-wage workers, while reducing marriage penalties.

4. Mobility is about fairness, but it is also fundamental to economic growth. When everyone has an equal chance to succeed, then the ablest and hardest working Americans will rise to the top. How does the fact that we are lagging behind in mobility affect our economy? How does it affect our international competitiveness?

[1] C. Eugene Steuerle, et al., 2008, "The Next State for Social Policy: Encouraging Work and Family Formation among Low-Income Men," http://www.urban.org/publications/411774.html

A: Mobility is closely related to investment. The studies I have undertaken show that government is increasingly favoring consumption over investment both in human capital, largely education, and physical capital. Almost all the growth in government spending over time goes to retirement and health in ways that partially discourage work and saving. Meanwhile, children and investment are expected to get essentially nothing from the additional $1 trillion that is likely to be spent by the federal government ten years from now—that is, from the additional spending expected to derive from ten years of economic growth. This is a budget for a declining economy.

5. Most analysts seem to agree that the mobility between generations is lower in the United States than it is in other wealthy countries, but the trend over time is less clear. How has mobility changed over time in the United States? What can we do to make sure that mobility is higher in the future?

   A: Not all is negative news. For instance, the U.S. offers significant opportunities for mobility among its immigrant populations, relative to what they had before. This often does not occur in other countries. Our average incomes are higher than most other places. Whether we are worse or better than other countries does not mitigate the need and opportunity for us to do a better job with upward mobility here at home. Again, I think the main requirement for government is to shift from a budget that emphasizes consumption to one that increasingly focuses on investment and on children. We don't need to abandon efforts in the past to the extent they have been successful. What we mainly need to do is gain control over the growth in government spending and tax subsidies and re-orient that growth in a more mobility-enhancing way.

6. Most of the money that the United States spends to promote mobility is spent through the tax code. This is efficient because tax returns already provide information about income. However, these tax expenditures often help high income people even more than they help low income people. How can we make sure that tax policy helps mobility for people at

the very bottom without giving tax breaks to people who don't need them? What provisions in the tax code are most effective at boosting intergenerational mobility?

A: The tax code primarily supports mobility through its subsidies for saving, particularly homes and retirement, and through the EITC. I have noted above the reform I would suggest for the EITC. For homeownership, we should consider re-orienting subsidies so they are provide more to lower and moderate income households. Private pension reform should be considered as an important component of Social Security reform when this committee takes up that issue. Recent pension reforms in Britain achieved just such an objective. One way to do this, a Super Simple Plan, has been proposed by Pamela Perun and myself.[2]

7. Dr. Corak states that the intergenerational earnings elasticity is twice as high in the United States as it is in Canada. These differences in mobility levels can be attributed to both monetary and non-monetary resources. What specific tax policies has Canada enacted to encourage mobility? What can we learn from these policies about the best policy for the United States?

   A: Dr. Corak may be better situated to answer this question. My sense is that Canada does have a somewhat cleaner and more efficient tax code. However, I would not make too strong a claim on how movement in that direction by the United States, as much as I might favor it, would affect relative comparisons between the two countries. Canada also has a much more homogenous population.

Questions from Senator Kerry

1. One of the most obvious ways that higher income parents can give their children an advantage in life is by giving them money. Wealthy parents can also help their children take risks and afford a quality education. What does the research say about the

[2] Pamela Perun and C. Eugene Steuerle, "Why not a 'Super Simple' Saving Plan for the United States?" http://www.urban.org/publications/411676.html

importance of wealth for intergenerational mobility? How important is wealth relative to other factors, like education? What role do wealth transfer taxes and the estate tax play in promoting or inhibiting intergenerational mobility?

A; Wealth in all forms—education, adult resources available to the child, traditions of work and small business formation, access to helping hands from other talented or wealthy neighbors and friends—clearly makes a difference. In fact, the downward mobility of some families that have obtained middle-income status, I believe, is related to the fact that they have not simultaneously obtained middle-wealth status along the many lines I just outlined.

Wealth and transfer taxes affect only a very small percentage of the population and would not have much, if any, effect on the various studies of intergenerational mobility.

Questions from Senator Hatch

1. In looking at data used to capture opportunities for upward mobility for Americans over time and mobility comparisons across countries, I wonder how you control for the many changes in the economic environment over time and differences in measures across countries. Surely, parents of children born in the 1960s or 1970s or 1980s faced far different economic policies, labor market dynamics, immigration dynamics, and global trade in labor and capital than those faced by their children. In the U.S., for example, it is difficult to deny that labor market experiences of females have changed markedly since the Second World War. Rewards to skill seem to have been changing due to technological changes. Entry of China and India into global trade has surely altered labor market dynamics and outcomes around the globe. And there is evidence that there has been growth in associative mating, with people marrying others who share similar occupations.

   When looking at intergenerational mobility, we look at comparisons between outcomes of parents and children. Yet the environments facing parents were often far different from those facing their children. In looking at income measures in the U.S.

over time, some studies, including ones by Pew, measure income exclusive of non-wage benefits and certain government benefits like food stamps. Yet, over time, Americans have increasingly taken compensation growth in the form of non-wage benefits. Excluding them seems, to me, to exclude a lot of what has been happening in labor markets over the past few decades.

How can we extrapolate from historical evidence on parents versus children when people are raised in far different economic environments and possibly receive income in far different forms over time, to craft federal mobility policies for today and the near future?

