Center for American Progress Action Fund

Testimony before
the U.S. Senate Committee on the Budget
on "Assessing Inequality, Mobility, and Opportunity."

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Thank you Chairman Conrad and Sen. Sessions for inviting me here to testify today. My name is Heather Boushey and I'm a Senior Economist with the Center for American Progress Action Fund.

A robust and expanding middle class was the engine that transformed the United States into the strongest economy in the world. Our middle class is today threatened by mounting income inequality and a tax code rigged to favor the rich. In my brief comments I will lay out how focusing on building a strong middle class is a necessary condition to establishing a vibrant, competitive, and stable economy.

My colleagues will discuss how high inequality has become in the United States and how the rungs on the economic-mobility ladder have become farther apart. This kind of inequality is not only bad for the 99 percent who've been left behind; it is actually responsible for some of the biggest problems facing Americans today—high home foreclosures, high unemployment, a low pace of business investment, and an inability to get ahead.

The analysis I will describe to you today is based on an in-depth, ongoing project at the Center for American Progress, where we are bringing together the economic evidence showing how a strong middle class and inequality at levels below what we currently have in the United States will enable everyone to have a fair shot, while encouraging and supporting the competitiveness of our firms and the strength of our economy.

Economists typically measure economic success by profits, the creation of good jobs, a growing GDP, and a falling unemployment rate. The economy grows when firms are either more productive or when they invest more capital and hire more labor.

A strong middle class supports improved productivity and investment, while high inequality can have real, pernicious effects on both. High inequality also makes the economy less stable, which can, as we've seen in the past few years, have devastating effects on the opportunity for millions of American families.

Inequality means everyone doesn't get a fair shot, which drags down our nation's economic productivity

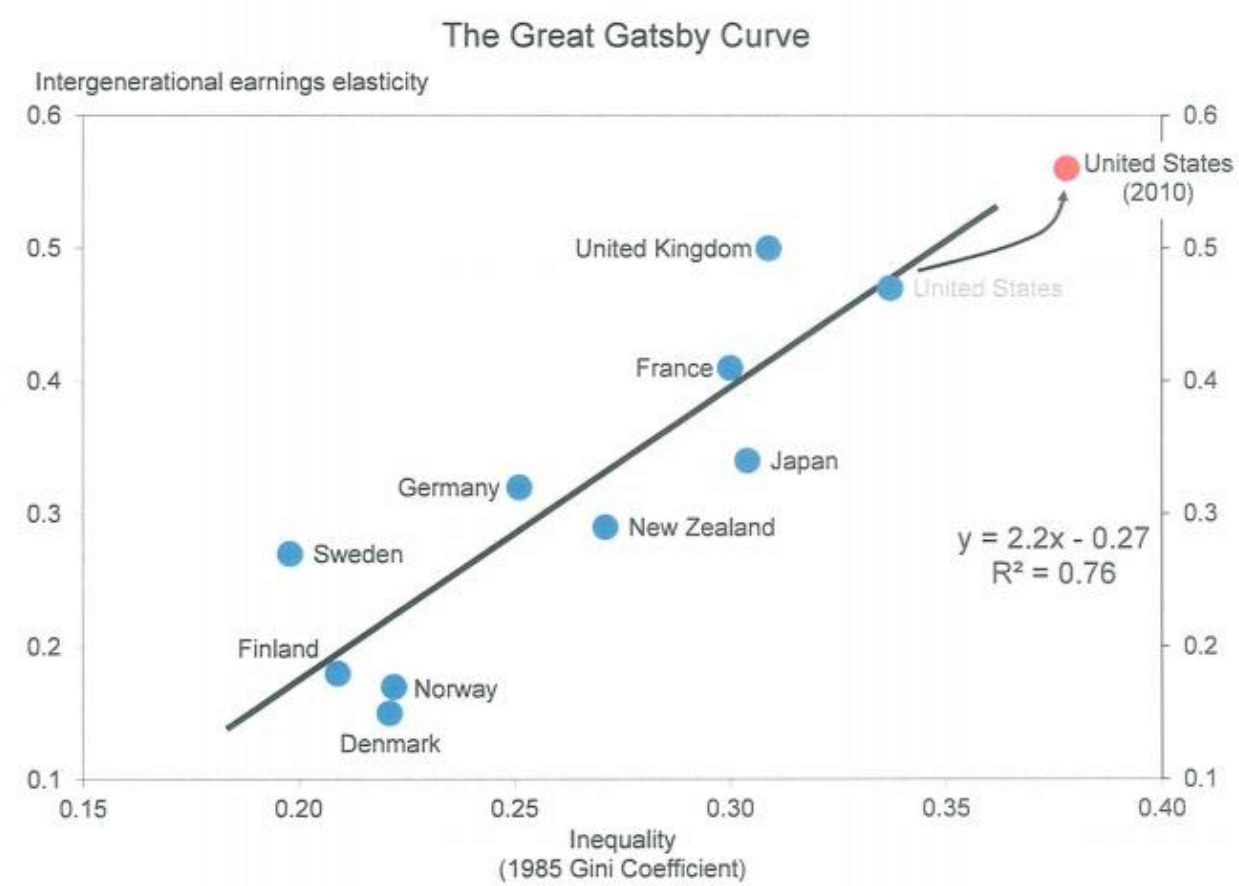
A strong middle class is positioned to make investments in education and incubate the next generation of high skilled workers, inventors, and entrepreneurs, which pushes up long-term economic growth primarily (though not exclusively) through their effects on productivity.