A: You certainly raise valid questions about how research can try to control for multiple influences, both over time and at a point in time. Some studies try, for instance, to compare different countries at a point in time, so as to mitigate differentials over time. Others attempt to separate out immigrants, where, as I say, we would often measure significant upward mobility relative to their former status in other countries. Some attempt to figure out the effect of the growth in single-parent families over time—a factor that most believe has had a negative influence on economic mobility.

As for including noncash benefits and transfers, these are often included in studies of income redistribution. For instance, CBO recently adjusted its measure of income status for purposes of measuring the extent of redistribution to include in income a higher value of health care benefits in the form of Medicaid. However, most studies of mobility attempt to see how well people are faring without the help of government, that is, how much they have gained over time or generations in their command of private resources and income. Thus, for the most part, a redistribution study might find that a population more dependent upon food stamps had improved in its relative distribution of consumption and total income, but a mobility study would not find that a family that became more dependent upon such government programs had achieved upward mobility if its own earnings and returns from saving had fallen.

2. Currently in the U.S., debt and deficits are at levels we have not seen since the years surrounding World War II, when it was necessary to gather resources to defend democracy around the world. Currently in the U.S., we also have unsustainable promises embedded in our entitlement programs, such as Medicare and Social Security. We are observing, in real time in the euro zone, the consequences of failing to act to put fiscal policies on sustainable courses. Young people today in the euro zone, because of the massive debt overhang from profligate government overextensions, face little to no opportunities. There are no jobs to be found.

   We have tragically seen a similar situation beginning here in the U.S., with unemployment remaining over 8 percent for 41 consecutive months through June, and youth unemployment close to 24 percent. Economists have found evidence that there are lifetime effects on income for young people entering their careers in a depressed labor market, like the one we have seen in the U.S. over the past three-and-a-half years.

   I wonder if any in the mobility research community has considered how mobility opportunities for a young person depend on the debt position of that person's country when they are in their formative years. Given the outsized debt and the labor market sluggishness of the last three-and-a-half years in the U.S., I wonder whether it is more likely for young people to end up with opportunities for economic advancement that are inferior to those of their parents?

   A: While I don't know that mobility studies per se have examined this issue, I have also written extensively about the concerns you express. In particular, I point to the projection for future budgets. While the government is projected to spend close to $1 trillion more annually in another decade or so, that increase all goes to interest on the debt and to health and retirement programs. Children and investment in the future get almost nothing.[3]

3. Ms. Currier's testimony points to something called "social capital," such as neighborhood effects, as a driver of opportunities for mobility. It appears that the community in which you are raised can have important effects on you opportunities to move up the economic ladder. Yet while many communities would enjoy being something like Silicon Valley, most are not. Yet we see some communities resurrect themselves after industrial transformations brought on by global forces or technological change force them to alter their economic bases, while other communities struggle in poverty traps for many, many years. To some extent, results depend on community, city, and State leaders and policies, and not directly on federal policy. And I would note that the economic resurrections I have observed in some cities but not others cannot be explained away merely by identifying that everyone would have done better if they would simply have had more federal funds.

Can you tell me what, if anything, we know about things that make good neighborhoods, things that do not, and things that stand in the way of a community adapting to change in a nimble fashion. That is, what do we know about the mechanisms giving rise to births and decay of cities and communities, and what helps create dynamic centers of innovation, growth, and opportunities? What are the mechanics of local development, which could be a core feature of mobility provision?

A: Cities that have invested in education, as well as taken advantage of all the money flowing into the health industry, have tended to fare better than other cities. Here higher education, not just primary and secondary education, also makes a difference. Traditions of homeownership and of small business formation also can be quite

[3] Julia Isaacs, et al., 2012, *Kids' Share 2012: Report on Federal Expenditures on Children through 2011*, http://www.urban.org/publications/412600.html

important. Cities and regions with heavy reliance upon single industries tend to go through a wider boom and bust cycle as those industries wax and wane.[4]

4. Dr. Newman's testimony identifies the Earned Income Tax Credit, or EITC, as an effective tool to help support low-income earners. As I understand it, there is evidence that the EITC has led to positive effects on labor force participation, mostly among single mothers, but smaller negative effects on hours of work for people already in the labor market and for secondary workers. Of course, the EITC combines with other low-income support programs that have been pieced together over time. The result is a mishmash of low-income support programs, with various phase-outs and cliffs from eligibility criteria that can lead to marginal tax rates for low-income households far higher than those on higher-income earners. Sometimes, the very act of marriage can lead to combined incomes that trigger such a high marginal tax rate for potential low-income households that the programs actually serve as a deterrent to family formation, which many believe is important for the provision of nurturing households and ultimate economic mobility of children.

Dr. Steuerle has written that "Income maintenance programs tend to be moderately more directed toward those with lower incomes. At times, however, these programs may impede economic mobility by discouraging work and saving, especially for those with the fewest resources."

I wonder if you have insights on ways to redesign the low-income support structure to remedy the high marginal rates and disincentives to work, save, and form families, possibly even at no net cost on the budget.

[4] "Notably, these 'balanced' metros are much more clustered around the median rates of growth than the areas with focal industries. This suggests that areas with a more diverse industrial mix were relatively insulated from the national economic conditions than those with one or two powerful industries." Erica Meade, "An Industry-Based Typology for the Employment Strength of Metro Areas in the Recovery," http://www.metrotrends.org/commentary/Metro-Employment-Recovery.cfm

A: I have made a number of suggestions over time, summarized somewhat in a recent testimony for two House Ways and Means subcommittees.[5] These include setting a maximum marginal tax rate from both direct taxes and the implicit taxes in the phase out of various programs, extending the EITC to low-wage workers now excluded (both singles and those who marry), emphasizing greater work requirements as conditions for receiving government benefits, and re-orienting the budget more toward investment rather than consumption—particularly with the additional resources that government is likely to provide as the economy and its tax revenues expand.

On the saving front, I again suggest that you consider ways of reforming both pension and housing policy. The two principal ways that people save are by paying off their mortgage and by putting money into pension and retirement plans. A great many , middle-income household, not just those with low incomes, today generate little in total saving, largely because they are not saving or saving only a little through homeownership or retirement plans.

5. Your testimony identifies the budget squeeze that we face as interest on our ballooning debt, along with unsustainable growth in the promises embedded in our entitlement programs will choke off any ability for spending on children and low-income support programs. In thinking about the federal government's role in promoting mobility, it seems to me that we inhibit mobility opportunities for our children and grandchildren the more we pile up unsustainable debt and the longer we wait to address the unsustainable promises made to current and future generations in our entitlement programs.

Recent experiences in the euro zone should serve as a stark reminder to us that our current path threatens to create a lost generation, who have few opportunities to enter

[5] C. Eugene Steuerle, 2012, "Marginal Tax Rates, Work, and the Nation's Real Tax System," http://www.urban.org/publications/901508.html

the labor force and get a job, have been saddled with government debt, and who will face un-mended entitlement promises. Of course, activists and redistributionists who care little to nothing about economic growth and incentives would suggest the simple cure is simply to raise taxes. Yet, as the euro zone countries have experienced, that becomes impossible once unsustainable debt throws an economy into deep contraction, with an ever-shrinking base upon which to levy taxes.

Dr. Steuerle, do you believe it is possible to think about significantly restructuring or expanding federal policy to support low-income households in attempts to bolster mobility without dealing with our unsustainable entitlement promises in Medicare, Medicaid, and Social Security programs?

A: No. Clearly, the budget must be brought under control. In fact, merely achieving sustainability—a goal that we are far from achieving—is not enough. A fixed but sustainable budget leaves almost no flexibility to respond to new needs or opportunities. No group is more disadvantaged than the young, for whom the future of government is already set in law by automatically growing health and retirement and tax subsidy programs, along with an unwillingness of older generations to collect enough taxes to pay our bills as we go along.

COMMUNICATIONS

Comments for the Record
United States Senate
Committee on Finance
Boosting Opportunities and Growth through Tax Reform:
Helping More Young People Achieve the American Dream
Tuesday, July 10, 2012, 2:45 PM
215 Dirksen Senate Office Building

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Chairman Baucus and Minority Leader Hatch, thank you for the opportunity to address this topic. As always, our comments will be in the context of our four part proposal for tax reform, which is as follows:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

While preserving Social Security in some form is essential to holding onto the American Dream in retirement, most of the impacts for young people come through our proposals to enact the NBRT. Before listing these impacts, however, a further word is needed on income tax rates.

It is absolutely essential that tax reform include increased tax rates on dividends and capital gains. If only dividend rates rise, than what would be paid in dividends will be used to manipulate the stock price, so both must be addressed and have an identical tax rate. Currently, young people are bearing the brunt of this recession. This is largely because investors and CEOs paid with carried interest or dividends get to keep 85 cents of every dollar in labor cost savings.

While that is not the whole story on the taxation of capital by any means, the low rate certainly provides a strong incentive to keep wages low and to hold back on hiring staff (two conditions that build on each other and keep the economy in Depression). Reducing these incentives, on the margin, will actually take away the personal incentive to continue cutting costs. This has been born out in the actual economy. Things will not get better until these cuts are reversed and I urge the Senate to block any changes that extend these cuts, even if poor and middle class families take a small hit in tax withholding (which according to the Brookings-Urban Tax Policy Center will only be between $5 a week and $20 a week for most families). A small tax increase is much easier to bear than having no job at all.

One of the chief problems young people face is paying for education. The NBRT would both fund public collegiate and vocational education and allow offsets for providing tuition assistance to employees for pursuing education after grade 14 (until that point, education would be free). We propose that tuition assistance take two forms – the creditable portion which need not be paid back and a loan portion that would be paid back with a service requirement, with the federal government offering student loans only when the employment situation does not work out or the degree is not completed. Involving employers more closely after grade 14 allows for the negotiation of volume discounts – which is a hallmark of the success of such programs as the H-1B Technical Skills Training Grant and the more recent community college initiative. Such employers might also provide housing or pay housing and living expenses through some kind of stipend.

Some young people have learning deficits. We propose that instead of placing them in job training right away, we first pay them to achieve literacy at the tenth grade level, with either vocational or college prep/community college after that. In all such cases, students who have families or are living outside the home should be paid a minimum wage for their study time, with the wage funded either by an employee-sponsor or directly by the taxpayer through the training provider, with the funding coming from the NBRT. This training can be arranged either by local government, a local public or private school system or by employers directly as an offset to the NBRT levy. This would replace Temporary Aid to Needy Families. Program providers would also receive a subsidy for providing insurance to participants through the policy under which their employees are covered, replacing Medicaid for needy families.