Economists agree that education is a key piece of the productivity puzzle. High-quality public education enables children from all backgrounds to achieve. A new paper by Stanford economist Peter Klenow and his colleagues shows just how big that kind of economic effect can be. They find that between 1960 and 2008, 17 to 20 percent of U.S. economic growth was due to gains from women and people of color entering professional occupations and able to make use of their talent.[1]

Increasingly, however, the data shows that we are a country where parents' earnings are paramount in determining their children's future earnings. As economists Flavio Cunha and James Heckman put it, "The best documented market failure in the life cycle of skill formation in contemporary American society is the inability of children to buy their parents or the lifetime resources that parents provide."[2]

This sort of class-stratified society is exactly what most of us think America is not (or at least should not be).[3] Plus, this kind of class calcification is also bad for economic growth.

The relationship between today's inequality and tomorrow's economic mobility—and the importance of a fair shot for everyone—was a key theme of a speech by Alan Krueger, chair of the President's Council of Economic Advisers, at the Center for American Progress last month. To show how class has become calcified in America, he showed this chart, which he called the "Great Gatsby Curve":



Source: Krueger, Alan. 2012. "The Rise and Consequences of Inequality." Speech at the Center for American Progress. Washington, DC, January 12.

In the chart, the Gini coefficient, one of the most commonly used measures of income inequality, is on the x-axis. The higher the Gini, the more unequal a nation is. Notably, for 1985, the United States was more unequal than any of the other nine advanced economies shown. A measure of economic mobility is on the y-axis. This measure, the "intergeneration earnings elasticity," measures how important a parent's earnings are to predicting their child's future earnings (in this chart, only looking at fathers and sons).[4]

Imagine two American fathers, Middle-Class Dad and Rich Dad, standing together with their adult sons. Rich Dad earned 100 percent more than Middle-Class Dad when the boys were young. This chart shows that Rich Dad's son will earn about 50 percent more than Middle-Class Dad's son.

When a parent's economic status has too big an impact on his children's economic status, it has a pernicious impact on the economy. Today, somewhere in America, there's a young toddler who may be the next Bill Gates or Steve Jobs (or just a really terrific worker who boosts productivity at her firm). But if she's not Rich Dad's little girl, our economy may never benefit from her talents and that would be a loss for everyone.

Yet this is the kind of country we have become. Today, the probability that a top-scoring low-income student attends college is at about the same as that of a low-scoring high-income student.[5]

The shrinking middle class also creates a vicious cycle as middle-class families typically support the kinds of investments in public education that give everyone a fair shot. In new work, my colleague David Madland finds that communities with less inequality tend to make greater investments in public education and tend to have better education outcomes.[6]

And new research is bringing to light the importance of the years before a child even enters school for long-term educational achievement and future earnings. Effective parenting is critically important to giving children a good start on the road to social and economic mobility. At the same time upward mobility is associated with stable family income, which is more common among those with two working parents—increasingly the norm in our society.[7]

Yet the ability of parents to be good workers and effective parents is sharply curtailed by workplaces that haven't adapted to this reality. Parents, especially those in low- and middle-wage jobs, are too often forced to choose between a day's pay and perhaps losing their job if they have to take care of a sick child. These Americans have little to no flexibility to create schedules that can help address—or at the very least not exacerbate—work-family conflict.

There is another, more immediate, impediment to upward mobility, which also threatens our future productivity: Young men are not attending college at the same rate as women. One could conclude that men don't understand that investing in a college degree pays off handsomely. But there is another interpretation. Many college-educated men are finding they have been sold a bill of goods, because one in five earns less than the typical high-school graduate.[8]

America's future productivity will be hampered if young men invest in their human capital yet end up with a historically high pile of student debt and are no better off than those that entered the labor market right out of high school. Improving our higher education system is yet another way to close the distance between the rungs on the economic ladder. Providing opportunity is imperative for our economic future.

Inequality limits the capacity of ordinary people to become entrepreneurs or follow up on an invention or innovative idea. Research by the Kauffman Foundation demonstrates that more than 70 percent of entrepreneurs in the United States come from the middle class.[9] Yet a hollowed-out middle class means that families have less access to resources that could float an entrepreneur while her vision takes shape. Many entrepreneurs start their businesses using home-equity loans or credit cards, which may be unavailable to the poor or middle class.[10]

A strong middle class also encourages firms to make productivity-enhancing investments and fosters the kind of trust that improves workplace productivity. Higher wages encourage firms to invest in capital to improve productivity, while falling or slow-growing wages discourage these kinds of investment. For example, higher wages encourage firms to make investments that reduce their reliance on labor, such as building a more efficient factory.