The other problem that young families face is low wages. While there are certainly tax credits that make having children more affordable, they are not adequate to meet expenses. We propose increasing the Child Tax Credit to $6000 per year (federal share) and making it refundable. This would consolidate assistance now provided by the current CTC, the Earned Income Tax Credit, the exemption for children, the Supplemental Nutrition Assistance Program, the Mortgage Interest Deduction, and the Property Tax Deduction.

Note that this proposal will likely result in a higher birthrate, as well as lower wages for non-parents or for parents whose children have moved away (which eliminates the incentive to fire productive workers who are at the age where salaries that allow them to raise their families also make them economically unattractive). As such, this provision will also decrease the use of both abortion and contraception. If support for it is not considered an essential vote for scoring the by National Right to Life Committee, then that scoring is hopelessly partisan, as this particular proposal will prevent more abortions than any criminal sanction ever would (the Guttmacher Institute estimates that 72% of abortions are for economic reasons, including the financial well-being of teen parents).

Part of the American Dream is self-determination. One option within the NBRT is a credit for funding insured personal retirement accounts in the employer, as appropriate. Unlike the Bush era proposal, which mostly empowered management and subsidized Wall Street, this scenario empowers workers and makes outside funding less necessary. It also shifts compensation from wages to stock dividends, possibly even before retirement (workers would have the option of either taking or reinvesting dividends), so that layoffs of older workers become less attractive.

We believe that employee-owned firms operating in a more cooperative manner will naturally offer financial services to their employees directly (most cooperative systems have both educational and credit union provisions), thus replacing the need to seek credit for mortgages from the banking system. Indeed, if such employers offer mortgages and lines of credit directly, they can do so at zero interest because such agreements need not be a profit center – they would simply impact the profitability

We have provided details previously on this proposal, including the insurance provision which assures that no one loses their retirement savings because of employer mismanagement or fraud. If the committee has further questions on these proposals, we are available to answer them at greater length.

One would hope that such proposals as this would deserve some kind of hearing before the Committee and in the public sphere generally. We do not expect such hearing, however, as they would be slowly revolutionary in their impact and would not make anyone rich or individually powerful. We would hope that you would have the courage to defy this expectation.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve The American Dream

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Testimony Submitted for the Written Record of a Hearing Held by the Senate Finance Committee

July 10, 2012

Tax reform presents an opportunity to review a jurisdiction's goals *and* its tax system to be sure the system supports and does not hinder achievement of the goals. Economic growth, ability to compete in the global marketplace, an educated workforce, no poverty, economic mobility, and a clean and sustainable environment are longstanding goals in the United States. The topic of this hearing is helpful in focusing attention on whether achievement of the nation's economic, societal and environmental goals for young people is supported by the tax system and whether changes are needed. Changes in the economy, technology, the workplace and K-16 education, are a few areas which call into question whether the existing tax system is supporting U.S. goals for young people and others.

This testimony addresses:

- The need for strategic tax reform
- Benefits of analyzing trends to help guide tax reform
- The need for tax reform to follow principles of good tax policy
- The need for tax expenditure reform to improve equity
- Suggestions for modernizing and addressing needs for:
    - Retirement plans and savings
    - Workforce preparedness and lifelong learning
    - Entrepreneurship

I. Strategic Tax Reform

An effective tax system should support the jurisdiction's economic, societal and environmental goals. Thus, it is important that these goals be articulated and at the forefront of tax reform discussions. Existing tax rules and proposals should be analyzed and evaluated to determine if they support achievement of the goals and to be sure they do not operate in opposition to the goals. For example, assume there is a goal to have over 50% of high school graduates finish college. A tax rule that provides a tax deduction for a portion of college costs for less than 20% of filers, with the benefit skewed to higher income individuals, likely works in opposition to achieving the goal and the tax rules should be restructured to support the goal.

II. Recognize Trends to Help Guide Tax Reform

No one would argue that the world has changed tremendously in the past 20 years and even in the last two years. Advancements in technology have changed business models, education, and health care. Longer life expectancies have changed the demography of the workforce, financial planning needs, and health care costs.

A review of trends can help identify areas where the tax system needs to be modernized because the system does not reflect today's ways of living and doing business. Numerous reports and data exist to help identify trends.[1] A sampling of data and reports describing and supporting trends are noted in the footnotes for the chart below.

The chart is an example of a more detailed analysis that is needed. Items included in the chart are ones pertinent to young people.

Trends and Relevance to Our Tax System

Trend and Examples	Relevance to Tax Law Design
ECONOMIC	
Increasing global and mobile business environment: • Growth of virtual workplaces and markets / E-commerce • Ability to serve customers worldwide from a single location • Telecommuting and distance workers, global work teams • Increasing need for special expertise on an as-needed basis	▪ The tax law should not hinder alternative compensation techniques, including equity compensation. ▪ Outdated and complex worker classification rules play too great a role in hiring practices which can adversely affect employers and workers. ▪ Existing tax rules for deductions for employees who telecommute require that it be done for employer-convenience. Ease and benefits of working anywhere with today's technology should not hinder employee and employer discretion in work locations and hours. ▪ Complexity of international provisions of the federal income tax system may hinder international operations of businesses of all sizes.
Workforce[2] ▪ Increased emphasis on technology literacy, adaptability to change, lifelong learning ▪ A college degree is required for many types of work ▪ Service economy and the possibility of serving someone via electronic means (over the Internet, for example) provide greater opportunity for being	▪ Education for job retraining is generally not deductible. ▪ Multiple education rules in the tax law create confusion. Tax rules that only encourage savings for college education are not enough to support lifetime learning needs beyond college and for non-degree learning. ▪ Employees and self-employed individuals who bear the cost of working at home, likely get no tax deduction for work-related expenses because of strict home office rules under IRC §280A (particularly the exclusive use requirement), and the 2% of AGI limitation for unreimbursed employee business expenses. ▪ Worker classification rules to determine if a worker is an

[1] See for example, data from the US Census Bureau, Department of Labor, and other government agencies, universities and non-profit organizations. For example, see *Global Trends 2025: A Transformed World*, National Intelligence Council, Nov. 2008; http://www.dni.gov/nic/PDF_2025/2025_Global_Trends_Final_Report.pdf.

[2] See for example, trends noted in "The Future of Work," *Time*, 5/25/09; http://www.time.com/time/specials/packages/article/0,28804,1898024_1898023_1898169,00.html.

self-employed and working out of one's home.[3] ▪ Increase in number of businesses operating out of someone's home.[4] ▪ Increase in number of self-employed individuals.[5] ▪ Increased mobility of the workforce ▪ Decline in defined benefit retirement plans and increase in defined contribution plans.[6]	employee or independent contractor are troublesome because the classification criteria are subjective and out-dated. ▪ Tax rules regarding retirement and benefits are focused on the employer, rather than the worker. Workers may lose retirement benefits or incur administrative difficulties when they change jobs. ▪ Worker may not have access to work-provided retirement plan. The number of self-directed retirement options in tax law creates confusion. Workers who must self-fund their retirement do not get same tax advantage as workers with an employer-sponsored and funded plan. ▪ Requirements for timing of required distributions from retirement plans and limits on Social Security benefits may be too strict where healthy, older workers prefer to continue to work or may have a financial need to keep working. ▪ Employees required to work in more than one state face myriad of filing and payment requirements among the states.
SOCIETAL	
Increasing gaps • Income[7] • Education opportunities[8] and attainment of college degree or required knowledge and skill	▪ Overall progressivity of the tax system hindered by payroll tax structure and differential rates for investment income versus earned income. ▪ Some low-income individuals may face high marginal tax rates due to phase-outs of earned income tax credit (EITC), child-care credit, education credits, etc.

[3] Pete Engardio, "Mom-and-Pop Multinationals," *Businessweek*, 7/2/08; http://www.businessweek.com/stories/2008-07-02/mom-and-pop-multinationals.

[4] US Census Bureau data for 2002indicates about 49% operating out of their home (9/27/06 release; http://www.census.gov/newsroom/releases/archives/business_ownership/cb06-148.html) and for 2007, 51.6% operated out of their home (6/14/11 release; http://www.census.gov/newsroom/releases/archives/business_ownership/cb11-110.html).

[5] For example, see Magnus Lofstrom, *Entrepreneurship Among California's Low-skilled Workers*, Public Policy Institute of California, April 2010, page 6; http://www.ppic.org/content/pubs/report/R_410MLR.pdf. "The number of self-employed workers in California has steadily increased over the last three decades, from 1.17 million in 1980 to 2.37 million in 2007. This represents an annual average growth rate of 2.7 percent, significantly greater than the 1.5 percent annual growth in wage or salary employment." Also see V. Dion Haynes, "High unemployment spurs rise in self-employed," *The Washington Post*, 4/24/11; http://www.washingtonpost.com/business/capitalbusiness/high-unemployment-spurs-rise-in-self-employed/2011/04/21/AFatf5cE_story.html.

[6] See data and links in Annette Nellen, "Rethinking IRAs," *AICPA Tax Insider*, 7/24/08; http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/rethinking.jsp.

[7] See for example, Adam Bee, *Household Income Inequality Within U.S. Counties: 2006–2010*, US Census Bureau, Feb 2012; http://www.census.gov/prod/2012pubs/acsbr10-18.pdf. "Since 1967, U.S. household income inequality has grown 18 percent."

[8] See for example, Sabrina Tavernise, "Education Gap Grows Between Rich and Poor, Studies Say," *New York Times*, 2/9/12; http://www.nytimes.com/2012/02/10/education/education-gap-grows-between-rich-and-poor-studies-show.html?pagewanted=all.

set for today's higher paying jobs.[9]	▪ Tax breaks for higher education are not fully refundable and therefore do not necessarily help those most in need. ▪ Tax credits for education tend to favor higher income individuals. Dollars spent to subsidize education via the tax system should be aligned with other government subsidies (such as Pell Grants) to be sure benefits go to those most in need.
Retirement[10] ▪ Increased life expectancy ▪ More people working past retirement age ("retirement age" becoming a less relevant concept)[11] ▪ Decline in number of defined benefit plans and increase in number of defined contribution plans ▪ About one-third of workers change jobs annually[12] ▪ Growing decline in ratio of workers to retired individuals[13]	▪ Social Security system needs to be reformed to address longevity and increasing numbers of retired individuals relative to workers. ▪ Participation in tax-favored retirement plans tends to be skewed to higher income individuals who are more likely to participate and to make the maximum allowed annual contributions.[14] ▪ Job changes likely to reduce retirement plan contributions and participation.