Inequality skews demand and limits incentives for investment

A strong middle class is a source of stable demand, which creates the incentive to invest. But don't believe me. Here's how Nick Hanauer, a ground-floor investor in Amazon who now runs a venture-capital firm, Second Avenue Partners, explained this in *Bloomberg Businessweek*: "[O]nly consumers can set in motion a virtuous cycle that allows companies to survive and thrive and business owners to hire. An ordinary middle-class consumer is far more of a job creator than I ever have been or ever will be."[11]

Placing the middle class at the core of what makes an economy grow is not a new idea. When Henry Ford began paying his workers the then-princely sum of $5 a day, this was not charity; it was a business strategy designed to lower costs and make production more efficient.[12]

Demand remains the most challenging issue facing businesses in the wake of the Great Recession. The National Federation of Independent Businesses conducts a monthly survey of its members and for over three years has reported that "sales"—another way of saying "demand"—are the single-most important problem for its members—more of a problem than regulations, taxes, inflation, or the cost of labor.[13]

Having a deep market with demonstrated demand from a strong middle class is how businesses receive signals as to profitable opportunities to invest. Yet the lack of such signals continues to plague the U.S. economy at present, although hopefully that is starting to change.

Growing inequality affected demand before the economic crisis. As Harvard Law School professor Elizabeth Warren (with her daughter Amelia Warren Tyagi) documented, Americans' debts are the result of a financially strapped middle class. Families borrowed to make ends meet, to cover health care costs, to put a child through college, and to purchase a home in a neighborhood with good schools.[14]

The financial sector was only too happy to oblige. Increasingly unencumbered by regulation and flush with cash, Wall Street created a variety of new ways to extend credit. Basically, America didn't get a raise and the financial sector said, "Don't worry, buddy, we'll loan you the money to pay the bills." Of course, the whole thing was unsustainable.

Recent research by IMF economists shows that investors were recycling their higher incomes into loans.[15] As demand dries up because of stagnating incomes, those at the top have great incentives to expand credit to keep up purchasing power. If incomes do not recover, however, this, as we have seen, is an unstable and unsustainable game.

Thus came the Great Recession and the struggle ever since among everyday Americans to make ends meet. The U.S. case does not appear to be an outlier. New research across 174 countries finds that the more equal the country, the longer it was able to sustain economic growth.[16]

Inequality does damage to our nation's institutions, which hinders economic performance

There is evidence that Wall Street has used its burgeoning wealth to benefit their industry, not the nation as a whole. Higher campaign contributions from the financial services industry have been associated with an increased likelihood of voting for legislation that transfers wealth from taxpayers to that industry.[17]

Sky-high incomes for those in finance allowed them to sell loans to the 99 percent and buy legislation that transfers wealth from taxpayers to themselves. And on top of all this, these same sky-high incomes increasingly encouraged the best and the brightest young people to enter finance instead of engineering, medicine, or teaching, all of which enhance our economy's productivity.[18]

Further, as finance has grown in its importance to the U.S. economy, economic policy has shifted to meet the needs of Wall Street rather than Main Street. Maintaining an uncompetitive dollar and a large U.S. trade deficit hurts U.S. manufacturing (and U.S. workers) by making U.S. goods more expensive overseas, but benefits the financial sector through keeping a lid on inflation through a wider array of cheap imports, reducing costs to acquire assets (and hire workers) overseas, and financing the trade deficit.[19] Further, trade agreements pursued new rights for financial investors over domestic manufacturing industries.

Growing inequality and the bias towards Wall Street and away from U.S. manufacturing also lowers overall economic productivity as low-productivity, service-sector jobs replace high-productivity manufacturing jobs.[20]

Inequality has also been shown to affect the ability of people to find common ground in governance and take action on pressing policy issues that benefit the majority. As American society has become wealthier, a larger segment can opt out of public goods, such as public education, Social Security, public parks, or even municipal policing. On the other hand, greater immigration and incarceration means that larger shares of lower-income groups are outside the electorate. The increased polarization has curtailed new legislation, with dramatic effects on social and tax policy, such as falling real minimum wages and less progressive taxation.[21]

What happens to 99 percent of Americans should be the focus of our nation's economic policy.

The budget for fiscal year 2013 should lay out a responsible course for rebuilding the economy so that it works for everyone, not just the privileged few. The American middle class is the engine of economic growth. But it is threatened by dwindling public investments, a tax system increasingly rigged to benefit the wealthy, a fraying safety net, and assaults on what should be the bedrock guarantees of Medicare, Medicaid, and Social Security.

The budget plan should protect those guarantees, boosts critical investments, and takes steps toward rebalancing the tax code so that all pay their fair share. And it does this a fiscally responsible way, charting a path that nurtures the economic recovery while reducing the deficit—without asking the middle class to shoulder a disproportionate share of the burden.

We can reverse inequality. The United States remains one of the wealthiest nations on the planet. The notion that we cannot afford to fix our economy is, quite simply, rubbish. We can if we have the political will.

Endnotes

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