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[9] See for example, Erin Ailworth, "Growing income gap threatens area, report says," *Boston Globe*, 3/14/12; http://www.boston.com/business/articles/2012/03/14/boston_foundation_finds_growing_income_disparity_is_greatest_threat_to_regions_prosperity/. "In 2010, Boston's richest 20 percent earned more than half of the income in the region. The poorest 20 percent made just over 2 percent of the income, according to the report. Part of the problem, the report says, is that while Boston has a thriving innovation economy with well-paying jobs in finance, high technology, and biotechnology, finding a job in those sectors requires training and skills that many residents don't have."

Also, *A Generation of Widening Inequality*, California Budget Project, Nov. 2011, page 19; http://www.cbp.org/pdfs/2011/111101_A_Generation_of_Widening_Inequality.pdf. "The top 1 percent had an average income of $1.2 million – 33 times the average income of the middle fifth. That gap is about twice as large as it was a generation ago. This means that in 2009, the average Californian in the top 1 percent of the distribution earned in less than eight workdays what the average middle-income Californian earned in a year."

[10] For additional information on this trend and links to data, see Annette Nellen, "Rethinking IRAs," *AICPA Tax Insider*, 7/24/08; http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/rethinking.jsp. Also, Annette Nellen, "401(k) Concerns and Ideas," *AICPA Tax Insider*, 11/20/08; http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/ConcernsAndIdeas.jsp. Also see Patrick Purcell, *Retirement Plan Participation and Contributions: Trends from 1998 to 2006*, Congressional Research Service, 1/30/09; http://assets.opencrs.com/rpts/RL33116_20090130.pdf.

[11] Kimberly Palmer, "Why These Retirees Are Still Working,"*U.S. News*, 6/13/12; http://money.usnews.com/money/retirement/articles/2012/06/13/why-these-retirees-are-still-working. "more *Californians are Working Later in Life*, California Budget Project, April 2009; http://www.cbp.org/pdfs/2009/090406_pp_WorkingLaterInLife.pdf.

[12] Bureau of Labor Statistics, USDL-10-1243; 9/10/10; http://www.bls.gov/news.release/pdf/nlsoy.pdf.

[13] Gayle L. Reznik, Dave Shoffner, and David A. Weaver, *Coping with the Demographic Challenge: Fewer Children and Living Longer*, Social Security Bulletin, Vol. 66 No. 4, 2005/2006; http://www.ssa.gov/policy/docs/ssb/v66n4/v66n4p37.html.

[14] In 2004, 4.5 percent of eligible taxpayers under age 30 contributed an average of $1,875 while 16.8 percent of eligible taxpayers ages 60 to 69 contributed an average of $3,849. See Victoria L. Bryant, *Accumulation and Distribution of IRAs*, IRS, 2004; http://www.irs.gov/pub/irs-soi/04inretirebul.pdf.

III. Use Principles of Good Tax Policy

Principles of good tax policy, such as simplicity, equity and economic efficiency, should be used to:

- Identify where current rules violate such principles and what reforms will enable rules to better meet the principles. The analysis of the equity, neutrality and economic growth principles will highlight areas of inequity that either harm or do not support opportunities for young people. Inequities are further discussed in the next section.
- Evaluate reform proposals to determine if they meet the principles of good tax policy and where such principles are not met, the principles can help identify improvements.

Various formulations of principles of good tax policy exist. The Joint Committee on Taxation and Government Accountability Office have suggested appropriate principles in reports. The American Institute of CPAs (AICPA) has suggested a set of ten principles. These formulations are all quite similar with key principles being:[15]

- Equity
- Simplicity
- Neutrality
- Economic growth and efficiency
- Minimum tax gap
- Transparency

IV. Bringing Equity to Tax System Spending (Tax Expenditures Review)

Key improvement: The needed funds to help benefit young people obtain necessary education and training, start retirement accounts, and start businesses, exists within the current array of special tax rules. The funds currently used for unnecessary and inequitable subsidies can be redirected to help bring more equity to the tax system and to benefit a larger group of individuals.

Definition: Tax expenditures can be thought of as special rules in a tax system that are not crucial to the basic design of that tax. For example, an income tax should consist of a tax base equal to income less expenses of producing the income. A personal income tax should also include some type of personal exemption and/or standard deduction to ensure that some portion of an individual's income is not taxed because it is needed for basic living expenses. Thus, these deductions are not tax expenditures.

The word "expenditure" is used because the special rules, such as the mortgage interest deduction or an energy credit, result in reduced revenues for the government – the same result as when the government makes a direct outlay, such as a grant. Most tax expenditures or special rules could instead be direct spending by a government agency, that is, a subsidy. For example, instead of a mortgage interest deduction, the government could provide a subsidy to individuals at the time of purchase or provide a subsidy to lenders so as to allow lower interest rates for borrowers.

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[15] For a list of various formulations including the ones noted in this testimony, see http://www.cob.sjsu.edu/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf.

Not all tax expenditures though are the equivalent of a government provided subsidy, yet they still represent a special rule not required for the basic (or normal) design of a particular tax system. For example, IRC Section 1202 allows non-corporate shareholders to exclude 50% of their gain from the disposition of qualified small business stock held over five years. This is a tax expenditure in that it is a rule not required to be in a basic income tax. It does not translate well though, to a subsidy.[16] A 2002 report on tax expenditures described two types of tax expenditures. One type could instead be direct government spending and the second type represent a "fiscal cost" of rules that are "departures from proper income measurement, even if they do not have an obvious programmatic spending counterpart."[17]

Problem: As part of tax reform, every special tax rule (tax expenditure) should be examined to determine if its purpose is appropriate (does it help support the country's economic, societal or environmental goals) and does it meet principles of good tax policy. Special tax rules tend to cause a tax system to not meet principles of good tax policy. For example, the simplicity principle is violated as any special rule creates complexity relative to a system without the special rule. Also, the equity principle is often violated because the tax benefit is not equal among filers. For example, assume two individuals who itemize deductions make a $1,000 charitable contribution. If one individual is in a 15% tax bracket, the deduction reduces his tax liability by $150. If the other individual is in the 35% tax bracket, the contribution reduces his tax liability by $350.

Today, the "cost" of all federal income tax expenditures is roughly $1 trillion in terms of tax savings for taxpayers and reduced revenues for the government. This amount is close to what the discretionary spending is in the federal budget. Thus, a significant amount of spending resides in the tax system. Unlike spending in a government agency's budget though, tax expenditures are not regularly reviewed for effectiveness. Tax reform should cause that analysis to occur for all tax expenditures.

Disadvantage to young people: Several tax expenditures provide significant benefit (tax savings) to higher income individuals (unlikely to be young people). For example, the Joint Committee on Taxation reports that the "cost" of the home mortgage interest deduction is $83.7 billion for 2012.[18] This benefit is only for the roughly one-third of individuals who itemize their deductions. The Joint Committee reports that the mortgage interest deduction benefits taxpayers in different income groups as follows.[19]

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[16] The gain exclusion might be viewed as the equivalent of the shareholder obtaining a subsidy from the government to help them purchase or carry the stock, but the tax benefit is not obtained until the stock is held over five years and sold at a gain. It does not translate to a subsidy as well as most other tax expenditures, such as tax credits for purchasing certain assets or deductions for certain activities, such as making mortgage interest payments on a home.

[17] Eric Toder, "Evaluating Tax Incentives as a Tool for Social and Economic Policy," essay included in *Bad Breaks All Around*, a report of The Century Foundation Working Group on Tax Expenditures, 2002, page 44.

[18] Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2011*-2015 (JCS-1-12) 6/17/12, page 36; https://www.jct.gov/publications.html?func=startdown&id=4386.

[19] *Id.* page 53.

Table 3.--Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2010 Rates and 2010 Income Levels [1] – Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Mortgage Interest Deduction		Phase out of Personal Exemption for Regular Income Tax, and Denial of Personal Exemption and the Standard Deduction for AMT	
	Returns	*Amount*	*Returns*	*Amount*
Below $10,000	[4]	[3]	[4]	[6]
$10,000 to $20,000	196	$63	[4]	[6]
$20,000 to $30,000	481	258	[4]	[6]
$30,000 to $40,000	985	654	[4]	[6]
$40,000 to $50,000	1,797	1,324	[4]	[6]
$50,000 to $75,000	5,750	6,855	22	-$13
$75,000 to $100,000	5,966	8,748	58	-52
$100,000 to $200,000	13,932	35,609	587	-745
$200,000 and over	4,575	29,142	3,279	-8,735
Total	**33,682**	**$82,654**	**3,947**	**-9,546**

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Positive tax expenditure of less than $500,000.

[4] Fewer than 500 returns.

[5] Includes the refundable portion.

[6] Negative tax expenditure of less than $500,000.

NOTE--Details may not add to totals due to rounding.
Source: Joint Committee on Taxation

As indicated in the table, over half of the "cost" of the mortgage interest deduction benefits individuals with income greater than $100,000.

Research shows that the mortgage interest deduction tends to help individuals afford a more expensive home rather than to enable them to buy any home.[20] Thus, this expensive tax provision is not fully meeting its goal of helping individuals purchase a home.

In examining whether the tax system hinders achievement of the American dream for young people, the mortgage interest deduction should be carefully examined and reformed. The roughly $85 billion annual cost could be distributed more equitably among various income categories and perhaps skewed to lower income individuals where it is likely able to do more good to help someone purchase a home who otherwise might not be able to do so. The broader home ownership that results could benefit the economy and strengthen communities.

Several other tax expenditures should be analyzed and either eliminated or reformed to enable them to benefit more taxpayers. Areas of particular relevance to helping young people are tax-favored retirement plans, employer-provided health insurance, property tax deductions on second homes and high value principal residences, and rules for higher education expenses and savings. That is, these (and other) tax expenditures could be reformed to ensure that the dollars involved are more equitably distributed among taxpayers. Such reform might include elimination of particular expenditures as well as creation of ones that better enable the tax system to support the country's economic, societal and environmental goals.

[20] Eric Toder, "Reforming the Mortgage Interest Deduction," Tax Policy Center, 5/26/10; http://www.taxpolicycenter.org/publications/url.cfm?ID=412099.

Tax expenditures are likely to be more equitable, (1) if provided in the form of tax credits rather than deductions, (2) if the tax benefit of deductions and exclusions is capped, (3) if the benefit phases out as income increases, or (4) if provided as direct grants based on need, if the required infrastructure to do so is not costly (such as providing grants and scholarships through the existing Department of Education mechanisms rather than via deductions and credits for higher education costs).

V. Consider How to Support Modern Workforce Preparedness and Lifelong Learning

Improve existing rules: Many jobs today require a well-educated, tech savvy workforce. A college degree is a requirement for more jobs today than in the past. Also, as technology and business models continue to change, workers often need to obtain new skills and knowledge.

IRS Publication 970, *Tax Benefits for Higher Education*, explains twelve rules that encourage and subsidize either costs of higher education or saving for future college costs. Some of the weaknesses that exist with this current set of rules include:

- *Complexity*: There are too many rules with varying definitions and qualifications. There is duplication among the rules and some rules cannot be used along with others.
- *Equity*: As noted in the prior section, special tax rules tend to provide a greater benefit to higher income individuals. This is true of deductions and exclusions. It can also be true of credits if not refundable. To support more people going to college, funds need to be available to those most in need rather than to individuals who may not have a financial need.
- *Transparency and Accountability*: Because the twelve special tax rules for education are in the tax system, their cost is not compared to higher education subsidies offered by the Department of Education, such as Pell grants. Thus, there is no analysis of how the total tax and direct spending dollars are allocated among income groups.

  There are often news stories about insufficient funding for Pell grants, yet several of the education-related tax rules provide benefits to taxpayers with income too high to qualify for Pell grants. Considerations should be given to distributing all education benefits out of a single government source to best ensure they are used for the greatest need and there is accountability for all of the spending.

Other reforms: Consideration should be given to modifying the tax law to allow a deduction or credit for costs of continuing education to maintain job skills or retool for a new job. Consideration should be given to allowing workers to create tax-free accounts with funds to be used for continuing education needs in order to encourage and support this necessary activity.

To help young people gain the necessary knowledge, skills and experience needed for today's workplace, consideration should be given to incentivizing donations by employers for scholarships and for providing internships.

VI. Rethink Retirement Plans and Savings Incentives for the Modern Era

As noted in the trends discussion earlier, several changes have occurred which make retirement savings more important to workers, but which also make it more difficult to build such savings. For example, years ago, many employees could expect to have a defined benefit type retirement vehicle provided by their employer. This required little action by employees. They did not have to understand investment options, contribution requirements, and tax rules. Today, many employees are offered no retirement plan and thus, must figure out on their own how to establish one. They have a choice of tax vehicles for an IRA (such as regular or Roth) and they have many options as to where to set up their IRA (stock brokerage firm, bank, etc.).

Many workers do not expect to stay, and in fact do not stay, at one employer for many years. Thus, even if an employer sponsors an IRA or 401(k) plan, the employee will need to be involved in the management and movement of the funds when they change jobs. Employees who changes jobs several times could end up with multiple accounts if they do not or cannot consolidate the funds saved at each place of employment into a single retirement plan.

There is a greater need for workers to have retirement savings today than was true decades ago because people are living longer.

Tax law changes to increase the number of workers participating in retirement plans should consider the following:

- A simple system to enable all workers (employees and self-employed individuals) to have a retirement savings account. This should occur for both part-time and full-time workers and even if an employer does not help with administration or contributions.
- Retirement savings contributions should be coordinated with payroll tax deductions. A system to enable self-employed individuals to also make contributions along with self-employment tax payments should also be considered.
- Find ways to help individuals improve their financial literacy.
- Portability. Be sure the system allows for contributions to be made to the one account even if a worker changes employers or also has income from self-employment.
- Strive for simplicity.

The government can play a role in establishing accounts, simplification, and educating individuals.

Example of a new approach: The first time an individual receives a W-2 or pays self-employment tax (whichever happens first), the government could set aside a set dollar amount in a retirement account for that person. This would constitute the start of their retirement account that would be used for all future contributions; there would be only one account. When the individual works for an employer who also wants to contribute to employee retirement accounts, such funds are placed in the individual's existing account. Also, for each paycheck or quarterly estimated tax payment of a self-employed individual, an amount would be contributed to their retirement account. Individuals could be allowed to transfer their retirement account to a commercial broker for management or let it stay with the federal government. The federal government could be allowed to transfer management to third parties for a fee.

Annual reporting would be required to let individuals know their account balance and other details. Rules would continue to exist, but in more simplified form, governing how much could be contributed annually, how much employers could also contribute, the age when distributions may begin, hardship withdrawals, etc.

Benefits of this type of approach:

- All individuals who work have a retirement account. This single account would be used whether they are an employee or sole proprietor or both.

- The initial contribution from the government ensures that all workers start a retirement account.
- The initial contribution from the government may also encourage individuals to be tax compliant from the start of the time they begin earning money.
- The system ties to payroll tax withholding and so should not be burdensome to any size employer since they already are required to comply with payroll tax rules.
- For low-income workers, the annual contribution could be made via part of the earned income tax credit (EITC) the worker receives.

VII. Support Modern Entrepreneurship

Several trends indicate that workers today are more likely to be self-employed, telecommute or work in their home, and have continual needs for new technologies (such as for hardware and software). Many existing tax rules though, work contrary to support these trends. For example, worker classification rules are unclear causing some employers to label all workers as employees, making it difficult for a self-employed entrepreneur to succeed. Strict home office deduction rules, particularly the exclusive use requirement, make it almost impossible for workers and self-employed individuals to qualify for the deduction. Thus, they are not able to properly calculate true taxable income because some valid business expenses are not deductible.

Additional reforms should be considered to help young people obtain initial funding to start a business. For example, existing tax rules could be modified to provide incentives for established businesses to donate to entrepreneur grant programs where individuals could submit business plans with the hope of being awarded a tax-free start-up grant. The reforms to help fund such grant programs could come from a lowered tax rate on repatriated earnings that go into the fund, or an enhanced charitable contribution deduction for donations to such grant programs.

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